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

MEMBERS' HANDBOOK

Update No. 79

(Issued 19 March 2010)

Handbook Improvements only

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

VOLUME II

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

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

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

This update 79 covers 12 documents set out below. Updates 76 - 78 cover 6 HKASs and 7 HKFRSs. The rest of the handbook improvements will be issued in later months.

HONG KONG ACCOUNTING STANDARDS (HKAS)

HKAS 11 *Construction Contracts*	Replace the Standard with revised Standard	Amendments due to - HKAS 1 (Revised) - HKAS 23 (Revised) - Editorial corrections to comply with IASB license agreement

HKAS 16 *Property, Plant and Equipment*	Replace the Standard and Basis for Conclusions with revised Standard and Basis for Conclusions	Amendments due to - HKAS 1 (Revised) - HKAS 23 (Revised) - HKFRS 3 (Revised) - *Improvements to HKFRSs 2008*
HKAS 18 *Revenue*	Replace the Standard with revised Standard	Amendments due to - Amendments to HKFRS 1 and HKAS 27 *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate* - HKFRS 9 - HK(IFRIC) – Int 15 - *Improvements to HKFRSs 2008* - *Improvements to HKFRSs 2009* - Editorial corrections to comply with IASB license agreement
HKAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*	Replace the Standard with revised Standard	Amendments due to - HKAS 1 (Revised) - *Improvements to HKFRSs 2008*
HKAS 23 (Revised) *Borrowing Costs*	Replace the Standard and Basis for Conclusions with revised Standard and Basis for Conclusions	Amendments due to - *Improvements to HKFRSs 2008*
HKAS 31 Interests in Joint Ventures	Replace the Standard and Basis for Conclusions with revised Standard and Basis for Conclusions	Amendments due to - HKAS 27 (Revised) - HKFRS 9 - *Improvements to HKFRSs 2008*
HKAS 32 *Financial Instruments: Presentation* (Standard)	Replace the cover page and pages 2-3 with revised cover page and pages 2-3. Insert pages 28A – 28B after page 28	Amendments due to - HKFRS 9
HKAS 32 *Financial Instruments: Presentation* (Basis for Conclusions)	Replace the cover page and page 3 with revised cover page and page 3. Insert page 25 after page 24	Amendments due to - HKFRS 9
HKAS 32 *Financial Instruments: Presentation* (Illustrative Examples)	Replace the Illustrative Examples with revised Illustrative Examples	Amendments due to - Editorial corrections to comply with IASB license agreement

HKAS 33 *Earnings per Share*	Replace the Standard, Basis for Conclusions and Illustrative Examples with revised Standard, Basis for Conclusions and Illustrative Examples	Amendments due to - HKAS 1 (Revised) - HKAS 27 (Revised) - HKFRS 3 (Revised) - HKFRS 8 - Editorial corrections to comply with IASB license agreement
HKAS 34 *Interim Financial Reporting*	Replace the Standard with revised Standard	Amendments due to - HKAS 1 (Revised) - HKFRS 3 (Revised) - HKFRS 8 - *Improvements to HKFRSs 2008* - Editorial corrections to comply with IASB license agreement
HKAS 36 *Impairment of Assets*	Replace the Standard, Basis for Conclusions and Illustrative Examples with revised Standard, Basis for Conclusions and Illustrative Examples	Amendments due to - HKAS 1 (Revised) - Amendments to HKFRS 1 and HKAS 27 *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate* - HKFRS 3 (Revised) - HKFRS 8 - HKFRS 9 - *Improvements to HKFRSs 2008* - *Improvements to HKFRSs 2009* - Editorial corrections to comply with IASB license agreement
HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*	Replace the Standard with revised Standard	Amendments due to - HKAS 1 (Revised) - HKFRS 3 (Revised) - Editorial corrections to comply with IASB license agreement

HKAS 38 *Intangible Assets*	Replace the Standard, Basis for Conclusions and Illustrative Examples with revised Standard, Basis for Conclusions and Illustrative Examples	Amendments due to - HKAS 1 (Revised) - HKAS 23 (Revised) - HKFRS 3 (Revised) - *Improvements to HKFRSs 2008* - *Improvements to HKFRSs 2009* - Editorial corrections to comply with IASB license agreement

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MEMBERS' HANDBOOK
CONTENTS OF VOLUME II

(Updated to March 2010)

HKAS 11
~~Issued October 2004~~Revised March 2010

Hong Kong Accounting Standard 11

Construction Contracts

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

CONTENTS
HONG KONG ACCOUNTING STANDARD 11
CONSTRUCTION CONTRACTS

Hong Kong Accounting Standard 11 *Construction Contracts* (HKAS 11) is set out in paragraphs 1-46. All the paragraphs have equal authority. HKAS 11 ~~shall~~should be read in the context of its objective, the *Preface to Hong Kong Financial Reporting Standards* and the *Framework for the Preparation and Presentation of Financial Statements*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Hong Kong Accounting Standard 11
Construction Contracts

Objective

The objective of this Standard is to prescribe the accounting treatment of revenue and costs associated with construction contracts. Because of the nature of the activity undertaken in construction contracts, Because of the nature of the activity undertaken in construction contracts, the date at which the contract activity is entered into and the date when the activity is completed usually fall into different accounting periods. Therefore, the primary issue in accounting for construction contracts is the allocation of contract revenue and contract costs to the accounting periods in which construction work is performed. This Standard uses the recognition criteria established in the *Framework for the Preparation and Presentation of Financial Statements* to determine when contract revenue and contract costs should be recognised as revenue and expenses in the ~~income~~ statement of comprehensive income. It also provides practical guidance on the application of these criteria.

Scope

1 This Standard shall be applied in accounting for construction contracts in the financial statements of contractors.

2 This Standard supersedes SSAP 23 *Construction Contracts* (revised in 2001).

Definitions

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

A *construction contract* **is a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.**

A *fixed price contract* **is a construction contract in which the contractor agrees to a fixed contract price, or a fixed rate per unit of output, which in some cases is subject to cost escalation clauses.**

A *cost plus contract* **is a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus a percentage of these costs or a fixed fee.**

4 A construction contract may be negotiated for the construction of a single asset such as a bridge, building, dam, pipeline, road, ship or tunnel. A construction contract may also deal with the construction of a number of assets which are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use; examples of such contracts include those for the construction of refineries and other complex pieces of plant or equipment.

5 For the purposes of this Standard, construction contracts include:

(a) contracts for the rendering of services which are directly related to the construction of the asset, for example, those for the services of project managers and architects; and

(b) contracts for the destruction or restoration of assets, and the restoration of the environment following the demolition of assets.

6 Construction contracts are formulated in a number of ways which, for the purposes of this Standard, are classified as fixed price contracts and cost plus contracts. Some construction contracts may contain characteristics of both a fixed price contract and a cost plus contract, for example in the case of a cost plus contract with an agreed maximum price. In such circumstances, a contractor needs to consider all the conditions in paragraphs 23 and 24 in order to determine when to recognise contract revenue and expenses.

Combining and segmenting construction contracts

7 The requirements of this Standard are usually applied separately to each construction contract. However, in certain circumstances, it is necessary to apply the Standard to the separately identifiable components of a single contract or to a group of contracts together in order to reflect the substance of a contract or a group of contracts.

8 When a contract covers a number of assets, the construction of each asset shall be treated as a separate construction contract when:

(a) separate proposals have been submitted for each asset;

(b) each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and

(c) the costs and revenues of each asset can be identified.

9 A group of contracts, whether with a single customer or with several customers, shall be treated as a single construction contract when:

(a) the group of contracts is negotiated as a single package;

(b) the contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and

(c) the contracts are performed concurrently or in a continuous sequence.

10 A contract may provide for the construction of an additional asset at the option of the customer or may be amended to include the construction of an additional asset. The construction of the additional asset shall be treated as a separate construction contract when:

(a) the asset differs significantly in design, technology or function from the asset or assets covered by the original contract; or

(b) the price of the asset is negotiated without regard to the original contract price.

Contract revenue

11 Contract revenue shall comprise:

(a) the initial amount of revenue agreed in the contract; and

(b) variations in contract work, claims and incentive payments:

(i) to the extent that it is probable that they will result in revenue; and

(ii) they are capable of being reliably measured.

12 Contract revenue is measured at the fair value of the consideration received or receivable. The measurement of contract revenue is affected by a variety of uncertainties that depend on the outcome of future events. The estimates often need to be revised as events occur and uncertainties are resolved. Therefore, the amount of contract revenue may increase or decrease from one period to the next. For example:

(a) a contractor and a customer may agree variations or claims that increase or decrease contract revenue in a period subsequent to that in which the contract was initially agreed;

(b) the amount of revenue agreed in a fixed price contract may increase as a result of cost escalation clauses;

(c) the amount of contract revenue may decrease as a result of penalties arising from delays caused by the contractor in the completion of the contract; or

(d) when a fixed price contract involves a fixed price per unit of output, contract revenue increases as the number of units is increased.

13 A variation is an instruction by the customer for a change in the scope of the work to be performed under the contract. A variation may lead to an increase or a decrease in contract revenue. Examples of variations are changes in the specifications or design of the asset and changes in the duration of the contract. A variation is included in contract revenue when:

(a) it is probable that the customer will approve the variation and the amount of revenue arising from the variation; and

(b) the amount of revenue can be reliably measured.

14 A claim is an amount that the contractor seeks to collect from the customer or another party as reimbursement for costs not included in the contract price. A claim may arise from, for example, customer caused delays, errors in specifications or design, and disputed variations in contract work. The measurement of the amounts of revenue arising from claims is subject to a high level of uncertainty and often depends on the outcome of negotiations. Therefore, claims are included in contract revenue only when:

(a) negotiations have reached an advanced stage such that it is probable that the customer will accept the claim; and

(b) the amount that it is probable will be accepted by the customer can be measured reliably.

15 Incentive payments are additional amounts paid to the contractor if specified performance standards are met or exceeded. For example, a contract may allow for an incentive payment to the contractor for early completion of the contract. Incentive payments are included in contract revenue when:

(a) the contract is sufficiently advanced that it is probable that the specified performance standards will be met or exceeded; and

(b) the amount of the incentive payment can be measured reliably.

Contract costs

16 Contract costs shall comprise:

(a) costs that relate directly to the specific contract;

(b) costs that are attributable to contract activity in general and can be allocated to the contract; and

(c) such other costs as are specifically chargeable to the customer under the terms of the contract.

17 Costs that relate directly to a specific contract include:

(a) site labour costs, including site supervision;

(b) costs of materials used in construction;

(c) depreciation of plant and equipment used on the contract;

(d) costs of moving plant, equipment and materials to and from the contract site;

(e) costs of hiring plant and equipment;

(f) costs of design and technical assistance that is directly related to the contract;

(g) the estimated costs of rectification and guarantee work, including expected warranty costs; and

(h) claims from third parties.

These costs may be reduced by any incidental income that is not included in contract revenue, for example income from the sale of surplus materials and the disposal of plant and equipment at the end of the contract.

18 Costs that may be attributable to contract activity in general and can be allocated to specific contracts include:

(a) insurance;

(b) costs of design and technical assistance that ~~is~~are not directly related to a specific contract; and

(c) construction overheads.

Such costs are allocated using methods that are systematic and rational and are applied consistently to all costs having similar characteristics. The allocation is based on the normal level of construction activity. Construction overheads include costs such as the preparation and processing of construction personnel payroll. Costs that may be attributable to contract activity in general and can be allocated to specific contracts also include borrowing costs~~ when the contractor adopts the allowed alternative treatment in HKAS 23 *Borrowing Costs*~~.

19 Costs that are specifically chargeable to the customer under the terms of the contract may include some general administration costs and development costs for which reimbursement is specified in the terms of the contract.

20 Costs that cannot be attributed to contract activity or cannot be allocated to a contract are excluded from the costs of a construction contract. Such costs include:

(a) general administration costs for which reimbursement is not specified in the contract;

(b) selling costs;

(c) research and development costs for which reimbursement is not specified in the contract; and

(d) depreciation of idle plant and equipment that is not used on a particular contract.

21 Contract costs include the costs attributable to a contract for the period from the date of securing the contract to the final completion of the contract. However, costs that relate directly to a contract and are incurred in securing the contract are also included as part of the contract costs if they can be separately identified and measured reliably and it is probable that the contract will be obtained. When costs incurred in securing a contract are recognised as an expense in the period in which they are incurred, they are not included in contract costs when the contract is obtained in a subsequent period.

Recognition of contract revenue and expenses

22 When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract shall be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the ~~balance sheet date~~ end of the reporting period. An expected loss on the construction contract shall be recognised as an expense immediately in accordance with paragraph 36.

23 In the case of a fixed price contract, the outcome of a construction contract can be estimated reliably when all the following conditions are satisfied:

(a) total contract revenue can be measured reliably;

(b) it is probable that the economic benefits associated with the contract will flow to the entity;

(c) both the contract costs to complete the contract and the stage of contract completion at the ~~balance sheet date~~ end of the reporting period can be measured reliably; and

(d) **the contract costs attributable to the contract can be clearly identified and measured reliably so that actual contract costs incurred can be compared with prior estimates.**

24 **In the case of a cost plus contract, the outcome of a construction contract can be estimated reliably when all the following conditions are satisfied:**

(a) **it is probable that the economic benefits associated with the contract will flow to the entity; and**

(b) **the contract costs attributable to the contract, whether or not specifically reimbursable, can be clearly identified and measured reliably.**

25 The recognition of revenue and expenses by reference to the stage of completion of a contract is often referred to as the percentage of completion method. Under this method, contract revenue is matched with the contract costs incurred in reaching the stage of completion, resulting in the reporting of revenue, expenses and profit which can be attributed to the proportion of work completed. This method provides useful information on the extent of contract activity and performance during a period.

26 Under the percentage of completion method, contract revenue is recognised as revenue in ~~the income statement~~ profit or loss in the accounting periods in which the work is performed. Contract costs are usually recognised as an expense in ~~the income statement~~ profit or loss in the accounting periods in which the work to which they relate is performed. However, any expected excess of total contract costs over total contract revenue for the contract is recognised as an expense immediately in accordance with paragraph 36.

27 A contractor may have incurred contract costs that relate to future activity on the contract. Such contract costs are recognised as an asset provided it is probable that they will be recovered. Such costs represent an amount due from the customer and are often classified as contract work in progress.

28 The outcome of a construction contract can only be estimated reliably when it is probable that the economic benefits associated with the contract will flow to the entity. However, when an uncertainty arises about the collectibility of an amount already included in contract revenue, and already recognised in ~~the income statement~~profit or loss, the uncollectible amount or the amount in respect of which recovery has ceased to be probable is recognised as an expense rather than as an adjustment of the amount of contract revenue.

29 An entity is generally able to make reliable estimates after it has agreed to a contract which establishes:

(a) each party's enforceable rights regarding the asset to be constructed;

(b) the consideration to be exchanged; and

(c) the manner and terms of settlement.

It is also usually necessary for the entity to have an effective internal financial budgeting and reporting system. The entity reviews and, when necessary, revises the estimates of contract revenue and contract costs as the contract progresses. The need for such revisions does not necessarily indicate that the outcome of the contract cannot be estimated reliably.

30 The stage of completion of a contract may be determined in a variety of ways. The entity uses the method that measures reliably the work performed. Depending on the nature of the contract, the methods may include:

(a) the proportion that contract costs incurred for work performed to date bear to the estimated total contract costs;

(b) surveys of work performed; or

(c) completion of a physical proportion of the contract work.

Progress payments and advances received from customers often do not reflect the work performed.

31 When the stage of completion is determined by reference to the contract costs incurred to date, only those contract costs that reflect work performed are included in costs incurred to date. Examples of contract costs which are excluded are:

(a) contract costs that relate to future activity on the contract, such as costs of materials that have been delivered to a contract site or set aside for use in a contract but not yet installed, used or applied during contract performance, unless the materials have been made specially for the contract; and

(b) payments made to subcontractors in advance of work performed under the subcontract.

32 When the outcome of a construction contract cannot be estimated reliably:

(a) revenue shall be recognised only to the extent of contract costs incurred that it is probable will be recoverable; and

(b) contract costs shall be recognised as an expense in the period in which they are incurred.

An expected loss on the construction contract shall be recognised as an expense immediately in accordance with paragraph 36.

33 During the early stages of a contract it is often the case that the outcome of the contract cannot be estimated reliably. Nevertheless, it may be probable that the entity will recover the contract costs incurred. Therefore, contract revenue is recognised only to the extent of costs incurred that are expected to be recoverable. As the outcome of the contract cannot be estimated reliably, no profit is recognised. However, even though the outcome of the contract cannot be estimated reliably, it may be probable that total contract costs will exceed total contract revenues. In such cases, any expected excess of total contract costs over total contract revenue for the contract is recognised as an expense immediately in accordance with paragraph 36.

34 Contract costs that are not probable of being recovered are recognised as an expense immediately. Examples of circumstances in which the recoverability of contract costs incurred may not be probable and in which contract costs may need to be recognised as an expense immediately include contracts:

(a) ~~which~~that are not fully enforceable, ~~that is~~ie, their validity is seriously in question;

(b) the completion of which is subject to the outcome of pending litigation or legislation;

(c) relating to properties that are likely to be condemned or expropriated;

(d) where the customer is unable to meet its obligations; or

(e) where the contractor is unable to complete the contract or otherwise meet its obligations under the contract.

35 When the uncertainties that prevented the outcome of the contract being estimated reliably no longer exist, revenue and expenses associated with the construction contract shall be recognised in accordance with paragraph 22 rather than in accordance with paragraph 32.

Recognition of expected losses

36 When it is probable that total contract costs will exceed total contract revenue, the expected loss shall be recognised as an expense immediately.

37 The amount of such a loss is determined irrespective of:

(a) whether work has commenced on the contract;

(b) the stage of completion of contract activity; or

(c) the amount of profits expected to arise on other contracts which are not treated as a single construction contract in accordance with paragraph 9.

Changes in estimates

38 The percentage of completion method is applied on a cumulative basis in each accounting period to the current estimates ~~on~~of contract revenue and contract costs. Therefore, the effect of a change in the estimate of contract revenue or contract costs, or the effect of a change in the estimate ~~on~~of the outcome of a contract, is accounted for as a change in accounting estimate (see HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.). The changed estimates are used in the determination of the amount of revenue and expenses recognised in ~~the income statement~~ profit or loss in the period in which the change is made and in subsequent periods.

Disclosure

39 An entity shall disclose:

(a) the amount of contract revenue recognised as revenue in the period;

(b) the methods used to determine the contract revenue recognised in the period; and

(c) the methods used to determine the stage of completion of contracts in progress.

40 An entity shall disclose each of the following for contracts in progress at the ~~balance sheet date~~ end of the reporting period:

(a) the aggregate amount of costs incurred and recognised profits (less recognised losses) to date;

(b) the amount of advances received; and

(c) the amount of retentions.

41 Retentions are amounts of progress billings that are not paid until the satisfaction of conditions specified in the contract for the payment of such amounts or until defects have been rectified. Progress billings are amounts billed for work performed on a contract whether or not they have been paid by the customer. Advances are amounts received by the contractor before the related work is performed.

42 An entity shall present:

(a) the gross amount due from customers for contract work as an asset; and

(b) the gross amount due to customers for contract work as a liability.

43 The gross amount due from customers for contract work is the net amount of:

(a) costs incurred plus recognised profits; less

(b) the sum of recognised losses and progress billings

for all contracts in progress for which costs incurred plus recognised profits (less recognised losses) exceeds progress billings.

44 The gross amount due to customers for contract work is the net amount of:

(a) costs incurred plus recognised profits; less

(b) the sum of recognised losses and progress billings

for all contracts in progress for which progress billings exceed costs incurred plus recognised profits (less recognised losses).

45 An entity discloses any contingent liabilities and contingent assets in accordance with HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets.* Contingent liabilities and contingent assets may arise from such items as warranty costs, claims, penalties or possible losses.

Effective date

46 This Standard becomes operative for financial statements covering periods beginning on or after 1 January 2005. Earlier application is encouraged.

Appendix A
Illustrative examples

This appendix accompanies, but is not part of, IAS 11.

Disclosure of accounting policies

The following are examples of accounting policy disclosures:

Revenue from fixed price construction contracts is recognised on the percentage of completion method, measured by reference to the percentage of labour hours incurred to date to estimated total labour hours for each contract.

Revenue from cost plus contracts is recognised by reference to the recoverable costs incurred during the period plus the fee earned, measured by the proportion that costs incurred to date bear to the estimated total costs of the contract.

The determination of contract revenue and expenses

The following example illustrates one method of determining the stage of completion of a contract and the timing of the recognition of contract revenue and expenses (see paragraphs 22 ~~to~~–35 of the Standard).

A construction contractor has a fixed price contract for 9,000 to build a bridge. The initial amount of revenue agreed in the contract is 9,000. The contractor's initial estimate of contract costs is 8,000. It will take 3 years to build the bridge.

By the end of year 1, the contractor's estimate of contract costs has increased to 8,050.

In year 2, the customer approves a variation resulting in an increase in contract revenue of 200 and estimated additional contract costs of 150. At the end of year 2, costs incurred include 100 for standard materials stored at the site to be used in year 3 to complete the project.

The contractor determines the stage of completion of the contract by calculating the proportion that contract costs incurred for work performed to date bear to the latest estimated total contract costs. A summary of the financial data during the construction period is as follows:

	Year 1	Year 2	Year 3
Initial amount of revenue agreed in contract	9,000	9,000	9,000
Variation	-	200	200
Total contract revenue	9,000	9,200	9,200
Contract costs incurred to date	2,093	6,168	8,200
Contract costs to complete	5,957	2,032	-
Total estimated contract costs	8,050	8,200	8,200
Estimated profit	950	1,000	1,000
Stage of completion	26%	74%	100%

The stage of completion for year 2 (74%) is determined by excluding from contract costs incurred for work performed to date the 100 of standard materials stored at the site for use in year 3.

The amounts of revenue, expenses and profit recognised in the ~~income~~ statement of comprehensive income in the three years are as follows:

	To date	Recognised in prior years	Recognised in current year
Year 1			
Revenue (9,000 x 0.26)	2,340	-	2,340
Expenses (8,050 x 0.26)	2,093	-	2,093
Profit	247	-	247
Year 2			
Revenue (9,200 x 0.74)	6,808	2,340	4,468
Expenses (8,200 x 0.74)	6,068	2,093	3,975
Profit	740	247	493
Year 3			
Revenue (9,200 x 1.00)	9,200	6,808	2,392
Expenses	8,200	6,068	2,132
Profit	1,000	740	260

Contract disclosures

A contractor has reached the end of its first year of operations. All its contract costs incurred have been paid for in cash and all its progress billings and advances have been received in cash. Contract costs incurred for contracts B, C and E include the cost of materials that have been purchased for the contract but which have not been used in contract performance to date. For contracts B, C and E, the customers have made advances to the contractor for work not yet performed.

The status of its five contracts in progress at the end of year 1 is as follows:

	Contract					
	A	B	C	D	E	Total
Contract revenue recognised in accordance with paragraph 22	145	520	380	200	55	1,300
Contract expenses recognised in accordance with paragraph 22	110	450	350	250	55	1,215
Expected losses recognised in accordance with paragraph 36	-	-	-	40	30	70
Recognised profits less recognised losses	35	70	30	(90)	(30)	15
Contract costs incurred in the period	110	510	450	250	100	1,420
Contract costs incurred recognised as contract expenses in the period in accordance with paragraph 22	110	450	350	250	55	1,215
Contract costs that relate to future activity recognised as an asset in accordance with paragraph 27	-	60	100	-	45	205
Contract revenue (see above)	145	520	380	200	55	1,300
Progress billings (paragraph 41)	100	520	380	180	55	1,235
Unbilled contract revenue	45	-	-	20	-	65
Advances (paragraph 41)	-	80	20	-	25	125

The amounts to be disclosed in accordance with the Standard are as follows:

Contract revenue recognised as revenue in the period (paragraph 39(a))	1,300
Contract costs incurred and recognised profits (less recognised losses) to date (paragraph 40(a))	1,435
Advances received (paragraph 40(b))	125
Gross amount due from customers for contract work - presented as an asset in accordance with paragraph 42(a)	220
Gross amount due to customers for contract work - presented as a liability in accordance with paragraph 42(b)	(20)

The amounts to be disclosed in accordance with paragraphs 40(a), 42(a) and 42(b) are calculated as follows:

	Contract					
	A	B	C	D	E	Total
Contract costs incurred	110	510	450	250	100	1,420
Recognised profits less recognised losses	35	70	30	(90)	(30)	15
	145	580	480	160	70	1,435
Progress billings	100	520	380	180	55	1,235
Due from customers	45	60	100	-	15	220
Due to customers	-	-	-	(20)	-	(20)

The amount disclosed in accordance with paragraph 40(a) is the same as the amount for the current period because the disclosures relat~~ed~~ to the first year of operation.

Appendix B

Comparison with International Accounting Standards

This comparison appendix, which was prepared as at October 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 11.

The International Accounting Standard comparable with HKAS 11 is IAS 11 *Construction Contracts*.

There are no major textual differences between HKAS 11 and IAS 11.

HKAS 16
Revised ~~October 2008~~ March 2010

Hong Kong Accounting Standard 16

Property, Plant and Equipment

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

CONTENTS
HONG KONG ACCOUNTING STANDARD 16
PROPERTY, PLANT AND EQUIPEMENT

Hong Kong Accounting Standard 16 *Property, Plant and Equipment* (HKAS 16) is set out in paragraphs 1-83 and the Appendix B. All the paragraphs have equal authority. HKAS 16 should be read in the context of its objective and the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Framework for the Preparation and Presentation of Financial Statements*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Introduction

IN1 Hong Kong Accounting Standard 16 *Property, Plant and Equipment* (HKAS 16) should be applied for annual periods beginning on or after 1 January 2005. Earlier application is encouraged.

Reasons for issuing HKAS 16

IN2 The objectives of Hong Kong Institute of Certified Public Accountants (HKICPA) issuing HKAS 16 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 16 the HKICPA's main objective was a limited revision to provide additional guidance and clarification on selected matters. The HKICPA did not reconsider the fundamental approach to the accounting for property, plant and equipment contained in HKAS 16.

The main features

IN4 The main features of HKAS 16 are described below.

Scope

IN5 This Standard clarifies that an entity is required to apply the principles of this Standard to items of property, plant and equipment used to develop or maintain (a) biological assets and (b) mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources.

Recognition: subsequent costs

IN6 An entity evaluates under the general recognition principle all property, plant and equipment costs at the time they are incurred. Those costs include costs incurred initially to acquire or construct an item of property, plant and equipment and costs incurred subsequently to add to, replace part of, or service an item.

Measurement at recognition: asset dismantlement, removal and restoration costs

IN7 The cost of an item of property, plant and equipment includes the costs of its dismantlement, removal or restoration, the obligation for which an entity incurs as a consequence of installing the item. Its cost also includes the costs of its dismantlement, removal or restoration, the obligation for which an entity incurs as a consequence of using the item during a particular period for purposes other than to produce inventories during that period.

Measurement at recognition: asset exchange transactions

IN8 An entity is required to measure an item of property, plant and equipment acquired in exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets, at fair value unless the exchange transaction lacks commercial substance.

Measurement after recognition: revaluation model

IN9 If fair value can be measured reliably, an entity may carry all items of property, plant and equipment of a class at a revalued amount, which is the fair value of the items at the date of the revaluation less any subsequent accumulated depreciation and accumulated impairment losses.

Depreciation: unit of measure

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

Depreciation: depreciable amount

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

Depreciation: depreciation period

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

Derecognition: derecognition date

IN13 An entity is required to derecognise the carrying amount of an item of property, plant and equipment that it disposes of on the date the criteria for the sale of goods in HKAS 18 *Revenue* would be met.

IN14 An entity is required to derecognise the carrying amount of a part of an item of property, plant and equipment if that part has been replaced and the entity has included the cost of the replacement in the carrying amount of the item.

Derecognition: gain classification

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

Hong Kong Accounting Standard 16
Property, Plant and Equipment

Objective

1 The objective of this Standard is to prescribe the accounting treatment for property, plant and equipment so that users of the financial statements can discern information about an entity's investment in its property, plant and equipment and the changes in such investment. The principal issues in accounting for property, plant and equipment are the recognition of the assets, the determination of their carrying amounts and the depreciation charges and impairment losses to be recognised in relation to them.

Scope

2 This Standard shall be applied in accounting for property, plant and equipment except when another Standard requires or permits a different accounting treatment.

3 This Standard does not apply to:

(a) property, plant and equipment classified as held for sale in accordance with HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*;

(b) biological assets related to agricultural activity (see HKAS 41 *Agriculture*);

(c) the recognition and measurement of exploration and evaluation assets (see HKFRS 6 *Exploration for and Evaluation of Mineral Resources*); or

(d) mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources.

However, this Standard applies to property, plant and equipment used to develop or maintain the assets described in (b) and (d).

4 Other Standards may require recognition of an item of property, plant and equipment based on an approach different from that in this Standard. For example, HKAS 17 *Leases* requires an entity to evaluate its recognition of an item of leased property, plant and equipment on the basis of the transfer of risks and rewards. However, in such cases other aspects of the accounting treatment for these assets, including depreciation, are prescribed by this Standard.

5 ~~An entity shall apply this Standard to property that is being constructed or developed for future use as investment property but does not yet satisfy the definition of 'investment property' in HKAS 40 *Investment Property*. Once the construction or development is complete, the property becomes investment property and the entity is required to apply HKAS 40. HKAS 40 also applies to investment property that is being redeveloped for continued future use as investment property.~~ An entity using the cost model for investment property in accordance with HKAS 40 *Investment Property* shall use the cost model in this Standard.

Definitions

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

Carrying amount **is the amount at which an asset is recognised after deducting any accumulated depreciation and accumulated impairment losses.**

Cost **is the amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other HKFRSs, e.g. HKFRS 2 *Share-based Payment*.**

Depreciable amount **is the cost of an asset, or other amount substituted for cost, less its residual value.**

Depreciation **is the systematic allocation of the depreciable amount of an asset over its useful life.**

Entity-specific value **is the present value of the cash flows an entity expects to arise from the continuing use of an asset and from its disposal at the end of its useful life or expects to incur when settling a liability.**

Fair value **is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.**

An *impairment loss* **is the amount by which the carrying amount of an asset exceeds its recoverable amount.**

Property, plant and equipment **are tangible items that:**

(a) **are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and**

(b) **are expected to be used during more than one period.**

Recoverable amount **is the higher of an asset's ~~net selling price~~ fair value less costs to sell and its value in use.**

The *residual value* **of an asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.**

Useful life **is:**

(a) **the period over which an asset is expected to be available for use by an entity; or**

(b) **the number of production or similar units expected to be obtained from the asset by an entity.**

Recognition

7 **The cost of an item of property, plant and equipment shall be recognised as an asset if, and only if:**

(a) **it is probable that future economic benefits associated with the item will flow to the entity; and**

(b) **the cost of the item can be measured reliably.**

8. Spare parts and servicing equipment are usually carried as inventory and recognised in profit or loss as consumed. However, major spare parts and stand-by equipment qualify as property, plant and equipment when an entity expects to use them during more than one period. Similarly, if the spare parts and servicing equipment can be used only in connection with an item of property, plant and equipment, they are accounted for as property, plant and equipment.

9 This Standard does not prescribe the unit of measure for recognition, ie what constitutes an item of property, plant and equipment. Thus, judgement is required in applying the recognition criteria to an entity's specific circumstances. It may be appropriate to aggregate individually insignificant items, such as moulds, tools and dies, and to apply the criteria to the aggregate value.

10 An entity evaluates under this recognition principle all its property, plant and equipment costs at the time they are incurred. These costs include costs incurred initially to acquire or construct an item of property, plant and equipment and costs incurred subsequently to add to, replace part of, or service it.

Initial costs

11 Items of property, plant and equipment may be acquired for safety or environmental reasons. The acquisition of such property, plant and equipment, although not directly increasing the future economic benefits of any particular existing item of property, plant and equipment, may be necessary for an entity to obtain the future economic benefits from its other assets. Such items of property, plant and equipment qualify for recognition as assets because they enable an entity to derive future economic benefits from related assets in excess of what could be derived had those items not been acquired. For example, a chemical manufacturer may install new chemical handling processes to comply with environmental requirements for the production and storage of dangerous chemicals; related plant enhancements are recognised as an asset because without them the entity is unable to manufacture and sell chemicals. However, the resulting carrying amount of such an asset and related assets is reviewed for impairment in accordance with HKAS 36 *Impairment of Assets*.

Subsequent costs

12 Under the recognition principle in paragraph 7, an entity does not recognise in the carrying amount of an item of property, plant and equipment the costs of the day-to-day servicing of the item. Rather, these costs are recognised in profit or loss as incurred. Costs of day-to-day servicing are primarily the costs of labour and consumables, and may include the cost of small parts. The purpose of these expenditures is often described as for the 'repairs and maintenance' of the item of property, plant and equipment.

13 Parts of some items of property, plant and equipment may require replacement at regular intervals. For example, a furnace may require relining after a specified number of hours of use, or aircraft interiors such as seats and galleys may require replacement several times during the life of the airframe. Items of property, plant and equipment may also be acquired to make a less frequently recurring replacement, such as replacing the interior walls of a building, or to make a non-recurring replacement. Under the recognition principle in paragraph 7, an entity recognises in the carrying amount of an item of property, plant and equipment the cost of replacing part of such an item when that cost is incurred if the recognition criteria are met. The carrying amount of those parts that are replaced is derecognised in accordance with the derecognition provisions of this Standard (see paragraphs 67-72).

14 A condition of continuing to operate an item of property, plant and equipment (for example, an aircraft) may be performing regular major inspections for faults regardless of whether parts of the item are replaced. When each major inspection is performed, its cost is recognised in the carrying amount of the item of property, plant and equipment as a replacement if the recognition criteria are satisfied. Any remaining carrying amount of the cost of the previous inspection (as distinct from physical parts) is derecognised. This occurs regardless of whether the cost of the previous inspection was identified in the transaction in which the item was acquired or constructed. If necessary, the estimated cost of a future similar inspection may be used as an indication of what the cost of the existing inspection component was when the item was acquired or constructed.

Measurement at recognition

15 An item of property, plant and equipment that qualifies for recognition as an asset shall be measured at its cost.

Elements of cost

16 The cost of an item of property, plant and equipment comprises:

(a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates;

(b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

(c) 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.

17 Examples of directly attributable costs are:

(a) costs of employee benefits (as defined in HKAS 19 *Employee Benefits*) arising directly from the construction or acquisition of the item of property, plant and equipment;

(b) costs of site preparation;

(c) initial delivery and handling costs;

(d) installation and assembly costs;

(e) costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment); and

(f) professional fees.

18 An entity applies HKAS 2 *Inventories* to the costs of obligations for dismantling, removing and restoring the site on which an item is located that are incurred during a particular period as a consequence of having used the item to produce inventories during that period. The obligations for costs accounted for in accordance with HKAS 2 or HKAS 16 are recognised and measured in accordance with HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

19 Examples of costs that are not ~~the~~ costs of an item of property, plant and equipment are:

(a) costs of opening a new facility;

(b) costs of introducing a new product or service (including costs of advertising and promotional activities);

(c) costs of conducting business in a new location or with a new class of customer (including costs of staff training); and

(d) administration and other general overhead costs.

20 Recognition of costs in the carrying amount of an item of property, plant and equipment ceases when the item is in the location and condition necessary for it to be capable of operating in the manner intended by management. Therefore, costs incurred in using or redeploying an item are not included in the carrying amount of that item. For example, the following costs are not included in the carrying amount of an item of property, plant and equipment:

(a) costs incurred while an item capable of operating in the manner intended by management has yet to be brought into use or is operated at less than full capacity;

(b) initial operating losses, such as those incurred while demand for the item's output builds up; and

(c) costs of relocating or reorganising part or all of an entity's operations.

21 Some operations occur in connection with the construction or development of an item of property, plant and equipment, but are not necessary to bring the item to the location and condition necessary for it to be capable of operating in the manner intended by management. These incidental operations may occur before or during the construction or development activities. For example, income may be earned through using a building site as a car park until construction starts. Because incidental operations are not necessary to bring an item to the location and condition necessary for it to be capable of operating in the manner intended by management, the income and related expenses of incidental operations are recognised in profit or loss and included in their respective classifications of income and expense.

22 The cost of a self-constructed asset is determined using the same principles as for an acquired asset. If an entity makes similar assets for sale in the normal course of business, the cost of the asset is usually the same as the cost of constructing an asset for sale (see HKAS 2). Therefore, any internal profits are eliminated in arriving at such costs. Similarly, the cost of abnormal amounts of wasted material, labour, or other resources incurred in self-constructing an asset is not included in the cost of the asset. HKAS 23 *Borrowing Costs* establishes criteria for the recognition of interest as a component of the carrying amount of a self-constructed item of property, plant and equipment.

Measurement of cost

23 The cost of an item of property, plant and equipment is the cash price equivalent at the recognition date. If payment is deferred beyond normal credit terms, the difference between the cash price equivalent and the total payment is recognised as interest over the period of credit unless such interest is ~~recognised in the carrying amount of the item~~ capitalised in accordance with ~~the allowed alternative treatment in~~ HKAS 23.

24 One or more items of property, plant and equipment may be acquired in exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets. The following discussion refers simply to an exchange of one non-monetary asset for another, but it also applies to all ~~the~~ exchanges described in the preceding sentence. The cost of such an item of property, plant and equipment is measured at fair value unless (a) the exchange transaction lacks commercial substance or (b) the fair value of neither the asset received nor the asset given up is reliably measurable. The acquired item is measured in this way even if an entity cannot immediately derecognise the asset given up. If the acquired item is not measured at fair value, its cost is measured at the carrying amount of the asset given up.

25 An entity determines whether an exchange transaction has commercial substance by considering the extent to which its future cash flows are expected to change as a result of the transaction. An exchange transaction has commercial substance if:

(a) the configuration (risk, timing and amount) of the cash flows of the asset received differs from the configuration of the cash flows of the asset transferred; or

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

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

For the purpose of determining whether an exchange transaction has commercial substance, the entity-specific value of the portion of the entity's operations affected by the transaction shall reflect post-tax cash flows. The result of these analyses may be clear without an entity having to perform detailed calculations.

26 The fair value of an asset for which comparable market transactions do not exist is reliably measurable if (a) the variability in the range of reasonable fair value estimates is not significant for that asset or (b) the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value. If an entity is able to determine reliably the fair value of either the asset received or the asset given up, then the fair value of the asset given up is used to measure the cost of the asset received unless the fair value of the asset received is more clearly evident.

27 The cost of an item of property, plant and equipment held by a lessee under a finance lease is determined ~~under~~in accordance with HKAS 17 ~~*Leases*~~.

28 The carrying amount of an item of property, plant and equipment may be reduced by government grants in accordance with HKAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*.

Measurement after recognition

29 **An entity shall choose either the cost model in paragraph 30 or the revaluation model in paragraph 31 as its accounting policy and shall apply that policy to an entire class of property, plant and equipment.**

Cost model

30 **After recognition as an asset, an item of property, plant and equipment shall be carried at its cost less any accumulated depreciation and any accumulated impairment losses.**

Revaluation model

31 **After recognition as an asset, an item of property, plant and equipment whose fair value can be measured reliably shall be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Revaluations shall be made with sufficient regularity 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.**

32 The fair value of land and buildings is usually determined from market-based evidence by appraisal that is normally undertaken by professionally qualified valuers. The fair value of items of plant and equipment is usually their market value determined by appraisal.

33 If there is no market-based evidence of fair value because of the specialised nature of the item of property, plant and equipment and the item is rarely sold, except as part of a continuing business, an entity may need to estimate fair value using an income or a depreciated replacement cost approach.

34 The frequency of revaluations depends upon the changes in fair values of the items of property, plant and equipment being revalued. When the fair value of a revalued asset differs materially from its carrying amount, a further revaluation is required. Some items of property, plant and equipment experience significant and volatile changes in fair value, thus necessitating annual revaluation. Such frequent revaluations are unnecessary for items of property, plant and equipment with only insignificant changes in fair value. Instead, it may be necessary to revalue the item only every three or five years.

35 When an item of property, plant and equipment is revalued, any accumulated depreciation at the date of the revaluation is treated in one of the following ways:

(a) restated proportionately with the change in the gross carrying amount of the asset so that the carrying amount of the asset after revaluation equals its revalued amount. This method is often used when an asset is revalued by means of applying an index to determine its depreciated replacement cost.

(b) eliminated against the gross carrying amount of the asset and the net amount restated to the revalued amount of the asset. This method is often used for buildings.

The amount of the adjustment arising on the restatement or elimination of accumulated depreciation forms part of the increase or decrease in carrying amount that is accounted for in accordance with paragraphs 39 and 40.

36 **If an item of property, plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belongs shall be revalued.**

37 A class of property, plant and equipment is a grouping of assets of a similar nature and use in an entity's operations. The following are examples of separate classes:

(a) land;

(b) land and buildings;

(c) machinery;

(d) ships;

(e) aircraft;

(f) motor vehicles;

(g) furniture and fixtures; and

(h) office equipment.

38 The items within a class of property, plant and equipment are revalued simultaneously to avoid selective revaluation of assets and the reporting of amounts in the financial statements that are a mixture of costs and values as at different dates. However, a class of assets may be revalued on a rolling basis provided revaluation of the class of assets is completed within a short period and provided the revaluations are kept up to date.

39 If an asset's carrying amount is increased as a result of a revaluation, the increase shall be ~~credited directly to equity~~ recognised in other comprehensive income and accumulated in equity under the heading of revaluation surplus. However, the increase shall be recognised in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in profit or loss.

40 If an asset's carrying amount is decreased as a result of a revaluation, the decrease shall be recognised in profit or loss. However, the decrease shall be ~~debited directly to equity under the heading of revaluation surplus~~ recognised in other comprehensive income to the extent of any credit balance existing in the revaluation surplus in respect of that asset. The decrease recognised in other comprehensive income reduces the amount accumulated in equity under the heading of revaluation surplus.

41 The revaluation surplus included in equity in respect of an item of property, plant and equipment may be transferred directly to retained earnings when the asset is derecognised. This may involve transferring the whole of the surplus when the asset is retired or disposed of. However, some of the surplus may be transferred as the asset is used by an entity. In such a case, the amount of the surplus transferred would be the difference between depreciation based on the revalued carrying amount of the asset and depreciation based on the asset's original cost. Transfers from revaluation surplus to retained earnings are not made through profit or loss.

42 The effects of taxes on income, if any, resulting from the revaluation of property, plant and equipment are recognised and disclosed in accordance with HKAS 12 *Income Taxes*.

Depreciation

43 Each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately.

44[♦] An entity allocates the amount initially recognised in respect of an item of property, plant and equipment to its significant parts and depreciates separately each such part. For example, it may be appropriate to depreciate separately the airframe and engines of an aircraft, whether owned or subject to a finance lease. Similarly, if an entity acquires property, plant and equipment subject to an operating lease in which it is the lessor, it may be appropriate to depreciate separately amounts reflected in the cost of that item that are attributable to favourable or unfavourable lease terms relative to market terms.

45 A significant part of an item of property, plant and equipment may have a useful life and a depreciation method that are the same as the useful life and the depreciation method of another significant part of that same item. Such parts may be grouped in determining the depreciation charge.

46 To the extent that an entity depreciates separately some parts of an item of property, plant and equipment, it also depreciates separately the remainder of the item. The remainder consists of the parts of the item that are individually not significant. If an entity has varying expectations for these parts, approximation techniques may be necessary to depreciate the remainder in a manner that faithfully represents the consumption pattern and/or useful life of its parts.

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

47 An entity may choose to depreciate separately the parts of an item that do not have a cost that is significant in relation to the total cost of the item.

48 The depreciation charge for each period shall be recognised in profit or loss unless it is included in the carrying amount of another asset.

49 The depreciation charge for a period is usually recognised in profit or loss. However, sometimes, the future economic benefits embodied in an asset are absorbed in producing other assets. In this case, the depreciation charge constitutes part of the cost of the other asset and is included in its carrying amount. For example, the depreciation of manufacturing plant and equipment is included in the costs of conversion of inventories (see HKAS 2). Similarly, depreciation of property, plant and equipment used for development activities may be included in the cost of an intangible asset recognised in accordance with HKAS 38 *Intangible Assets*.

Depreciable amount and depreciation period

50 The depreciable amount of an asset shall be allocated on a systematic basis over its useful life.

51 The residual value and the useful life of an asset shall be reviewed at least at each financial year-end and, if expectations differ from previous estimates, the change(s) shall be accounted for as a change in an accounting estimate in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

52 Depreciation is recognised even if the fair value of the asset exceeds its carrying amount, as long as the asset's residual value does not exceed its carrying amount. Repair and maintenance of an asset do not negate the need to depreciate it.

53 The depreciable amount of an asset is determined after deducting its residual value. In practice, the residual value of an asset is often insignificant and therefore immaterial in the calculation of the depreciable amount.

54 The residual value of an asset may increase to an amount equal to or greater than the asset's carrying amount. If it does, the asset's depreciation charge is zero unless and until its residual value subsequently decreases to an amount below the asset's carrying amount.

55 Depreciation of an asset begins when it is available for use, ie when it is in the location and condition necessary for it to be capable of operating in the manner intended by management. Depreciation of an asset ceases at the earlier of the date that the asset is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with HKFRS 5 and the date that the asset is derecognised. Therefore, depreciation does not cease when the asset becomes idle or is retired from active use unless the asset is fully depreciated. However, under usage methods of depreciation the depreciation charge can be zero while there is no production.

56 The future economic benefits embodied in an asset are consumed by an entity principally through its use. However, other factors, such as technical or commercial obsolescence and wear and tear while an asset remains idle, often result in the diminution of the economic benefits that might have been obtained from the asset. Consequently, all the following factors are considered in determining the useful life of an asset:

(a) expected usage of the asset. Usage is assessed by reference to the asset's expected capacity or physical output.

(b) expected physical wear and tear, which depends on operational factors such as the number of shifts for which the asset is to be used and the repair and maintenance programme, and the care and maintenance of the asset while idle.

(c) technical or commercial obsolescence arising from changes or improvements in production, or from a change in the market demand for the product or service output of the asset.

(d) legal or similar limits on the use of the asset, such as the expiry dates of related leases.

57 The useful life of an asset is defined in terms of the asset's expected utility to the entity. The asset management policy of the entity may involve the disposal of assets after a specified time or after consumption of a specified proportion of the future economic benefits embodied in the asset. Therefore, the useful life of an asset may be shorter than its economic life. The estimation of the useful life of the asset is a matter of judgement based on the experience of the entity with similar assets.

58 Land and buildings are separable assets and are accounted for separately, even when they are acquired together. With some exceptions, such as quarries and sites used for landfill, land has an unlimited useful life and therefore is not depreciated. Buildings have a limited useful life and therefore are depreciable assets. An increase in the value of the land on which a building stands does not affect the determination of the depreciable amount of the building.

59 If the cost of land includes the costs of site dismantlement, removal and restoration, that portion of the land asset is depreciated over the period of benefits obtained by incurring those costs. In some cases, the land itself may have a limited useful life, in which case it is depreciated in a manner that reflects the benefits to be derived from it.

Depreciation method

60 The depreciation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.

61 The depreciation method applied to an asset shall be reviewed at least at each financial year-end and, if there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, the method shall be changed to reflect the changed pattern. Such a change shall be accounted for as a change in an accounting estimate in accordance with HKAS 8.

62 A variety of depreciation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include the straight-line method, the diminishing balance method and the units of production method. Straight-line depreciation results in a constant charge over the useful life if the asset's residual value does not change. The diminishing balance method results in a decreasing charge over the useful life. The units of production method results in a charge based on the expected use or output. The entity selects the method that most closely reflects the expected pattern of consumption of the future economic benefits embodied in the asset. That method is applied consistently from period to period unless there is a change in the expected pattern of consumption of those future economic benefits.

Impairment

63 To determine whether an item of property, plant and equipment is impaired, an entity applies HKAS 36 *Impairment of Assets*. That Standard explains how an entity reviews the carrying amount of its assets, how it determines the recoverable amount of an asset, and when it recognises, or reverses the recognition of, an impairment loss.

64 [Deleted]

Compensation for impairment

65 Compensation from third parties for items of property, plant and equipment that were impaired, lost or given up shall be included in profit or loss when the compensation becomes receivable.

66. Impairments or losses of items of property, plant and equipment, related claims for or payments of compensation from third parties and any subsequent purchase or construction of replacement assets are separate economic events and are accounted for separately as follows:

(a) impairments of items of property, plant and equipment are recognised in accordance with HKAS 36;

(b) derecognition of items of property, plant and equipment retired or disposed of is determined in accordance with this Standard;

(c) compensation from third parties for items of property, plant and equipment that were impaired, lost or given up is included in determining profit or loss when it becomes receivable; and

(d) the cost of items of property, plant and equipment restored, purchased or constructed as replacements is determined in accordance with this Standard.

Derecognition

67 The carrying amount of an item of property, plant and equipment shall be derecognised:

(a) on disposal; or

(b) when no future economic benefits are expected from its use or disposal.

68 The gain or loss arising from the derecognition of an item of property, plant and equipment shall be included in profit or loss when the item is derecognised (unless HKAS 17 requires otherwise on a sale and leaseback). Gains shall not be classified as revenue.

68A However, an entity that, in the course of its ordinary activities, routinely sells items of property, plant and equipment that it has held for rental to others shall transfer such assets to inventories at their carrying amount when they cease to be rented and become held for sale. The proceeds from the sale of such assets shall be recognised as revenue in accordance with HKAS 18 *Revenue*. HKFRS 5 does not apply when assets that are held for sale in the ordinary course of business are transferred to inventories.

69 The disposal of an item of property, plant and equipment may occur in a variety of ways (eg by sale, by entering into a finance lease or by donation). In determining the date of disposal of an item, an entity applies the criteria in HKAS 18 ~~*Revenue*~~ for recognising revenue from the sale of goods. HKAS 17 applies to disposal by a sale and leaseback.

70 If, under the recognition principle in paragraph 7, an entity recognises in the carrying amount of an item of property, plant and equipment the cost of a replacement for part of the item, then it derecognises the carrying amount of the replaced part regardless of whether the replaced part had been depreciated separately. If it is not practicable for an entity to determine the carrying amount of the replaced part, it may use the cost of the replacement as an indication of what the cost of the replaced part was at the time it was acquired or constructed.

71 The gain or loss arising from the derecognition of an item of property, plant and equipment shall be determined as the difference between the net disposal proceeds, if any, and the carrying amount of the item.

72 The consideration receivable on disposal of an item of property, plant and equipment is recognised initially at its fair value. If payment for the item is deferred, the consideration received is recognised initially at the cash price equivalent. The difference between the nominal amount of the consideration and the cash price equivalent is recognised as interest revenue in accordance with HKAS 18 reflecting the effective yield on the receivable.

Disclosure

73 The financial statements shall disclose, for each class of property, plant and equipment:

(a) the measurement bases used for determining the gross carrying amount;

(b) the depreciation methods used;

(c) the useful lives or the depreciation rates used;

(d) the gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period; and

(e) a reconciliation of the carrying amount at the beginning and end of the period showing:

(i) additions;

(ii) **assets classified as held for sale or included in a disposal group classified as held for sale in accordance with HKFRS 5 and other disposals;**

(iii) **acquisitions through business combinations;**

(iv) **increases or decreases resulting from revaluations under paragraphs 31, 39 and 40 and from impairment losses ~~recognised or reversed directly in equity~~ recognised or reversed in other comprehensive income in accordance with HKAS 36;**

(v) **impairment losses recognised in profit or loss in accordance with HKAS 36;**

(vi) **impairment losses reversed in profit or loss in accordance with HKAS 36;**

(vii) **depreciation;**

(viii) **the net exchange differences arising on the translation of the financial statements from the functional currency into a different presentation currency, including the translation of a foreign operation into the presentation currency of the reporting entity; and**

(ix) **other changes.**

74 **The financial statements shall also disclose:**

(a) **the existence and amounts of restrictions on title, and property, plant and equipment pledged as security for liabilities;**

(b) **the amount of expenditures recognised in the carrying amount of an item of property, plant and equipment in the course of its construction;**

(c) **the amount of contractual commitments for the acquisition of property, plant and equipment; and**

(d) **if it is not disclosed separately ~~on the face of the income statement~~ in the statement of comprehensive income, the amount of compensation from third parties for items of property, plant and equipment that were impaired, lost or given up that is included in profit or loss.**

75 Selection of the depreciation method and estimation of the useful life of assets are matters of judgement. Therefore, disclosure of the methods adopted and the estimated useful lives or depreciation rates provides users of financial statements with information that allows them to review the policies selected by management and enables comparisons to be made with other entities. For similar reasons, it is necessary to disclose:

(a) depreciation, whether recognised in profit or loss or as a part of the cost of other assets, during a period; and

(b) accumulated depreciation at the end of the period.

76 In accordance with HKAS 8 an entity discloses the nature and effect of a change in an accounting estimate that has an effect in the current period or is expected to have an effect in subsequent periods. For property, plant and equipment, such disclosure may arise from changes in estimates with respect to:

(a) residual values;

(b) the estimated costs of dismantling, removing or restoring items of property, plant and equipment;

(c) useful lives; and

(d) depreciation methods.

77 If items of property, plant and equipment are stated at revalued amounts, the following shall be disclosed:

(a) the effective date of the revaluation;

(b) whether an independent valuer was involved;

(c) the methods and significant assumptions applied in estimating the items' fair values;

(d) the extent to which the items' fair values were determined directly by reference to observable prices in an active market or recent market transactions on arm's length terms or were estimated using other valuation techniques;

(e) for each revalued class of property, plant and equipment, the carrying amount that would have been recognised had the assets been carried under the cost model; and

(f) the revaluation surplus, indicating the change for the period and any restrictions on the distribution of the balance to shareholders.

78 In accordance with HKAS 36 an entity discloses information on impaired property, plant and equipment in addition to the information required by paragraph 73(e)(iv)-(vi).

79 Users of financial statements may also find the following information relevant to their needs:

(a) the carrying amount of temporarily idle property, plant and equipment;

(b) the gross carrying amount of any fully depreciated property, plant and equipment that is still in use;

(c) the carrying amount of property, plant and equipment retired from active use and not classified as held for sale in accordance with HKFRS 5; and

(d) when the cost model is used, the fair value of property, plant and equipment when this is materially different from the carrying amount.

Therefore, entities are encouraged to disclose these amounts.

Transitional provisions

80 The requirements of paragraphs 24-26 regarding the initial measurement of an item of property, plant and equipment acquired in an exchange of assets transaction shall be applied prospectively to future transactions.

80A Enterprises which carried property, plant and equipment at revalued amounts in financial statements relating to periods ended before 30 September 1995 are not required to make regular revaluations in accordance with paragraphs 31 and 36 even if the carrying amounts of the revalued assets are materially different from the asset's fair values provided that:

(a) these enterprises do not revalue their property, plant and equipment subsequent to 1995; and

(b) disclosure of reliance of this paragraph is made in the financial statements.

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

Effective date

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

81a If an entity decides to apply this Standard for an earlier period, it is not required to apply all the HKASs with the effective date for that same period. However, it is required to apply the amendments set out in the appendix on amendments to other pronouncements for that earlier period(s).

81A An entity shall apply the amendments in paragraph 3 for annual periods beginning on or after 1 January 2006. If an entity applies HKFRS 6 for an earlier period, those amendments shall be applied for that earlier period.

81B HKAS 1 *Presentation of Financial Statements* (as revised in 2007) amended the terminology used throughout HKFRSs. In addition it amended paragraphs 39, 40 and 73(e)(iv). An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. If an entity applies HKAS 1 (revised 2007) for an earlier period, the amendments shall be applied for that earlier period.

81C[⌖] HKFRS 3 *Business Combinations* (as revised in 2008) amended paragraph 44. An entity shall apply that amendment for annual periods beginning on or after 1 July 2009. If an entity applies HKFRS 3 (revised 2008) for an earlier period, the amendment shall also be applied for that earlier period.

81D Paragraphs 6 and 69 were amended and paragraph 68A was added by *Improvements to HKFRSs* issued in October 2008. An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. Earlier application is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact and at the same time apply the related amendments to HKAS 7 *Statement of Cash Flows*.

81E. Paragraph 5 was amended by *Improvements to HKFRSs* issued in October 2008. An entity shall apply that amendment prospectively for annual periods beginning on or after 1 January 2009. Earlier application is permitted if an entity also applies the amendments to paragraphs 8, 9, 22, 48, 53, 53A, 53B, 54, 57 and 85B of HKAS 40 at the same time. If an entity applies the amendment for an earlier period it shall disclose that fact.

Withdrawal of other pronouncements

82 This Standard supersedes SSAP 17 *Property, Plant and Equipment* revised in 2001.

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

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

Appendix

Comparison with International Accounting Standards

This comparison appendix, which was prepared as at 24 November 2005 and deals only with significant differences in the standards extant, is produced for information only and does not form part of the standards in HKAS 16.

The International Accounting Standard comparable with HKAS 16 is IAS 16 *Property, Plant and Equipment*.

The following sets out the major textual difference between HKAS 16 and IAS 16 and the reason for the difference.

Difference	Reason for the difference
(i) HKAS 16 para 80A A transitional arrangement was introduced in the original SSAP 17 issued in 1995 to relieve certain enterprises which carried their property, plant and equipment at revalued amounts before 30 September 1995 from making regular revaluations.	 To carry forward the transitional arrangement previously included in SSAP 17.
(ii) HKAS 16 para 80B A transitional arrangement is included to allow those entities that have previously taken advantage of the exemption under SSAP 17 *Property, Plant and Equipment* to deem the carrying amount of an item of property, plant and equipment immediately before applying this Standard on its effective date (or earlier) as the cost of that item.	 To deal with the concern of those exempted entities that it might not be possible for them to trace back the original cost of the asset for applying this Standard.

Appendix

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.

CONTENTS

Basis for Conclusions on IAS 16 *Property, Plant and Equipment*

This Basis for Conclusions accompanies, but is not part of, IAS 16.

HKAS 16 is based on IAS 16 *Property, Plant and Equipment*. In approving HKAS 16, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IASB's Basis for Conclusions on IAS 16. Accordingly, there are no significant differences between HKAS 16 and IAS 16. The IASB's Basis for Conclusions is reproduced below. The paragraph numbers of IAS 16 referred to below generally correspond with those in HKAS 16.

Introduction

BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching its conclusions on revising IAS 16 *Property, Plant and Equipment* 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 16. 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 property, plant and equipment that was established by IAS 16, this Basis for Conclusions does not discuss requirements in IAS 16 that the Board has not reconsidered.

Scope

BC4 The Board clarified that the requirements of IAS 16 apply to items of property, plant and equipment that an entity uses to develop or maintain (a) biological assets and (b) mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources. The Board noted that items of property, plant and equipment that an entity uses for these purposes possess the same characteristics as other items of property, plant and equipment.

Recognition

BC5 In considering potential improvements to the previous version of IAS 16, the Board reviewed its subsequent expenditure recognition principle for two reasons. First, the existing subsequent expenditure recognition principle did not align with the asset recognition principle in the *Framework*. Second, the Board noted difficulties in practice in making the distinction it required between expenditures that maintain, and those that enhance, an item of property, plant and equipment. Some expenditures seem to do both.

BC6 The Board ultimately decided that the separate recognition principle for subsequent expenditure was not needed. As a result, an entity will evaluate all its property, plant and equipment costs under IAS 16's general recognition principle. Also, if the cost of a replacement for part of an item of property, plant and equipment is recognised in the carrying amount of an asset, then an entity will derecognise the carrying amount of what was replaced to avoid carrying both the replacement and the replaced portion as assets. This derecognition occurs whether or not what is replaced is a part of an item that the entity depreciates separately.

BC7 The Board's decision on how to handle the recognition principles was not reached easily. In the Exposure Draft (ED), the Board proposed to include within IAS 16's general recognition principle only the recognition of subsequent expenditures that are replacements of a part of an item of property, plant and equipment. Also in the ED, the Board proposed to modify the subsequent expenditure recognition principle to distinguish more clearly the expenditures to which it would continue to apply.

BC8 Respondents to the ED agreed that it was appropriate for subsequent expenditures that were replacements of a part of an item of property, plant and equipment that an entity depreciated separately to be covered by the general recognition principle. However, the respondents argued, and the Board agreed, that the modified second principle was not clearer because it would result in an entity recognising in the carrying amount of an asset and then depreciating subsequent expenditures that were for the day-to-day servicing of items of property, plant and equipment, those that might commonly be regarded as for 'repairs and maintenance'. That result was not the Board's intention.

BC9 In its redeliberation of the ED, the Board concluded it could not retain the proposed modified subsequent expenditure recognition principle. It also concluded that it could not revert to the subsequent expenditure principle in the previous version of IAS 16 because, if it did, nothing was improved; the *Framework* conflict was not resolved and the practice issues were not addressed.

BC10 The Board concluded that it was best for all subsequent expenditures to be covered by IAS 16's general recognition principle. This solution had the following advantages:

(a) use of IAS 16's general recognition principle fits the *Framework.*

(b) use of a single recognition principle is a straightforward approach.

(c) retaining IAS 16's general recognition principle and combining it with the derecognition principle will result in financial statements that reflect what is occurring, ie both the flow of property, plant and equipment through an entity and the economics of the acquisition and disposal process.

(d) use of one recognition principle fosters consistency. With two principles, consistency is not achieved unless it is clear when each should apply. Because IAS 16 does not address what constitutes an 'item' of property, plant and equipment, this clarity was not assured because some might characterise a particular cost as the initial cost of a new item of property, plant and equipment and others might regard it as a subsequent cost of an existing item of property, plant and equipment.

BC11 As a consequence of placing all subsequent expenditures under IAS 16's general recognition principle, the Board also included those expenditures under IAS 16's derecognition principle. In the ED, the Board proposed the derecognition of the carrying amount of a part of an item that was depreciated separately and was replaced by a subsequent expenditure that an entity recognised in the carrying amount of the asset under the general recognition principle. With this change, replacements of a part of an item that are not depreciated separately are subject to the same approach.

BC12 The Board noted that some subsequent expenditures on property, plant and equipment, although arguably incurred in the pursuit of future economic benefits, are not sufficiently certain to be recognised in the carrying amount of an asset under the general recognition principle. Thus, the Board decided to state in the Standard that an entity recognises in profit or loss as incurred the costs of the day-to-day servicing of property, plant and equipment.

Measurement at recognition

Asset dismantlement, removal and restoration costs

BC13 The previous version of IAS 16 previously provided that in initially measuring an item of property, plant and equipment at its cost, an entity would include the cost of dismantling and removing that item and restoring the site on which it is located to the extent it had recognised an obligation for that cost. As part of its deliberations, the Board evaluated whether it could improve this guidance by addressing associated issues that have arisen in practice.

BC14 The Board concluded that the relatively limited scope of the Improvements project warranted addressing only one matter. That matter was whether the cost of an item of property, plant and equipment should include the initial estimate of the cost of dismantlement, removal and restoration that an entity incurs as a consequence of using the item (instead of as a consequence of acquiring it). Therefore, the Board did not address how an entity should 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 an entity did not face when it acquired the item, such as an obligation triggered by a law change enacted after the asset was acquired.

BC15 The Board observed that whether the obligation is incurred upon acquisition of the item or while it is being used, its underlying nature and its association with the asset are the same. Therefore, the Board decided that the cost of an item should include the costs of dismantlement, removal or restoration, the obligation for which an entity has incurred as a consequence of having used the item during a particular period other than to produce inventories during that period. An entity applies IAS 2 *Inventories* to the costs of these obligations that are incurred as a consequence of having used the item during a particular period to produce inventories during that period. The Board observed that accounting for these costs initially in accordance with IAS 2 acknowledges their nature. Furthermore, doing so achieves the same result as including these costs as an element of the cost of an item of property, plant and equipment, depreciating them over the production period just completed and identifying the depreciation charge as a cost to produce another asset (inventory), in which case the depreciation charge constitutes part of the cost of that other asset.

BC16 The Board noted that because IAS 16's initial measurement provisions are not affected by an entity's subsequent decision to carry an item under the cost model or the revaluation model, the Board's decision applies to assets that an entity carries under either treatment.

Asset exchange transactions

BC17 Paragraph 22 of the previous version of IAS 16 indicated that if (a) an item of property, plant and equipment is acquired in exchange for a similar asset that has a similar use in the same line of business and has a similar fair value or (b) an item of property, plant and equipment is sold in exchange for an equity interest in a similar asset, then no gain or loss is recognised on the transaction. The cost of the new asset is the carrying amount of the asset given up (rather than the fair value of the purchase consideration given for the new asset).

BC18 This requirement in the previous version of IAS 16 was consistent with views that:

(a) gains should not be recognised on exchanges of assets unless the exchanges represent the culmination of an earning process;

(b) exchanges of assets of a similar nature and value are not a substantive event warranting the recognition of gains; and

(c) requiring or permitting the recognition of gains from such exchanges enables entities to 'manufacture' gains by attributing inflated values to the assets exchanged, if the assets do not have observable market prices in active markets.

BC19 The approach described above raised issues about how to identify whether assets exchanged are similar in nature and value. The Board reviewed this topic, and noted views that:

(a) under the *Framework*, the recognition of income from an exchange of assets does not depend on whether the assets exchanged are dissimilar;

(b) income is not necessarily earned only at the culmination of an earning process, and in some cases it is arbitrary to determine when an earning process culminates;

(c) generally, under both measurement bases after recognition that are permitted under IAS 16, gain recognition is not deferred beyond the date at which assets are exchanged; and

(d) removing 'existing carrying amount' measurement of property, plant and equipment acquired in exchange for similar assets would increase the consistency of measurement of acquisitions of assets.

BC20 The Board decided to require in IAS 16 that all items of property, plant and equipment acquired in exchange for non-monetary assets or a combination of monetary and non-monetary assets should be measured at fair value, except that, if the exchange transaction lacks commercial substance or the fair value of neither of the assets exchanged can be determined reliably, then the cost of the asset acquired in the exchange should be measured at the carrying amount of the asset given up.

BC21 The Board added the 'commercial substance' test in response to a concern raised in the comments it received on the ED. This concern was that, under the Board's proposal, an entity would measure at fair value an asset acquired in a transaction that did not have commercial substance, ie the transaction did not have a discernible effect on an entity's economics. The Board agreed that requiring an evaluation of commercial substance would help to give users of the financial statements assurance that the substance of a transaction in which the acquired asset is measured at fair value (and often, consequentially, a gain on the disposal of the transferred asset is recognised in income) is the same as its legal form.

BC22 The Board concluded that in evaluating whether a transaction has commercial substance, an entity should calculate the present value of the post-tax cash flows that it can reasonably expect to derive from the portion of its operations affected by the transaction. The discount rate should reflect the entity's current assessment of the time value of money and the risks specific to those operations rather than those that marketplace participants would make.

BC23 The Board included the 'reliable measurement' test for using fair value to measure these exchanges to minimise the risk that entities could 'manufacture' gains by attributing inflated values to the assets exchanged. Taking into consideration its project for the convergence of IFRSs and US GAAP, the Board discussed whether to change the manner in which its 'reliable measurement' test is described. The Board observed this was unnecessary because it believes that its guidance and that contained in US GAAP are intended to have the same meaning.

BC24 The Board decided to retain, in IAS 18 *Revenue,* its prohibition on recognising revenue from exchanges or swaps of goods or services of a similar nature and value. The Board has on its agenda a project on revenue recognition and does not propose to make any significant amendments to IAS 18 until that project is completed.

Measurement after recognition

Revaluation model

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

Depreciation: unit of measure

BC26 The Board's discussions about the potential improvements to the depreciation principle in the previous version of IAS 16 included consideration of the unit of measure an entity uses to depreciate its items of property, plant and equipment. Of particular concern to the Board were situations in which the unit of measure is the 'item as a whole' even though that item may be composed of significant parts with individually varying useful lives or consumption patterns. The Board did not believe that, in these situations, an entity's use of approximation techniques, such as a weighted average useful life for the item as a whole, resulted in depreciation that faithfully represents an entity's varying expectations for the significant parts.

BC27 The Board sought to improve the previous version of IAS 16 by proposing in the ED revisions to existing guidance on separating an item into its parts and then further clarifying in the Standard the need for an entity to depreciate separately any significant parts of an item of property, plant and equipment. By doing so an entity will also separately depreciate the item's remainder.

Depreciation: depreciable amount

BC28 During its discussion of depreciation principles, the Board noted the concern that, under the cost model, the previously version of IAS 16 does not state clearly why an entity deducts an asset's residual value from its cost to determine the asset's depreciable amount. Some argue that the objective is one of precision, ie reducing the amount of depreciation so that it reflects the item's net cost. Others argue that the objective is one of economics, ie stopping depreciation if, because of inflation or otherwise, an entity expects that during its useful life an asset will increase in value by an amount greater than it will diminish.

BC29 The Board decided to improve the previous version of IAS 16 by making clear the objective of deducting a residual value in determining an asset's depreciable amount. In doing so, the Board did not adopt completely either the 'net cost' or the 'economics' objective. Given the concept of depreciation as a cost allocation technique, the Board concluded that an entity's expectation of increases in an asset's value, because of inflation or otherwise, does not override the need to depreciate it. Thus, the Board changed the definition of residual value to the amount an entity could receive for the asset currently (at the financial reporting date) if the asset were already as old and worn as it will be when the entity expects to dispose of it. Thus, an increase in the expected residual value of an asset because of past events will affect the depreciable amount; expectations of future changes in residual value other than the effects of expected wear and tear will not.

Depreciation: depreciation period

BC30 The Board decided that the useful life of an asset should encompass the entire time it is available for use, regardless of whether during that time it is in use or is idle. Idle periods most commonly occur just after an asset is acquired and just before it is disposed of, the latter while the asset is held either for sale or for another form of disposal.

BC31 The Board concluded that, whether idle or not, it is appropriate to depreciate an asset with a limited useful life so that the financial statements reflect the consumption of the asset's service potential that occurs while the asset is held. The Board also discussed but decided not to address the measurement of assets held for sale. The Board concluded that whether to apply a different measurement model to assets held for sale—which may or may not be idle— was a different question and was beyond the scope of the Improvements project.

BC32 In July 2003 the Board published ED 4 *Disposal of Non-current Assets and Presentation of Discontinued Operations*. ED 4 was published as part of the Board's short-term convergence project, the scope of which was broader than that of the Improvements project. In ED 4, the Board proposed that an entity should classify some of its assets as 'assets held for sale' if specified criteria are met. Among other things, the Board proposed that an entity should cease depreciating an asset classified in this manner, irrespective of whether the asset is idle. The basis for this proposal was that the carrying amount of an asset held for sale will be recovered principally through sale rather than future operations, and therefore accounting for the asset should be a process of valuation rather than allocation. The Board will amend IAS 16 accordingly when ED 4 is finalised.

Depreciation: depreciation method

BC33 The Board considered how an entity should account for a change in a depreciation method. The Board concluded that a change in a depreciation method is a change in the technique used to apply the entity's accounting policy to recognise depreciation as an asset's future economic benefits are consumed. Therefore, it is a change in an accounting estimate.

Derecognition

Derecognition date

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

Gain classification

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

Assets held for rental to others*

BC35A The Board identified that, in some industries, entities are in the business of renting and subsequently selling the same assets.

BC35B The Board noted that the Standard prohibits classification as revenue of gains arising from derecognition of items of property, plant and equipment. The Board also noted that paragraph BC35 states the reason for this is 'users of financial statements would consider these gains and the proceeds from an entity's sale of goods in the course of its ordinary activities differently in their evaluation of an entity's past results and their projections of future cash flows.'

BC35C Consistently with that reason, the Board concluded that entities whose ordinary activities include renting and subsequently selling the same assets should recognise revenue from both renting and selling the assets. In the Board's view, the presentation of gross selling revenue, rather than a net gain or loss on the sale of the assets, would better reflect the ordinary activities of such entities.

BC35D The Board concluded that the disclosure requirements of IAS 16, IAS 2 and IAS 18 would lead an entity to disclose relevant information for users.

BC35E The Board also concluded that paragraph 14 of IAS 7 *Statement of Cash Flows* should be amended to present within operating activities cash payments to manufacture or acquire such assets and cash receipts from rents and sales of such assets.

BC35F The Board discussed the comments received in response to its exposure draft of proposed *Improvements to International Financial Reporting Standards* published in 2007 and noted that a few respondents would prefer the issue to be included in one of the Board's major projects such as the revenue recognition project or the financial statement presentation project. However, the Board noted that the proposed amendment would improve financial statement presentation before those projects could be completed and decided to add paragraph 68A as previously exposed. A few respondents raised the concern that the term 'held for sale' in the amendment could be confused with the notion of held for sale in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. Consequently, the Board clarified in the amendment that IFRS 5 should not be applied in those circumstances.

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

Transitional provisions

BC36. The Board concluded that it would be impracticable for an entity to determine retrospectively whether a previous transaction involving an exchange of non-monetary assets had commercial substance. This is because it would not be possible for management to avoid using hindsight in making the necessary estimates as of earlier dates. Accordingly, the Board decided that in accordance with the provisions of IAS 8 an entity should consider commercial substance only in evaluating the initial measurement of future transactions involving an exchange of non-monetary assets.

Summary of changes from the Exposure Draft

BC37. The main changes from the ED proposals to the revised Standard are as follows.

(a) The ED contained two recognition principles, one applying to subsequent expenditures on existing items of property, plant and equipment. The Standard contains a single recognition principle that applies to costs incurred initially to acquire an item and costs incurred subsequently to add to, replace part of or service an item. An entity applies the recognition principle to the latter costs at the time it incurs them.

(b) Under the approach proposed in the ED, an entity measured an item of property, plant and equipment acquired in exchange for a non-monetary asset at fair value irrespective of whether the exchange transaction in which it was acquired had commercial substance. Under the Standard, a lack of commercial substance is cause for an entity to measure the acquired asset at the carrying amount of the asset given up.

(c) Compared with the Standard, the ED did not as clearly set out the principle that an entity separately depreciates at least the parts of an item of property, plant and equipment that are of significant cost.

(d) Under the approach proposed in the ED, an entity derecognised the carrying amount of a replaced part of an item of property, plant and equipment if it recognised in the carrying amount of the asset the cost of the replacement under the general recognition principle. In the Standard, an entity also applies this approach to a replacement of a part of an item that is not depreciated separately.

(e) In finalising the Standard, the Board identified further necessary consequential amendments to IFRS 1, IAS 14, IAS 34, IAS 36, IAS 37, IAS 38, IAS 40, SIC-13, SIC-21, SIC-22 and SIC-32.

Table of Concordance

This table shows how the contents of the superseded SSAP 17 and the current HKAS 16 correspond. Paragraphs are treated as corresponding if they broadly address the same matter even though their guidance may differ.

The table also shows how the requirements of Interpretation 5 have been incorporated into the current HKAS 16.

Superseded SSAP 17 paragraph	Current HKAS 16 paragraph
Introduction	1
1	2
2	None
3	None
4	3
5	4
6	6
7	7
8	None
9	None
10	None
11	None
12	8, 9
13	43-47
14	11
15	15
16	16-18
17	23
18	19, 20
19	22
20	27
21	26
22	None
23	None
24	None

Superseded SSAP 17 paragraph	Current HKAS 16 paragraph
25	None
26	None
27	13
28-29	14
30	30
31	31
32	32
33	32, 33
34	34
35	35
36	36
37	37
38	38
39	39
40	40
41	41
42	None
43	48, 50, 60
44	52
45	56
46	57
47	58
48	51, 53
49	62
50	49
51	51

Superseded SSAP 17 paragraph	Current HKAS 16 paragraph
52	None
53	None
54	61
55	63
56	64
57-65	None
66	67
67	68, 71
68	None
69	69
70	55
71	73
72	74
73	75
74	76
75	77
76	78

Superseded SSAP 17 paragraph or Interpretation	Current HKAS 16 paragraph
77	79
78	81
79	82, 83
80	80A
81	None
82	None
Interpretation 5	65, 66
None	5
None	10
None	12
None	21
None	24, 25
None	28
None	29
None	42
None	54
None	59
None	70
None	72
None	80-82

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Hong Kong Accounting Standard 18

Revenue

Hong Kong Institute of
Certified Public Accountants
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paragraphs

HONG KONG ACCOUNTING STANDARD 18

REVENUE

Hong Kong Accounting Standard 18 *Revenue* (HKAS 18) is set out in paragraphs 1-~~37~~38. All the paragraphs have equal authority. HKAS 18 shall be read in the context of its objective, the *Preface to Hong Kong Financial Reporting Standards* and the *Framework for the Preparation and Presentation of Financial Statements*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Hong Kong Accounting Standard 18
Revenue

Objective

Income is defined in the *Framework for the Preparation and Presentation of Financial Statements* as increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants. Income encompasses both revenue and gains. Revenue is income that arises in the course of ordinary activities of an entity and is referred to by a variety of different names including sales, fees, interest, dividends and royalties. The objective of this Standard is to prescribe the accounting treatment of revenue arising from certain types of transactions and events.

The primary issue in accounting for revenue is determining when to recognise revenue. Revenue is recognised when it is probable that future economic benefits will flow to the entity and these benefits can be measured reliably. This Standard identifies the circumstances in which these criteria will be met and, therefore, revenue will be recognised. It also provides practical guidance on the application of these criteria.

Scope

1 This Standard shall be applied in accounting for revenue arising from the following transactions and events:

- **(a) the sale of goods;**
- **(b) the rendering of services; and**
- **(c) the use by others of entity assets yielding interest, royalties and dividends.**

2 This Standard supersedes SSAP 18 *Revenue* (revised in May 2001).

3 Goods includes goods produced by the entity for the purpose of sale and goods purchased for resale, such as merchandise purchased by a retailer or land and other property held for resale.

4 The rendering of services typically involves the performance by the entity of a contractually agreed task over an agreed period of time. The services may be rendered within a single period or over more than one period. Some contracts for the rendering of services are directly related to construction contracts, for example, those for the services of project managers and architects. Revenue arising from these contracts is not dealt with in this Standard but is dealt with in accordance with the requirements for construction contracts as specified in HKAS 11 *Construction Contracts*.

5 The use by others of entity assets gives rise to revenue in the form of:

- (a) interest - charges for the use of cash or cash equivalents or amounts due to the entity;
- (b) royalties - charges for the use of long-term assets of the entity, for example, patents, trademarks, copyrights and computer software; and
- (c) dividends - distributions of profits to holders of equity investments in proportion to their holdings of a particular class of capital.

6 This Standard does not deal with revenue arising from:

- (a) lease agreements (see HKAS 17 *Leases*);
- (b) dividends arising from investments which are accounted for under the equity method (see HKAS 28 *Investments in Associates*);
- (c) insurance contracts within the scope of HKFRS 4 *Insurance Contracts*;
- (d) changes in the fair value of financial assets and financial liabilities or their disposal (see HKAS 39 *Financial Instruments: Recognition and Measurement*);

(e) changes in the value of other current assets;

(f) initial recognition and from changes in the fair value of biological assets related to agricultural activity (see HKAS 41 *Agriculture*);

(g) initial recognition of agricultural produce (see HKAS 41); and

(h) the extraction of mineral ores.

Definitions

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

Revenue **is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants.**

Fair value **is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.**

8 Revenue includes only the gross inflows of economic benefits received and receivable by the entity on its own account. Amounts collected on behalf of third parties such as sales taxes, goods and services taxes and value added taxes are not economic benefits which flow to the entity and do not result in increases in equity. Therefore, they are excluded from revenue. Similarly, in an agency relationship, the gross inflows of economic benefits include amounts collected on behalf of the principal and which do not result in increases in equity for the entity. The amounts collected on behalf of the principal are not revenue. Instead, revenue is the amount of commission.

Measurement of revenue

9 **Revenue shall be measured at the fair value of the consideration received or receivable.***

10 The amount of revenue arising on a transaction is usually determined by agreement between the entity and the buyer or user of the asset. It is measured at the fair value of the consideration received or receivable taking into account the amount of any trade discounts and volume rebates allowed by the entity.

11 In most cases, the consideration is in the form of cash or cash equivalents and the amount of revenue is the amount of cash or cash equivalents received or receivable. However, when the inflow of cash or cash equivalents is deferred, the fair value of the consideration may be less than the nominal amount of cash received or receivable. For example, an entity may provide interest-free credit to the buyer or accept a note receivable bearing a below-market interest rate from the buyer as consideration for the sale of goods. When the arrangement effectively constitutes a financing transaction, the fair value of the consideration is determined by discounting all future receipts using an imputed rate of interest. The imputed rate of interest is the more clearly determinable of either:

(a) the prevailing rate for a similar instrument of an issuer with a similar credit rating; or

(b) a rate of interest that discounts the nominal amount of the instrument to the current cash sales price of the goods or services.

The difference between the fair value and the nominal amount of the consideration is recognised as interest revenue in accordance with paragraphs 29 and 30 and in accordance with HKAS 39.

12 When goods or services are exchanged or swapped for goods or services which are of a similar nature and value, the exchange is not regarded as a transaction which generates revenue. This is often the case with commodities like oil or milk where suppliers exchange or swap inventories in various locations to fulfil demand on a timely basis in a particular location. When goods are sold or services are rendered in exchange for dissimilar goods or services,

* See also HK(SIC) - Int 31 *Revenue—Barter Transactions Involving Advertising Services*

the exchange is regarded as a transaction which generates revenue. The revenue is measured at the fair value of the goods or services received, adjusted by the amount of any cash or cash equivalents transferred. When the fair value of the goods or services received cannot be measured reliably, the revenue is measured at the fair value of the goods or services given up, adjusted by the amount of any cash or cash equivalents transferred.

Identification of the transaction

13 The recognition criteria in this Standard are usually applied separately to each transaction. However, in certain circumstances, it is necessary to apply the recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction. For example, when the selling price of a product includes an identifiable amount for subsequent servicing, that amount is deferred and recognised as revenue over the period during which the service is performed. Conversely, the recognition criteria are applied to two or more transactions together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole. For example, an entity may sell goods and, at the same time, enter into a separate agreement to repurchase the goods at a later date, thus negating the substantive effect of the transaction; in such a case, the two transactions are dealt with together.

Sale of goods

14 Revenue from the sale of goods shall be recognised when all the following conditions have been satisfied:

- **(a) the entity has transferred to the buyer the significant risks and rewards of ownership of the goods;**
- **(b) the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;**
- **(c) the amount of revenue can be measured reliably;**
- **(d) it is probable that the economic benefits associated with the transaction will flow to the entity; and**
- **(e) the costs incurred or to be incurred in respect of the transaction can be measured reliably.**

15 The assessment of when an entity has transferred the significant risks and rewards of ownership to the buyer requires an examination of the circumstances of the transaction. In most cases, the transfer of risks and rewards of ownership coincides with the transfer of the legal title or the passing of possession to the buyer. This is the case for most retail sales. In other cases, the transfer of the risks and rewards of ownership occurs at a different time from the transfer of legal title or the passing of possession.

16 If the entity retains significant risks of ownership, the transaction is not a sale and revenue is not recognised. An entity may retain a significant risk of ownership in a number of ways. Examples of situations in which the entity may retain the significant risks and rewards of ownership are:

- (a) when the entity retains an obligation for unsatisfactory performance not covered by normal warranty provisions;
- (b) when the receipt of the revenue from a particular sale is contingent on the derivation of revenue by the buyer from its sale of the goods;

(c) when the goods are shipped subject to installation and the installation is a significant part of the contract which has not yet been completed by the entity; and

(d) when the buyer has the right to rescind the purchase for a reason specified in the sales contract and the entity is uncertain about the probability of return.

17 If an entity retains only an insignificant risk of ownership, the transaction is a sale and revenue is recognised. For example, a seller may retain the legal title to the goods solely to protect the collectibility of the amount due. In such a case, if the entity has transferred the significant risks and rewards of ownership, the transaction is a sale and revenue is recognised. Another example of an entity retaining only an insignificant risk of ownership may be a retail sale when a refund is offered if the customer is not satisfied. Revenue in such cases is recognised at the time of sale provided the seller can reliably estimate future returns and recognises a liability for returns based on previous experience and other relevant factors.

18 Revenue is recognised only when it is probable that the economic benefits associated with the transaction will flow to the entity. In some cases, this may not be probable until the consideration is received or until an uncertainty is removed. For example, it may be uncertain that a foreign governmental authority will grant permission to remit the consideration from a sale in a foreign country. When the permission is granted, the uncertainty is removed and revenue is recognised. However, when an uncertainty arises about the collectibility of an amount already included in revenue, the uncollectible amount or the amount in respect of which recovery has ceased to be probable is recognised as an expense, rather than as an adjustment of the amount of revenue originally recognised.

19 Revenue and expenses that relate to the same transaction or other event are recognised simultaneously; this process is commonly referred to as the matching of revenues and expenses. Expenses, including warranties and other costs to be incurred after the shipment of the goods can normally be measured reliably when the other conditions for the recognition of revenue have been satisfied. However, revenue cannot be recognised when the expenses cannot be measured reliably; in such circumstances, any consideration already received for the sale of the goods is recognised as a liability.

Rendering of services

20 When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction shall be recognised by reference to the stage of completion of the transaction at the ~~balance sheet date~~ end of the reporting period. The outcome of a transaction can be estimated reliably when all the following conditions are satisfied:

(a) the amount of revenue can be measured reliably;

(b) it is probable that the economic benefits associated with the transaction will flow to the entity;

(c) the stage of completion of the transaction at the ~~balance sheet date~~ end of the reporting period can be measured reliably; and

(d) the costs incurred for the transaction and the costs to complete the transaction can be measured reliably.[*]

21 The recognition of revenue by reference to the stage of completion of a transaction is often referred to as the percentage of completion method. Under this method, revenue is recognised in the accounting periods in which the services are rendered. The recognition of revenue on this basis provides useful information on the extent of service activity and performance during a period. HKAS 11 also requires the recognition of revenue on this basis. The requirements of that Standard are generally applicable to the recognition of revenue and the associated expenses for a transaction involving the rendering of services

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[*] See also HK(SIC)-Int-27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease* and HK(SIC)-Int-31 *Revenue—Barter Transactions Involving Advertising Services.*

22 Revenue is recognised only when it is probable that the economic benefits associated with the transaction will flow to the entity. However, when an uncertainty arises about the collectibility of an amount already included in revenue, the uncollectible amount, or the amount in respect of which recovery has ceased to be probable, is recognised as an expense, rather than as an adjustment of the amount of revenue originally recognised.

23 An entity is generally able to make reliable estimates after it has agreed to the following with the other parties to the transaction:

(a) each party's enforceable rights regarding the service to be provided and received by the parties;

(b) the consideration to be exchanged; and

(c) the manner and terms of settlement.

It is also usually necessary for the entity to have an effective internal financial budgeting and reporting system. The entity reviews and, when necessary, revises the estimates of revenue as the service is performed. The need for such revisions does not necessarily indicate that the outcome of the transaction cannot be estimated reliably.

24 The stage of completion of a transaction may be determined by a variety of methods. An entity uses the method that measures reliably the services performed. Depending on the nature of the transaction, the methods may include:

(a) surveys of work performed;

(b) services performed to date as a percentage of total services to be performed; or

(c) the proportion that costs incurred to date bear to the estimated total costs of the transaction. Only costs that reflect services performed to date are included in costs incurred to date. Only costs that reflect services performed or to be performed are included in the estimated total costs of the transaction.

Progress payments and advances received from customers often do not reflect the services performed.

25 For practical purposes, when services are performed by an indeterminate number of acts over a specified period of time, revenue is recognised on a straight-line basis over the specified period unless there is evidence that some other method better represents the stage of completion. When a specific act is much more significant than any other acts, the recognition of revenue is postponed until the significant act is executed.

26 When the outcome of the transaction involving the rendering of services cannot be estimated reliably, revenue shall be recognised only to the extent of the expenses recognised that are recoverable.

27 During the early stages of a transaction, it is often the case that the outcome of the transaction cannot be estimated reliably. Nevertheless, it may be probable that the entity will recover the transaction costs incurred. Therefore, revenue is recognised only to the extent of costs incurred that are expected to be recoverable. As the outcome of the transaction cannot be estimated reliably, no profit is recognised.

28 When the outcome of a transaction cannot be estimated reliably and it is not probable that the costs incurred will be recovered, revenue is not recognised and the costs incurred are recognised as an expense. When the uncertainties that prevented the outcome of the contract being estimated reliably no longer exist, revenue is recognised in accordance with paragraph 20 rather than in accordance with paragraph 26.

Interest, royalties and dividends

29 Revenue arising from the use by others of entity assets yielding interest, royalties and dividends shall be recognised on the bases set out in paragraph 30 when:

(a) it is probable that the economic benefits associated with the transaction will flow to the entity; and

(b) the amount of the revenue can be measured reliably.

30 Revenue shall be recognised on the following bases:

(a) interest shall be recognised using the effective interest method as set out in HKAS 39, paragraphs 9 and AG5-AG8;

(b) royalties shall be recognised on an accrual basis in accordance with the substance of the relevant agreement; and

(c) dividends shall be recognised when the shareholder's right to receive payment is established.

31 [Deleted]

32 When unpaid interest has accrued before the acquisition of an interest-bearing investment, the subsequent receipt of interest is allocated between pre-acquisition and post-acquisition periods; only the post-acquisition portion is recognised as revenue. ~~When dividends on equity securities are declared from pre-acquisition profits, those dividends are deducted from the cost of the securities. If it is difficult to make such an allocation except on an arbitrary basis, dividends are recognised as revenue unless they clearly represent a recovery of part of the cost of the equity securities.~~

33 Royalties accrue in accordance with the terms of the relevant agreement and are usually recognised on that basis unless, having regard to the substance of the agreement, it is more appropriate to recognise revenue on some other systematic and rational basis.

34 Revenue is recognised only when it is probable that the economic benefits associated with the transaction will flow to the entity. However, when an uncertainty arises about the collectibility of an amount already included in revenue, the uncollectible amount, or the amount in respect of which recovery has ceased to be probable, is recognised as an expense, rather than as an adjustment of the amount of revenue originally recognised.

Disclosure

35 An entity shall disclose:

(a) the accounting policies adopted for the recognition of revenue including the methods adopted to determine the stage of completion of transactions involving the rendering of services;

(b) the amount of each significant category of revenue recognised during the period, including revenue arising from:

(i) the sale of goods;

(ii) the rendering of services;

(iii) interest;

(iv) royalties;

(v) dividends; and

(c) the amount of revenue arising from exchanges of goods or services included in each significant category of revenue.

36 An entity discloses any contingent liabilities and contingent assets in accordance with HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. Contingent liabilities and contingent assets may arise from items such as warranty costs, claims, penalties or possible losses.

Effective date

37 This Standard becomes operative for financial statements covering periods beginning on or after 1 January 2005. Earlier application is encouraged. If an entity applies this Standard for a period beginning before 1 January 2005, it shall disclose that fact and apply Hong Kong (SIC) Interpretation (HK(SIC)-Int) 31 *Revenue – Barter Transactions Involving Advertising Services* **at the same time.**

38 *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate* (Amendments to HKFRS 1 *First-time Adoption of Hong Kong Financial Reporting Standards* and HKAS 27 *Consolidated and Separate Financial Statements*), issued in October 2008, amended paragraph 32. An entity shall apply that amendment prospectively for annual periods beginning on or after 1 January 2009. Earlier application is permitted. If an entity applies the related amendments in paragraphs 4 and 38A of HKAS 27 for an earlier period, it shall apply the amendment in paragraph 32 at the same time.

Appendix

This appendix accompanies, but is not part of, IAS 18. The examples focus on particular aspects of a transaction and are not a comprehensive discussion of all the relevant factors that might influence the recognition of revenue. The examples generally assume that the amount of revenue can be measured reliably, it is probable that the economic benefits will flow to the entity and the costs incurred or to be incurred can be measured reliably.

Sale of goods

The law in different countries may mean the recognition criteria in this Standard are met at different times. In particular, the law may determine the point in time at which the entity transfers the significant risks and rewards of ownership. Therefore, the examples in this section of the appendix need to be read in the context of the laws relating to the sale of goods in the country in which the transaction takes place.

1 *'Bill and hold' sales, in which delivery is delayed at the buyer's request but the buyer takes title and accepts billing.*

Revenue is recognised when the buyer takes title, provided:

(a) it is probable that delivery will be made;

(b) the item is on hand, identified and ready for delivery to the buyer at the time the sale is recognised;

(c) the buyer specifically acknowledges the deferred delivery instructions; and

(d) the usual payment terms apply.

Revenue is not recognised when there is simply an intention to acquire or manufacture the goods in time for delivery.

2 *Goods shipped subject to conditions.*

(a) *installation and inspection.*

Revenue is normally recognised when the buyer accepts delivery, and installation and inspection are complete. However, revenue is recognised immediately upon the buyer's acceptance of delivery when:

(i) the installation process is simple in nature, for example the installation of a factory tested television receiver which only requires unpacking and connection of power and antennae; or

(ii) the inspection is performed only for purposes of final determination of contract prices, for example, shipments of iron ore, sugar or soya beans.

(*b*) *on approval when the buyer has negotiated a limited right of return.*

If there is uncertainty about the possibility of return, revenue is recognised when the shipment has been formally accepted by the buyer or the goods have been delivered and the time period for rejection has elapsed.

(c) *consignment sales under which the recipient (buyer) undertakes to sell the goods on behalf of the shipper (seller).*

Revenue is recognised by the shipper when the goods are sold by the recipient to a third party.

(d) *cash on delivery sales.*

Revenue is recognised when delivery is made and cash is received by the seller or its agent.

3 *Lay away sales under which the goods are delivered only when the buyer makes the final payment in a series of instalments.*

Revenue from such sales is recognised when the goods are delivered. However, when experience indicates that most such sales are consummated, revenue may be recognised when a significant deposit is received provided the goods are on hand, identified and ready for delivery to the buyer.

4 *Orders when payment (or partial payment) is received in advance of delivery for goods not presently held in inventory, for example, the goods are still to be manufactured or will be delivered directly to the customer from a third party.*

Revenue is recognised when the goods are delivered to the buyer.

5 *Sale and repurchase agreements (other than swap transactions) under which the seller concurrently agrees to repurchase the same goods at a later date, or when the seller has a call option to repurchase, or the buyer has a put option to require the repurchase, by the seller, of the goods.*

For a sale and repurchase agreement on an asset other than a financial asset, the terms of the agreement need to be analysed to ascertain whether, in substance, the seller has transferred the risks and rewards of ownership to the buyer and hence revenue is recognised. When the seller has retained the risks and rewards of ownership, even though legal title has been transferred, the transaction is a financing arrangement and does not give rise to revenue. For a sale and repurchase agreement on a financial asset, IAS 39 *Financial Instruments: Recognition and Measurement* applies.

6 *Sales to intermediate parties, such as distributors, dealers or others for resale.*

Revenue from such sales is generally recognised when the risks and rewards of ownership have passed. However, when the buyer is acting, in substance, as an agent, the sale is treated as a consignment sale.

7 *Subscriptions to publications and similar items.*

When the items involved are of similar value in each time period, revenue is recognised on a straight-line basis over the period in which the items are despatched. When the items vary in value from period to period, revenue is recognised on the basis of the sales value of the item despatched in relation to the total estimated sales value of all items covered by the subscription.

8 *Instalment sales, under which the consideration is receivable in instalments.*

Revenue attributable to the sales price, exclusive of interest, is recognised at the date of sale. The sale price is the present value of the consideration, determined by discounting the instalments receivable at the imputed rate of interest. The interest element is recognised as revenue as it is earned, using the effective interest method.

9 *Real estate sales.*

This example has been superseded by IFRIC Interpretation 15 *Agreements for the Construction of Real Estate*.

~~Revenue is normally recognised when legal title passes to the buyer. However, in some jurisdictions the equitable interest in a property may vest in the buyer before legal title passes and therefore the risks and rewards of ownership have been transferred at that stage. In such cases, provided that the seller has no further substantial acts to complete under the contract, it may be appropriate to recognise revenue. In either case, if the seller is obliged to perform any significant acts after the transfer of the equitable and/or legal title, revenue is recognised as the acts are performed. An example is a building or other facility on which construction has not been completed~~

~~In some cases, real estate may be sold with a degree of continuing involvement by the seller such that the risks and rewards of ownership have not been transferred. Examples are sale and repurchase agreements which include put and call options, and agreements whereby the seller guarantees occupancy of the property for a specified period, or guarantees a return on the buyer's investment for a specified period. In such cases, the nature and extent of the seller's continuing involvement determines how the transaction is accounted for. It may be accounted for as a sale, or as a financing, leasing or some other profit sharing arrangement. If it is accounted for as a sale, the continuing involvement of the seller may delay the recognition of revenue.~~

~~A seller also considers the means of payment and evidence of the buyer's commitment to complete payment. For example, when the aggregate of the payments received, including the buyer's initial down payment, or continuing payments by the buyer, provide insufficient evidence of the buyer's commitment to complete payment, revenue is recognised only to the extent cash is received.~~

Rendering of services

10 *Installation fees.*

Installation fees are recognised as revenue by reference to the stage of completion of the installation, unless they are incidental to the sale of a product in which case they are recognised when the goods are sold.

11 *Servicing fees included in the price of the product.*

When the selling price of a product includes an identifiable amount for subsequent servicing (for example, after sales support and product enhancement on the sale of software), that amount is deferred and recognised as revenue over the period during which the service is performed. The amount deferred is that which will cover the expected costs of the services under the agreement, together with a reasonable profit on those services.

12 *Advertising commissions.*

Media commissions are recognised when the related advertisement or commercial appears before the public. Production commissions are recognised by reference to the stage of completion of the project.

13 *Insurance agency commissions*.

Insurance agency commissions received or receivable which do not require the agent to render further service are recognised as revenue by the agent on the effective commencement or renewal dates of the related policies. However, when it is probable that the agent will be required to render further services during the life of the policy, the commission, or part thereof, is deferred and recognised as revenue over the period during which the policy is in force.

14 *Financial service fees.*

The recognition of revenue for financial service fees depends on the purposes for which the fees are assessed and the basis of accounting for any associated financial instrument. The description of fees for financial services may not be indicative of the nature and substance of the services provided. Therefore, it is necessary to distinguish between fees that are an integral part of the effective interest rate of a financial instrument, fees that are earned as services are provided, and fees that are earned on the execution of a significant act.

(a) *Fees that are an integral part of the effective interest rate of a financial instrument.*

Such fees are generally treated as an adjustment to the effective interest rate. However, when the financial instrument is measured at fair value with the change in fair value recognised in profit or loss, the fees are recognised as revenue when the instrument is initially recognised.

(i) *Origination fees received by the entity relating to the creation or acquisition of a financial asset other than one that under IAS 39 is classified as a financial asset at 'fair value through profit or loss'.*

Such fees may include compensation for activities such as evaluating the borrower's financial condition, evaluating and recording guarantees, collateral and other security arrangements, negotiating the terms of the instrument, preparing and processing documents and closing the transaction. These fees are an integral part of generating an involvement with the resulting financial instrument and, together with the related ~~direct~~ transaction costs[*] (as defined in IAS 39), are deferred and recognised as an adjustment to the effective interest rate.

(ii) *Commitment fees received by the entity to originate a loan when the loan commitment is outside the scope of IAS 39.*

If it is probable that the entity will enter into a specific lending arrangement and the loan commitment is not within the scope of IAS 39, the commitment fee received is regarded as compensation for an ongoing involvement with the acquisition of a financial instrument and, together with the related ~~direct~~ transaction costs (as defined in IAS 39), is deferred and recognised as an adjustment to the effective interest rate. If the commitment expires without the entity making the loan, the fee is recognised as revenue on expiry. Loan commitments that are within the scope of IAS 39 are accounted for as derivatives and measured at fair value.

(iii) *Origination fees received on issuing financial liabilities measured at amortised cost.*

These fees are an integral part of generating an involvement with a financial liability. When a financial liability is not classified as 'at fair value through profit or loss', the origination fees received are included, with the related transaction costs (as defined in IAS 39) incurred, in the initial carrying amount of the financial liability and recognised as an adjustment to the effective interest rate. An entity distinguishes fees and costs that are an integral part of the effective interest rate for the financial liability from origination fees and transaction costs relating to the right to provide services, such as investment management services.

(b) *Fees earned as services are provided.*

(i) *Fees charged for servicing a loan.*

Fees charged by an entity for servicing a loan are recognised as revenue as the services are provided.

(ii) *Commitment fees to originate a loan when the loan commitment is outside the scope of IAS 39.*

If it is unlikely that a specific lending arrangement will be entered into and the loan commitment is outside the scope of IAS 39, the commitment fee is recognised as revenue on a time proportion basis over the commitment period. Loan commitments that are within the scope of IAS 39 are accounted for as derivatives and measured at fair value.

(iii) *Investment management fees*

Fees charged for managing investments are recognised as revenue as the services are provided.

[*] In *Improvements to IFRSs* issued in May 2008, the Board replaced the term 'direct costs' with 'transaction costs' as defined in paragraph 9 of IAS 39. This amendment removed an inconsistency for costs incurred in originating financial assets and liabilities that should be deferred and recognised as an adjustment to the underlying effective interest rate. 'Direct costs', as previously defined, did not require such costs to be incremental.

Incremental costs that are directly attributable to securing an investment management contract are recognised as an asset if they can be identified separately and measured reliably and if it is probable that they will be recovered. As in IAS 39, an incremental cost is one that would not have been incurred if the entity had not secured the investment management contract. The asset represents the entity's contractual right to benefit from providing investment management services, and is amortised as the entity recognises the related revenue. If the entity has a portfolio of investment management contracts, it may assess their recoverability on a portfolio basis.

Some financial services contracts involve both the origination of one or more financial instruments and the provision of investment management services. An example is a long-term monthly saving contract linked to the management of a pool of equity securities. The provider of the contract distinguishes the transaction costs relating to the origination of the financial instrument from the costs of securing the right to provide investment management services.

(c) *Fees that are earned on the execution of a significant act.*

The fees are recognised as revenue when the significant act has been completed, as in the examples below.

(i) *Commission on the allotment of shares to a client.*

The commission is recognised as revenue when the shares have been allotted.

(ii) *Placement fees for arranging a loan between a borrower and an investor.*

The fee is recognised as revenue when the loan has been arranged.

(iii) *Loan syndication fees.*

A syndication fee received by an entity that arranges a loan and retains no part of the loan package for itself (or retains a part at the same effective interest rate for comparable risk as other participants) is compensation for the service of syndication. Such a fee is recognised as revenue when the syndication has been completed.

15 Admission fees.

Revenue from artistic performances, banquets and other special events is recognised when the event takes place. When a subscription to a number of events is sold, the fee is allocated to each event on a basis which reflects the extent to which services are performed at each event.

16 Tuition fees.

Revenue is recognised over the period of instruction.

17 Initiation, entrance and membership fees.

Revenue recognition depends on the nature of the services provided. If the fee permits only membership, and all other services or products are paid for separately, or if there is a separate annual subscription, the fee is recognised as revenue when no significant uncertainty as to its collectibility exists. If the fee entitles the member to services or publications to be provided during the membership period, or to purchase goods or services at prices lower than those charged to non-members, it is recognised on a basis that reflects the timing, nature and value of the benefits provided.

18 Franchise fees.

Franchise fees may cover the supply of initial and subsequent services, equipment and other tangible assets, and know-how. Accordingly, franchise fees are recognised as revenue on a basis that reflects the purpose for which the fees were charged. The following methods of franchise fee recognition are appropriate:

(a) *Supplies of equipment and other tangible assets.*

The amount, based on the fair value of the assets sold, is recognised as revenue when the items are delivered or title passes.

(b) *Supplies of initial and subsequent services.*

Fees for the provision of continuing services, whether part of the initial fee or a separate fee, are recognised as revenue as the services are rendered. When the separate fee does not cover the cost of continuing services together with a reasonable profit, part of the initial fee, sufficient to cover the costs of continuing services and to provide a reasonable profit on those services, is deferred and recognised as revenue as the services are rendered.

The franchise agreement may provide for the franchisor to supply equipment, inventories, or other tangible assets, at a price lower than that charged to others or a price that does not provide a reasonable profit on those sales. In these circumstances, part of the initial fee, sufficient to cover estimated costs in excess of that price and to provide a reasonable profit on those sales, is deferred and recognised over the period the goods are likely to be sold to the franchisee. The balance of an initial fee is recognised as revenue when performance of all the initial services and other obligations required of the franchisor (such as assistance with site selection, staff training, financing and advertising) has been substantially accomplished.

The initial services and other obligations under an area franchise agreement may depend on the number of individual outlets established in the area. In this case, the fees attributable to the initial services are recognised as revenue in proportion to the number of outlets for which the initial services have been substantially completed.

If the initial fee is collectible over an extended period and there is a significant uncertainty that it will be collected in full, the fee is recognised as cash instalments are received.

(c) *Continuing franchise fees.*

Fees charged for the use of continuing rights granted by the agreement, or for other services provided during the period of the agreement, are recognised as revenue as the services are provided or the rights used.

(d) *Agency transactions.*

Transactions may take place between the franchisor and the franchisee which, in substance, involve the franchisor acting as an agent for the franchisee. For example, the franchisor may order supplies and arrange for their delivery to the franchisee at no profit. Such transactions do not give rise to revenue.

19 Fees from the development of customised software.

Fees from the development of customised software are recognised as revenue by reference to the stage of completion of the development, including completion of services provided for post-delivery service support.

Interest, royalties and dividends

20 Licence fees and royalties.

Fees and royalties paid for the use of an entity's assets (such as trademarks, patents, software, music copyright, record masters and motion picture films) are normally recognised in accordance with the substance of the agreement. As a practical matter, this may be on a straight-line basis over the life of the agreement, for example, when a licensee has the right to use certain technology for a specified period of time.

An assignment of rights for a fixed fee or non refundable guarantee under a non-cancellable contract which permits the licensee to exploit those rights freely and the licensor has no remaining obligations to perform is, in substance, a sale. An example is a licensing agreement for the use of software when the licensor has no obligations subsequent to delivery. Another example is the granting of rights to exhibit a motion picture film in markets where the licensor has no control over the distributor and expects to receive no further revenues from the box office receipts. In such cases, revenue is recognised at the time of sale.

In some cases, whether or not a licence fee or royalty will be received is contingent on the occurrence of a future event. In such cases, revenue is recognised only when it is probable that the fee or royalty will be received, which is normally when the event has occurred.

21 *Determining whether an entity is acting as a principal or as an agent (2009 amendment).*

Paragraph 8 states that 'in an agency relationship, the gross inflows of economic benefits include amounts collected on behalf of the principal and which do not result in increases in equity for the entity. The amounts collected on behalf of the principal are not revenue. Instead, revenue is the amount of commission.' Determining whether an entity is acting as a principal or as an agent requires judgement and consideration of all relevant facts and circumstances.

An entity is acting as a principal when it has exposure to the significant risks and rewards associated with the sale of goods or the rendering of services. Features that indicate that an entity is acting as a principal include:

(a) the entity has the primary responsibility for providing the goods or services to the customer or for fulfilling the order, for example by being responsible for the acceptability of the products or services ordered or purchased by the customer;

(b) the entity has inventory risk before or after the customer order, during shipping or on return;

(c) the entity has latitude in establishing prices, either directly or indirectly, for example by providing additional goods or services; and

(d) the entity bears the customer's credit risk for the amount receivable from the customer.

An entity is acting as an agent when it does not have exposure to the significant risks and rewards associated with the sale of goods or the rendering of services. One feature indicating that an entity is acting as an agent is that the amount the entity earns is predetermined, being either a fixed fee per transaction or a stated percentage of the amount billed to the customer.

Appendix A

Comparison with International Accounting Standards

This comparison appendix, which was prepared as at October 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 18.

The International Accounting Standard comparable with HKAS 18 is IAS 18 *Revenue*.

There are no major textual differences between HKAS 18 and IAS 18.

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 the rubric the reference to 'paragraphs 1–38' is amended to 'paragraphs 1–39'. Paragraph 6(d) and the last sentence of paragraph 11 are amended and paragraph 39 is added as follows:

6 This Standard does not deal with revenue arising from:

...

(d) changes in the fair value of financial assets and financial liabilities or their disposal (see HKFRS 9 *Financial Instruments* and HKAS 39 *Financial Instruments: Recognition and Measurement*);

11 In most cases … The difference between the fair value and the nominal amount of the consideration is recognised as interest revenue in accordance with paragraphs 29 and 30 and in accordance with HKAS 39 and HKFRS 9.

39 HKFRS 9, issued in November 2009, amended paragraphs 6(d) and 11. An entity shall apply those amendments when it applies HKFRS 9.

In the appendix to IAS 18, examples 5 and 14(a) are amended as follows:

5 ...

For a sale and repurchase agreement on an asset other than a financial asset, the terms of the agreement need to be analysed to ascertain whether, in substance, the seller has transferred the risks and rewards of ownership to the buyer and hence revenue is recognised. When the seller has retained the risks and rewards of ownership, even though legal title has been transferred, the transaction is a financing arrangement and does not give rise to revenue. For a sale and repurchase agreement on a financial asset, IFRS 9 *Financial Instruments* and IAS 39 *Financial Instruments: Recognition and Measurement* apply ~~applies~~.

14 *Financial service fees*

...

(a) *Fees that are an integral part of the effective interest rate of a financial instrument.*

...

(i) Origination fees received by the entity relating to the creation or acquisition of a financial asset other than one that under IFRS 9 ~~IAS 39~~ is measured ~~classified~~ ~~as a financial asset '~~at fair value through profit or loss~~'~~.

Such fees may include compensation for activities such as evaluating the borrower's financial condition, evaluating and recording guarantees, collateral and other security arrangements, negotiating the terms of the instrument, preparing and processing documents and closing the transaction. These fees are an integral part of generating an involvement with the resulting financial instrument and, together with the related transaction costs [footnote omitted] (as defined in IAS 39), are deferred and recognised as an adjustment to the effective interest rate.

...

HKAS 20

~~Issued December 2004~~Revised March 2010

Hong Kong Accounting Standard 20

Accounting for Government Grants and Disclosure of Government Assistance

CPA

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

CONTENTS

paragraphs

HONG KONG ACCOUNTING STANDARD 20
ACCOUNTING FOR GOVERNMENT GRANTS AND DISCLOSURE OF GOVERNMENT ASSISTANCE

Hong Kong Accounting Standard 20 *Accounting for Governments Grants and Disclosure of Government Assistance* (HKAS 20) is set out in paragraphs 1-~~41A~~43. All the paragraphs have equal authority. HKAS 20 ~~shall~~should be read in the context of~~ its objective~~ the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Statements* and the *Framework for the Preparation and Presentation of Financial Statements*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Hong Kong Accounting Standard 20

Accounting for Government Grants and Disclosure of Government Assistance~~+~~

Scope

1 **This Standard shall be applied in accounting for, and in the disclosure of, government grants and in the disclosure of other forms of government assistance.**

2 This Standard does not deal with:

(a) the special problems arising in accounting for government grants in financial statements reflecting the effects of changing prices or in supplementary information of a similar nature~~;~~.

(b) government assistance that is provided for an entity in the form of benefits that are available in determining taxable ~~income~~ profit or tax loss, or are determined or limited on the basis of income tax liability. Examples of such benefits are ~~(such as~~ income tax holidays, investment tax credits, accelerated depreciation allowances and reduced income tax rates~~);~~.

(c) government participation in the ownership of the entity~~;~~.

(d) government grants covered by HKAS 41 *Agriculture.*

Definitions

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

Government **refers to government, government agencies and similar bodies whether local, national or international.**

Government assistance **is action by government designed to provide an economic benefit specific to an entity or range of entities qualifying under certain criteria. Government assistance for the purpose of this Standard does not include benefits provided only indirectly through action affecting general trading conditions, such as the provision of infrastructure in development areas or the imposition of trading constraints on competitors.**

Government grants **are assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the entity.***

Grants related to assets **are government grants whose primary condition is that an entity qualifying for them ~~shall~~ should purchase, construct or otherwise acquire long-term assets. Subsidiary conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.**

Grants related to income **are government grants other than those related to assets.**

+ As part of *Improvements to HKFRSs* issued in October 2008 the HKICPA amended terminology used in this Standard to be consistent with other HKFRSs as follows: (a) ‘taxable income’ was amended to ‘taxable profit or tax loss’, (b) ‘recognised as income/expense’ was amended to ‘recognised in profit or loss’, (c) ‘credited directly to shareholders’ interests/equity’ was amended to ‘recognised outside profit or loss’, and (d)‘revision to an accounting estimate’ was amended to ‘change in accounting estimate’.

* See also HK(SIC)-Int 10 *Government Assistance – No Specific Relation to Operating Activities.*

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

Fair value **is the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction.**

4 Government assistance takes many forms varying both in the nature of the assistance given and in the conditions which are usually attached to it. The purpose of the assistance may be to encourage an entity to embark on a course of action which it would not normally have taken if the assistance was not provided.

5 The receipt of government assistance by an entity may be significant for the preparation of the financial statements for two reasons. Firstly, if resources have been transferred, an appropriate method of accounting for the transfer must be found. Secondly, it is desirable to give an indication of the extent to which the entity has benefited from such assistance during the reporting period. This facilitates comparison of an entity's financial statements with those of prior periods and with those of other entities.

6 Government grants are sometimes called by other names such as subsidies, subventions, or premiums.

Government grants

7 Government grants, including non-monetary grants at fair value, shall not be recognised until there is reasonable assurance that:

(a) the entity will comply with the conditions attaching to them; and

(b) the grants will be received.

8 A government grant is not recognised until there is reasonable assurance that the entity will comply with the conditions attaching to it, and that the grant will be received. Receipt of a grant does not of itself provide conclusive evidence that the conditions attaching to the grant have been or will be fulfilled.

9 The manner in which a grant is received does not affect the accounting method to be adopted in regard to the grant. Thus a grant is accounted for in the same manner whether it is received in cash or as a reduction of a liability to the government.

10 A forgivable loan from government is treated as a government grant when there is reasonable assurance that the entity will meet the terms for forgiveness of the loan.

10A The benefit of a government loan at a below-market rate of interest is treated as a government grant. The loan shall be recognised and measured in accordance with HKAS 39 *Financial Instruments: Recognition and Measurement*. The benefit of the below-market rate of interest shall be measured as the difference between the initial carrying value of the loan determined in accordance with HKAS 39 and the proceeds received. The benefit is accounted for in accordance with this Standard. The entity shall consider the conditions and obligations that have been, or must be, met when identifying the costs for which the benefit of the loan is intended to compensate.

11 Once a government grant is recognised, any related contingent liability or contingent asset is treated in accordance with HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

12 Government grants shall be recognised ~~as income~~ in profit or loss on a systematic basis over the periods ~~necessary to match them with~~ in which the entity recognises as expenses the related costs for which ~~they~~ the grants are intended to compensate.~~, on a systematic basis. They shall not be credited directly to shareholders' interests.~~

13 There are two broad approaches ~~may be found~~ to the accounting ~~treatment of~~ for government grants: the capital approach, under which a grant is recognised outside profit or loss ~~credited directly to shareholders' interests~~, and the income approach, under which a grant is ~~taken to income~~ recognised in profit or loss over one or more periods.

14 Those in support of the capital approach argue as follows:

(a) government grants are a financing device and should be dealt with as such in the ~~balance sheet~~ statement of financial position rather than be ~~passed through~~ recognised in ~~the income statement~~ profit or loss to offset the items of expense ~~which~~ that they finance. ~~Since~~ Because no repayment is expected, ~~they~~ such grants should be ~~credited directly to shareholders' interests~~ recognised outside profit or loss~~; and~~.

(b) it is inappropriate to recognise government grants in ~~the income statement~~ profit or loss, ~~since~~ because they are not earned but represent an incentive provided by government without related costs.

15 Arguments in support of the income approach are as follows:

(a) ~~since~~ because government grants are receipts from a source other than shareholders, they should not be ~~credited directly to shareholders' interests~~ recognised directly in equity but should be recognised ~~as income~~ in profit or loss in appropriate periods~~;~~.

(b) government grants are rarely gratuitous. The entity earns them through compliance with their conditions and meeting the envisaged obligations. They should therefore be recognised ~~as income~~ in profit or loss over the periods in which the entity recognises as expenses the related ~~and matched with the associated~~ costs for which the grant is intended to compensate~~; and~~.

(c) ~~as~~ because income and other taxes are ~~charges against income~~ expenses, it is logical to deal also with government grants, which are an extension of fiscal policies, in ~~the income statement~~ profit or loss.

16 It is fundamental to the income approach that government grants should be recognised ~~as income~~ in profit or loss on a systematic ~~and rational~~ basis over the periods in which the entity recognises as expenses the ~~necessary to match them with the~~ related costs for which the grant is intended to compensate. ~~Income r~~Recognition of government grants in profit or loss on a receipts basis is not in accordance with the accrual accounting assumption (see HKAS 1 *Presentation of Financial Statements*) and would ~~only~~ be acceptable only if no basis existed for allocating a grant to periods other than the one in which it was received.

17 In most cases the periods over which an entity recognises the costs or expenses related to a government grant are readily ascertainable. ~~and t~~Thus grants in recognition of specific expenses are recognised ~~as income~~ in profit or loss in the same period as the relevant expenses. Similarly, grants related to depreciable assets are usually recognised ~~as income~~ in profit or loss over the periods and in the proportions in which depreciation expense on those assets is ~~charged~~recognised.

18 Grants related to non-depreciable assets may also require the fulfilment of certain obligations and would then be recognised ~~as income~~ in profit or loss over the periods that ~~which~~ bear the cost of meeting the obligations. As an example, a grant of land may be conditional upon the erection of a building on the site and it may be appropriate to recognise ~~it~~ the grant ~~as income~~ in profit or loss over the life of the building.

19 Grants are sometimes received as part of a package of financial or fiscal aids to which a number of conditions are attached. In such cases, care is needed in identifying the conditions giving rise to costs and expenses which determine the periods over which the grant will be earned. It may be appropriate to allocate part of a grant on one basis and part on another.

20 A government grant that becomes receivable as compensation for expenses or losses already incurred or for the purpose of giving immediate financial support to the entity with no future related costs shall be recognised ~~as income~~ in profit or loss of the period in which it becomes receivable.

21 In some circumstances, a government grant may be awarded for the purpose of giving immediate financial support to an entity rather than as an incentive to undertake specific expenditures. Such grants may be confined to ~~an individual~~ a particular entity and may not be available to a whole class of beneficiaries. These circumstances may warrant recognising a grant ~~as income~~ in profit or loss of ~~in~~ the period in which the entity qualifies to receive it, with disclosure to ensure that its effect is clearly understood.

22 A government grant may become receivable by an entity as compensation for expenses or losses incurred in a previous period. Such a grant is recognised ~~as income~~ in profit or loss of the period in which it becomes receivable, with disclosure to ensure that its effect is clearly understood.

Non-monetary government grants

23 A government grant may take the form of a transfer of a non-monetary asset, such as land or other resources, for the use of the entity. In these circumstances it is usual to assess the fair value of the non-monetary asset and to account for both grant and asset at that fair value. An alternative course that is sometimes followed is to record both asset and grant at a nominal amount.

Presentation of grants related to assets

24 Government grants related to assets, including non-monetary grants at fair value, shall be presented in the ~~balance sheet~~ statement of financial position either by setting up the grant as deferred income or by deducting the grant in arriving at the carrying amount of the asset.

25 Two methods of presentation in financial statements of grants (or the appropriate portions of grants) related to assets are regarded as acceptable alternatives.

26 One method ~~sets up~~ recognises the grant as deferred income that ~~which~~ is recognised ~~as income~~ in profit or loss on a systematic ~~and rational~~ basis over the useful life of the asset.

27 The other method deducts the grant in ~~arriving at~~ calculating the carrying amount of the asset. The grant is recognised ~~as income~~ in profit or loss over the life of a depreciable asset ~~by way of~~ as a reduced depreciation ~~charge~~ expense.

28 The purchase of assets and the receipt of related grants can cause major movements in the cash flow of an entity. For this reason and in order to show the gross investment in assets, such movements are often disclosed as separate items in the statement of cash flows ~~statement~~ regardless of whether or not the grant is deducted from the related asset ~~for the purpose of balance sheet presentation~~ for presentation purposes in the statement of financial position.

Presentation of grants related to income

29 Grants related to income are sometimes presented as a credit in the ~~income statement~~ statement of comprehensive income, either separately or under a general heading such as "Other income"; alternatively, they are deducted in reporting the related expense.

29A If an entity presents the components of profit or loss in a separate income statement as described in paragraph 81 of HKAS 1 (as revised in 2007), it presents grants related to income as required in paragraph 29 in that separate statement.

30 Supporters of the first method claim that it is inappropriate to net income and expense items and that separation of the grant from the expense facilitates comparison with other expenses not affected by a grant. For the second method it is argued that the expenses might well not have been incurred by the entity if the grant had not been available and presentation of the expense without offsetting the grant may therefore be misleading.

31 Both methods are regarded as acceptable for the presentation of grants related to income. Disclosure of the grant may be necessary for a proper understanding of the financial statements. Disclosure of the effect of the grants on any item of income or expense which is required to be separately disclosed is usually appropriate.

Repayment of government grants

32 **A government grant that becomes repayable shall be accounted for as a ~~revision to an~~ change in accounting estimate (see HKAS 8** *Accounting Policies, Changes in Accounting Estimates and Errors***). Repayment of a grant related to income shall be applied first against any unamortised deferred credit ~~set up~~ recognised in respect of the grant. To the extent that the repayment exceeds any such deferred credit, or when ~~where~~ no deferred credit exists, the repayment shall be recognised immediately ~~as an expense~~ in profit or loss. Repayment of a grant related to an asset shall be ~~recorded~~ recognised by increasing the carrying amount of the asset or reducing the deferred income balance by the amount repayable. The cumulative additional depreciation that would have been recognised in profit or loss to date ~~as an expense~~ in the absence of the grant shall be recognised immediately ~~as an expense~~ in profit or loss.**

33 Circumstances giving rise to repayment of a grant related to an asset may require consideration to be given to the possible impairment of the new carrying amount of the asset.

Government assistance

34 Excluded from the definition of government grants in paragraph 3 are certain forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the entity.

35 Examples of assistance that cannot reasonably have a value placed upon them are free technical or marketing advice and the provision of guarantees. An example of assistance that cannot be distinguished from the normal trading transactions of the entity is a government procurement policy that is responsible for a portion of the entity's sales. The existence of the benefit might be unquestioned but any attempt to segregate the trading activities from government assistance could well be arbitrary.

36 The significance of the benefit in the above examples may be such that disclosure of the nature, extent and duration of the assistance is necessary in order that the financial statements may not be misleading.

37 [Deleted]~~Loans at nil or low interest rates are a form of government assistance, but the benefit is not quantified by the imputation of interest.~~

38 In this Standard, government assistance does not include the provision of infrastructure by improvement to the general transport and communication network and the supply of improved facilities such as irrigation or water reticulation which is available on an ongoing indeterminate basis for the benefit of an entire local community.

Disclosure

39 **The following matters shall be disclosed:**

(a) **the accounting policy adopted for government grants, including the methods of presentation adopted in the financial statements;**

(b) **the nature and extent of government grants recognised in the financial statements and an indication of other forms of government assistance from which the entity has directly benefited; and**

(c) **unfulfilled conditions and other contingencies attaching to government assistance that has been recognised.**

Transitional provisions

40 [Not used]

Effective date

41 This Standard becomes operative for financial statements covering periods beginning on or after 1 January 2005. Earlier application is encouraged. If an entity applies this Standard for a period beginning before 1 January 2005, it shall disclose that fact and apply Hong Kong (SIC) Interpretation (HK(SIC)-Int) 10 *Government Assistance – No Specific Relation to Operating Activities* **at the same time.**

41~~A~~a This Standard supersedes SSAP 35 *Accounting for Government Grants and Disclosure of Government Assistance* (issued in March 2002).

42 HKAS 1 (as revised in 2007) amended the terminology used throughout HKFRSs. In addition it added paragraph 29A. An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. If an entity applies HKAS 1 (revised 2007) for an earlier period, the amendments shall be applied for that earlier period.

43 Paragraph 37 was deleted and paragraph 10A added by *Improvements to HKFRSs* issued in October 2008. An entity shall apply those amendments prospectively to government loans received in periods beginning on or after 1 January 2009. Earlier application is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact.

Appendix

Comparison with International Accounting Standards

This comparison appendix, which was prepared as at December 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 20.

The International Accounting Standard comparable with HKAS 20 is IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance.*

There are no major textual differences between HKAS 20 and IAS 20.

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

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

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

BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in amending IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* as part of *Improvements to IFRSs* issued in May 2008.

BC2 IAS 20 was developed by the International Accounting Standards Committee in 1983 and did not include a Basis for Conclusions. This Basis refers to the insertion of paragraphs 10A and 43 and the deletion of paragraph 37. Those changes require government loans with below-market rates of interest to be recognised and measured in accordance with IAS 39 *Financial Instruments: Recognition and Measurement* and the benefit of the reduced interest to be accounted for using IAS 20.

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

BC3 The Board identified an apparent inconsistency between the guidance in IAS 20 and IAS 39. It related to the accounting for loans with a below-market rate of interest received from a government. IAS 20 stated that no interest should be imputed for such a loan, whereas IAS 39 required all loans to be recognised at fair value, thus requiring interest to be imputed to loans with a below-market rate of interest.

BC4 The Board decided to remove this inconsistency. It believed that the imputation of interest provides more relevant information to a user of the financial statements. Accordingly the Board amended IAS 20 to require that loans received from a government that have a below-market rate of interest should be recognised and measured in accordance with IAS 39. The benefit of the government loan is measured at the inception of the loan as the difference between the cash received and the amount at which the loan is initially recognised in the statement of financial position. This benefit is accounted for in accordance with IAS 20.

BC5 Noting that applying IAS 39 to loans retrospectively may require entities to measure the fair value of loans at a past date, the Board decided that the amendment should be applied prospectively to new loans.

HKAS 23 (Revised)
Revised ~~October 2008~~ March 2010

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

Hong Kong Accounting Standard 23 (Revised)

Borrowing Costs

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

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Hong Kong Accounting Standard 23 *Borrowing Costs* (HKAS 23) is set out in paragraphs 1 – 30. All of the paragraphs have equal authority. HKAS 23 should be read in the context of its core principle and the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Framework for the Preparation and Presentation of Financial Statements*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

This revised Standard was issued in June 2007. It supersedes HKAS 23, issued in 2004.

Hong Kong Accounting Standard 23
Borrowing Costs

Core principle

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

Scope

2 **An entity shall apply this Standard in accounting for borrowing costs.**

3 The Standard does not deal with the actual or imputed cost of equity, including preferred capital not classified as a liability.

4 An entity is not required to apply the Standard to borrowing costs directly attributable to the acquisition, construction or production of:

(a) a qualifying asset measured at fair value, for example a biological asset; or

(b) inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis.

Definitions

5 **This Standard uses the following terms with the meanings specified:**

Borrowing costs **are interest and other costs that an entity incurs in connection with the borrowing of funds.**

A *qualifying asset* **is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.**

6 Borrowing costs may include:

(a) interest expense calculated using the effective interest method as described in HKAS 39 *Financial Instruments: Recognition and Measurement* ~~interest on bank overdrafts and short-term and long-term borrowings~~;

(b) [deleted] ~~amortisation of discounts or premiums relating to borrowings;~~

(c) [deleted] ~~amortisation of ancillary costs incurred in connection with the arrangement of borrowings;~~

(d) finance charges in respect of finance leases recognised in accordance with HKAS 17 *Leases*; and

(e) exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

7 Depending on the circumstances, any of the following may be qualifying assets:

(a) inventories

(b) manufacturing plants

(c) power generation facilities

(d) intangible assets

(e) investment properties.

Financial assets, and inventories that are manufactured, or otherwise produced, over a short period of time, are not qualifying assets. Assets that are ready for their intended use or sale when acquired are not qualifying assets.

Recognition

8 An entity shall capitalise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset. An entity shall recognise other borrowing costs as an expense in the period in which it incurs them.

9 Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are included in the cost of that asset. Such borrowing costs are capitalised as part of the cost of the asset when it is probable that they will result in future economic benefits to the entity and the costs can be measured reliably. When an entity applies HKAS 29 *Financial Reporting in Hyperinflationary Economies*, it recognises as an expense the part of borrowing costs that compensates for inflation during the same period in accordance with paragraph 21 of that Standard.

Borrowing costs eligible for capitalisation

10 The borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. When an entity borrows funds specifically for the purpose of obtaining a particular qualifying asset, the borrowing costs that directly relate to that qualifying asset can be readily identified.

11 It may be difficult to identify a direct relationship between particular borrowings and a qualifying asset and to determine the borrowings that could otherwise have been avoided. Such a difficulty occurs, for example, when the financing activity of an entity is co-ordinated centrally. Difficulties also arise when a group uses a range of debt instruments to borrow funds at varying rates of interest, and lends those funds on various bases to other entities in the group. Other complications arise through the use of loans denominated in or linked to foreign currencies, when the group operates in highly inflationary economies, and from fluctuations in exchange rates. As a result, the determination of the amount of borrowing costs that are directly attributable to the acquisition of a qualifying asset is difficult and the exercise of judgement is required.

12 To the extent that an entity borrows funds specifically for the purpose of obtaining a qualifying asset, the entity shall determine the amount of borrowing costs eligible for capitalisation as the actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowings.

13 The financing arrangements for a qualifying asset may result in an entity obtaining borrowed funds and incurring associated borrowing costs before some or all of the funds are used for expenditures on the qualifying asset. In such circumstances, the funds are often temporarily invested pending their expenditure on the qualifying asset. In determining the amount of borrowing costs eligible for capitalisation during a period, any investment income earned on such funds is deducted from the borrowing costs incurred.

14 To the extent that an entity borrows funds generally and uses them for the purpose of obtaining a qualifying asset, the entity shall determine the amount of borrowing costs eligible for capitalisation by applying a capitalisation rate to the expenditures on that asset. The capitalisation rate shall be the weighted average of the borrowing costs applicable to the borrowings of the entity that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. The amount of borrowing costs that an entity capitalises during a period shall not exceed the amount of borrowing costs it incurred during that period.

15 In some circumstances, it is appropriate to include all borrowings of the parent and its subsidiaries when computing a weighted average of the borrowing costs; in other circumstances, it is appropriate for each subsidiary to use a weighted average of the borrowing costs applicable to its own borrowings.

Excess of the carrying amount of the qualifying asset over recoverable amount

16 When the carrying amount or the expected ultimate cost of the qualifying asset exceeds its recoverable amount or net realisable value, the carrying amount is written down or written off in accordance with the requirements of other Standards. In certain circumstances, the amount of the write-down or write-off is written back in accordance with those other Standards.

Commencement of capitalisation

17 An entity shall begin capitalising borrowing costs as part of the cost of a qualifying asset on the commencement date. The commencement date for capitalisation is the date when the entity first meets all of the following conditions:

(a) it incurs expenditures for the asset;

(b) it incurs borrowing costs; and

(c) it undertakes activities that are necessary to prepare the asset for its intended use or sale.

18 Expenditures on a qualifying asset include only those expenditures that have resulted in payments of cash, transfers of other assets or the assumption of interest-bearing liabilities. Expenditures are reduced by any progress payments received and grants received in connection with the asset (see HKAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*). The average carrying amount of the asset during a period, including borrowing costs previously capitalised, is normally a reasonable approximation of the expenditures to which the capitalisation rate is applied in that period.

19 The activities necessary to prepare the asset for its intended use or sale encompass more than the physical construction of the asset. They include technical and administrative work prior to the commencement of physical construction, such as the activities associated with obtaining permits prior to the commencement of the physical construction. However, such activities exclude the holding of an asset when no production or development that changes the asset's condition is taking place. For example, borrowing costs incurred while land is under development are capitalised during the period in which activities related to the development are being undertaken. However, borrowing costs incurred while land acquired for building purposes is held without any associated development activity do not qualify for capitalisation.

Suspension of capitalisation

20 An entity shall suspend capitalisation of borrowing costs during extended periods in which it suspends active development of a qualifying asset.

21 An entity may incur borrowing costs during an extended period in which it suspends the activities necessary to prepare an asset for its intended use or sale. Such costs are costs of holding partially completed assets and do not qualify for capitalisation. However, an entity does not normally suspend capitalising borrowing costs during a period when it carries out substantial technical and administrative work. An entity also does not suspend capitalising borrowing costs when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale. For example, capitalisation continues during the extended period that high water levels delay construction of a bridge, if such high water levels are common during the construction period in the geographical region involved.

Cessation of capitalisation

22 An entity shall cease capitalising borrowing costs when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

23 An asset is normally ready for its intended use or sale when the physical construction of the asset is complete even though routine administrative work might still continue. If minor modifications, such as the decoration of a property to the purchaser's or user's specification, are all that are outstanding, this indicates that substantially all the activities are complete.

24 When an entity completes the construction of a qualifying asset in parts and each part is capable of being used while construction continues on other parts, the entity shall cease capitalising borrowing costs when it completes substantially all the activities necessary to prepare that part for its intended use or sale.

25 A business park comprising several buildings, each of which can be used individually, is an example of a qualifying asset for which each part is capable of being usable while construction continues on other parts. An example of a qualifying asset that needs to be complete before any part can be used is an industrial plant involving several processes which are carried out in sequence at different parts of the plant within the same site, such as a steel mill.

Disclosure

26 An entity shall disclose:

(a) the amount of borrowing costs capitalised during the period; and

(b) the capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation.

Transitional provisions

27 When application of this Standard constitutes a change in accounting policy, an entity shall apply the Standard to borrowing costs relating to qualifying assets for which the commencement date for capitalisation is on or after the effective date.

28 However, an entity may designate any date before the effective date and apply the Standard to borrowing costs relating to all qualifying assets for which the commencement date for capitalisation is on or after that date.

Effective date

29 An entity shall apply the Standard for annual periods beginning on or after 1 January 2009. Earlier application is permitted. If an entity applies the Standard from a date before 1 January 2009, it shall disclose that fact.

29A Paragraph 6 was amended by *Improvements to HKFRSs* issued in October 2008. An entity shall apply that amendment for annual periods beginning on or after 1 January 2009. Earlier application is permitted. If an entity applies the amendment for an earlier period it shall disclose that fact.

Withdrawal of HKAS 23 (issued 2004)

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

Appendix
Amendments to other pronouncements

The amendments in this appendix shall be applied for annual periods beginning on or after 1 January 2009. If an entity applies this Standard for an earlier period, the amendments in this appendix 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.

Basis for Conclusions on IAS 23 *Borrowing Costs*

This Basis for Conclusions accompanies, but is not part of, IAS 23.

HKAS 23 is based on IAS 23 *Borrowing Costs*. In approving HKAS 23, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IASB's Basis for Conclusions on IAS 23. Accordingly, there are no significant differences between HKAS 23 and IAS 23. The IASB's Basis for Conclusions is reproduced below. The paragraph numbers of IAS 23 referred to below generally correspond with those in HKAS 23.

Introduction

BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching its conclusions on revising IAS 23 *Borrowing Costs* in 2007. Individual Board members gave greater weight to some factors than to others.

BC2 The revisions to IAS 23 result from the Board's Short-term Convergence project. The project is being conducted jointly with the United States standard-setter, the Financial Accounting Standards Board (FASB). The objective of the project is to reduce differences between IFRSs and US generally accepted accounting principles (GAAP) that are capable of resolution in a relatively short time and can be addressed outside major projects. The revisions to IAS 23 are principally concerned with the elimination of one of the two treatments that exist for borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset. The application of only one method will enhance comparability. For the reasons set out below, the Board decided to eliminate the option of immediate recognition of such borrowing costs as an expense. It believes this will result in an improvement in financial reporting as well as achieving convergence in principle with US GAAP.

BC3 The Board considered whether to seek convergence on the detailed requirements for the capitalisation of borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset. However, the Board noted statements by the US Securities and Exchange Commission (SEC) and the European Commission that the IASB and FASB should focus their short-term convergence effort on eliminating major differences of principle between IFRSs and US GAAP. For their purposes, convergence on the detailed aspects of accounting treatments is not necessary. The Board further noted that both IAS 23 and SFAS 34 *Capitalization of Interest Cost* were developed some years ago. Consequently, neither set of specific provisions may be regarded as being of a clearly higher quality than the other. Therefore, the Board concluded that it should not spend time and resources considering aspects of IAS 23 beyond the choice between capitalisation and immediate recognition as an expense. This Basis for Conclusions does not, therefore, discuss aspects of IAS 23 that the Board did not reconsider. Paragraphs BC19 – BC26 analyse the differences between IAS 23 and SFAS 34.

Amendments to the scope

Assets measured at fair value

BC4 The exposure draft of proposed amendments to IAS 23 proposed excluding from the scope of IAS 23 assets measured at fair value. Some respondents objected to the proposal, interpreting the scope exclusion as limiting capitalisation of borrowing costs to qualifying assets measured at cost. The Board confirmed its decision not to require capitalisation of borrowing costs relating to assets that are measured at fair value. The measurement of such assets will not be affected by the amount of borrowing costs incurred during their construction or production period. Therefore, requirements on how to account for borrowing costs are unnecessary, as paragraphs B61 and B62 of the Basis for Conclusions on IAS 41 *Agriculture* explain. But the Board noted that the exclusion of assets measured at fair value from the requirements of IAS 23 does not prohibit an entity from presenting items in profit or loss as if borrowing costs had been capitalised on such assets before measuring them at fair value.

Inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis

BC5 The US standard, SFAS 34, requires an entity to recognise as an expense interest costs for inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis because, in the FASB's view, the informational benefit from capitalising interest costs does not justify the cost. The exposure draft did not make an exception for borrowing costs relating to such inventories. The exposure draft, therefore, proposed to require an entity to capitalise borrowing costs relating to inventories that are manufactured in large quantities on a repetitive basis and take a substantial period of time to get ready for sale. Respondents argued that capitalising those borrowing costs would create a significant administrative burden, would not be informative to users and would create a reconciling item between IFRSs and US GAAP.

BC6 The Board decided to exclude from the scope of IAS 23 inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis, even if they take a substantial period of time to get ready for sale. The Board acknowledges the difficulty in both allocating borrowing costs to inventories that are manufactured in large quantities on a repetitive basis and monitoring those borrowing costs until the inventory is sold. It concluded that it should not require an entity to capitalise borrowing costs on such inventories because the costs of capitalisation are likely to exceed the potential benefits.

Elimination of the option of immediate recognition as an expense of borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset

BC7 The previous version of IAS 23 permitted two treatments for accounting for borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset. They could be capitalised or, alternatively, recognised immediately as an expense. SFAS 34 requires the capitalisation of such borrowing costs.

BC8 The Board proposed in the exposure draft to eliminate the option of immediate recognition as an expense. Many respondents disagreed with the Board's proposal in the exposure draft, arguing that:

(a) borrowing costs should not be the subject of a short-term convergence project.

(b) the Board had not explored in sufficient detail the merits of both accounting options.

(c) the proposal did not result in benefits for users of financial statements because:

  (i) it addressed only one of the differences between IAS 23 and SFAS 34.

  (ii) comparability would not be enhanced because the capital structure of an entity could affect the cost of an asset.

  (iii) credit analysts reverse capitalised borrowing costs when calculating coverage ratios.

(d) the costs of implementing the capitalisation model in IAS 23 would be burdensome.

(e) the proposal was not consistent with the Board's approach on other projects (in particular, the second phase of the Business Combinations project).

BC9 The Board concluded that borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are part of the cost of that asset. During the period when an asset is under development, the expenditures for the resources used must be financed. Financing has a cost. The cost of the asset should include all costs necessarily incurred to get the asset ready for its intended use or sale, including the cost incurred in financing the expenditures as a part of the asset's acquisition cost. The Board reasoned that recognising immediately as an expense borrowing costs relating to qualifying assets does not give a faithful representation of the cost of the asset.

BC10 The Board confirmed that the objective of the project is not to achieve full convergence on all aspects of accounting for borrowing costs. Rather, it is to reduce differences between IFRSs and US GAAP that are capable of resolution in a relatively short time. The removal of a choice of accounting treatment and convergence in principle with US GAAP will enhance comparability. The Board acknowledges that capitalising borrowing costs does not achieve comparability between assets that are financed with borrowings and those financed with equity. However, it achieves comparability among all non-equity financed assets, which is an improvement.

BC11 A requirement to recognise immediately as an expense borrowing costs relating to qualifying assets would not enhance comparability. Rather, comparability between assets that are internally developed and those acquired from third parties would be impaired. The purchase price of a completed asset purchased from a third party would include financing costs incurred by the third party during the development phase.

BC12 Respondents to the exposure draft argued that requiring the capitalisation of borrowing costs is not consistent with the Board's proposal in the second phase of the Business Combinations project to require an entity to treat as an expense acquisition costs relating to a business combination. The Board disagrees with those respondents. Acquisition costs as defined in the context of a business combination are different from borrowing costs incurred in constructing or producing a qualifying asset. Borrowing costs are part of the cost necessarily incurred to get the asset ready for its intended use or sale. Acquisition costs relating to a business combination are costs incurred for services performed to help with the acquisition, such as due diligence and professional fees. They are not costs of assets acquired in a business combination.

BC13 The Board concluded that the additional benefits in terms of higher comparability, improvements in financial reporting and achieving convergence in principle with US GAAP exceed any additional costs of implementation. Achieving convergence in principle with US GAAP on this topic is a milestone in the Memorandum of Understanding published by the FASB and IASB in February 2006, which is a step towards removal of the requirement imposed on foreign registrants with the SEC to reconcile their financial statements to US GAAP.

BC14 The Board observes that there is an unavoidable cost of complying with any new financial reporting standard. Accordingly, the Board carefully considers the costs and benefits of any new pronouncement. In this case, the Board has not been told that preparers who elected to capitalise borrowing costs under the previous version of IAS 23 found doing so unnecessarily burdensome. In the Board's judgement, any additional costs of capitalising an item of cost of an asset are offset by the advantage of having all entities account for that item in the same way.

Effective date and transition

BC15 Development of a qualifying asset may take a long time. Additionally, some assets currently in use may have undergone and completed their production or construction process many years ago. If the entity has been following the accounting policy of immediately recognising borrowing costs as an expense, the costs of gathering the information required to capitalise them retrospectively and to adjust the carrying amount of the asset may exceed the potential benefits. Hence, the Board decided to require prospective application, which was supported by respondents to the exposure draft.

BC16 The Board noted that the revisions would result in information that is more comparable between entities. On that basis, if an entity wished to apply the revised Standard from any date before the effective date, users of the entity's financial statements would receive more useful and comparable information than previously.

BC17 Therefore, an entity is permitted to apply the revised Standard from any designated date before the effective date. However, if an entity applies the Standard from such an earlier date, it should apply the Standard to all qualifying assets for which the commencement date for capitalisation is on or after that designated date.

BC18 The Board recognises that the Standard may require an entity that reconciles its IFRS financial statements to US GAAP to maintain two sets of capitalisation information—one set that complies with the requirements of IAS 23 and one that complies with the requirements of SFAS 34. The Board wishes to avoid imposing on such entities the need to maintain two sets of capitalisation information. Therefore, before the effective date, the Board will consider what actions it might take to avoid this outcome.

Differences between IAS 23 and SFAS 34

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

Definition of borrowing costs

BC20 IAS 23 uses the term "borrowing costs" whereas SFAS 34 uses the term "interest costs". "Borrowing costs" reflects the broader definition in IAS 23, which encompasses interest and other costs, such as ~~:~~

~~(a)~~ exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs~~;~~.[*] and

~~(b) amortisation of ancillary costs incurred in connection with the arrangement of borrowings.~~

[*] In 2007 the Board was advised that some of the components of borrowing costs in paragraph 6 are broadly equivalent to the components of interest expense calculated using the effective interest method in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*. Therefore, the Board amended paragraph 6 to refer to the relevant guidance in IAS 39 when describing the components of borrowing costs.

BC21 EITF Issue No. 99-9 concludes that derivative gains and losses (arising from the effective portion of a derivative instrument that qualifies as a fair value hedge) are part of the capitalised interest cost. IAS 23 does not address such derivative gains and losses.

Definition of a qualifying asset

BC22 The main differences are as follows:

(a) IAS 23 defines a qualifying asset as one that takes a substantial period of time to get ready for its intended use or sale. The SFAS 34 definition does not include the term *substantial*.

(b) IAS 23 excludes from its scope qualifying assets that are measured at fair value. SFAS 34 does not address assets measured at fair value.

(c) SFAS 34 includes as qualifying assets investments in investees accounted for using the equity method, in some circumstances.[+] Such investments are not qualifying assets according to IAS 23.

(d) SFAS 34 does not permit the capitalisation of interest costs on assets acquired with gifts or grants that are restricted by the donor or grantor in some situations. IAS 23 does not address such assets.

Measurement

BC23 When an entity borrows funds specifically for the purpose of obtaining a qualifying asset:

(a) IAS 23 requires an entity to capitalise the actual borrowing costs incurred on that borrowing. SFAS 34 states that an entity may use the rate of that borrowing.

(b) IAS 23 requires an entity to deduct any income earned on the temporary investment of actual borrowings from the amount of borrowing costs to be capitalised. SFAS 34 does not generally permit this deduction, unless particular tax-exempt borrowings are involved.

BC24 SFAS 34 requires an entity to use judgement in determining the capitalisation rate to apply to the expenditures on the asset—an entity selects the borrowings that it considers appropriate to meet the objective of capitalising the interest costs incurred that otherwise could have been avoided. When an entity borrows funds generally and uses them to obtain a qualifying asset, IAS 23 permits some flexibility in determining the capitalisation rate, but requires an entity to use all outstanding borrowings other than those made specifically to obtain a qualifying asset.

Disclosure requirements

BC25 IAS 23 requires disclosure of the capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation. SFAS 34 does not require this disclosure.

BC26 SFAS 34 requires disclosure of the total amount of interest cost incurred during the period, including the amount capitalised and the amount recognised as an expense.

[+] While the investee has activities in progress necessary to commence its planned principal operations provided that the investee's activities include the use of funds to acquire qualifying assets for its operations.

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

Consequential amendments to IAS 11 *Construction Contracts*

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

Dissenting opinions on IAS 23

Dissent of Anthony T Cope, Philippe Danjou and Robert P Garnett

DO1 The Board's decision to require the capitalisation of borrowing costs relating to qualifying assets will cause a significant change in accounting for the many preparers that currently apply the benchmark treatment of recognising borrowing costs as an expense. Messrs Cope, Danjou and Garnett believe that such a change will require the establishment of cumbersome measurement processes and monitoring of capitalised costs over a long period. This is likely to involve considerable accounting work and incremental auditing costs.

DO2 Users of financial statements responding to the exposure draft did not support the change because they saw no informational benefit in a model that capitalises costs, other than the capitalisation of the actual economic cost of capital of the investment. In addition, Messrs Cope, Danjou and Garnett believe that a standard requiring the capitalisation of borrowing costs should discuss more extensively which assets qualify for the purpose of capitalising which borrowing costs.

DO3 As a consequence, Messrs Cope, Danjou and Garnett dissent because, in their view, the costs of this particular change will far outweigh the benefits to users.

DO4 In addition, this requirement to capitalise borrowing costs will achieve only limited convergence with US GAAP—differences will remain that could lead to materially different capitalised amounts. Furthermore, entities that are required to reconcile net income and shareholders' equity to US GAAP already have the option to capitalise borrowing costs and, thus, may recognise amounts that are more comparable to, albeit still potentially materially different from, those recognised in accordance with US GAAP.

DO5 The Memorandum of Understanding published by the FASB and the IASB states that trying to eliminate differences between standards that are both in need of significant improvement is not the best use of resources. Messrs Cope, Danjou and Garnett support the convergence work programme, but only if it results in higher quality standards and improved financial reporting. They are of the opinion that IAS 23 and SFAS 34 are both in need of significant improvement and should not have been addressed as part of short-term convergence.

Appendix
Amendments to Basis for Conclusions on other pronouncements

This appendix contains amendments to the Basis for Conclusions on other pronouncements that are necessary in order to ensure consistency with the revised IAS 23.

* * *

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

Amendments to guidance on other pronouncements

The following amendments to guidance on other pronouncements are necessary in order to ensure consistency with the revised HKAS 23. In the amended paragraphs, new text is underlined and deleted text is struck through.

* * *

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

Table of Concordance

This table shows how the contents of the superseded version of HKAS 23 and the revised version of HKAS 23 correspond. Paragraphs are treated as corresponding if they broadly address the same matter even though the guidance may differ.

Superseded HKAS 23 paragraph	Revised HKAS 23 paragraph	Superseded HKAS 23 paragraph	Revised HKAS 23 paragraph
Objective	1	18	15
1	2	19	16
2	None	20	17
3	3	21	18
4	5	22	19
5	6	23	20
6	7	24	21
7	None	25	22
8	None	26	23
9	None	27	24
10	8	28	25
11	None	29	26
12	9	30	None
13	10	31	None
14	11	None	4
15	12	None	27,28
16	13	None	29
17	14	None	30

HKAS 31
Revised ~~October 2008~~March 2010

Effective for annual periods
beginning on or after 1 January 2005

Hong Kong Accounting Standard 31

Interests in Joint Ventures

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

CONTENTS

Hong Kong Accounting Standard 31 *Interests in Joint Ventures* (HKAS 31) is set out in paragraphs 1-59 and Appendices B and C. All the paragraphs have equal authority. HKAS 31 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 31 *Interests in Joint Ventures* (HKAS 31) should be applied for annual periods beginning on or after 1 January 2005. Earlier application is encouraged.

Reasons for issuing HKAS 31

IN2 The objectives of the Hong Kong Institute of Certified Public Accountants (HKICPA) issuing HKAS 31 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 31 the HKICPA did not reconsider the fundamental approach to the accounting for interests in joint ventures contained in HKAS 31.

The main features

IN4 The main features of HKAS 31 are described below.

Scope

IN5 The Standard does not apply to investments that would otherwise be 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 being recognised in profit or loss in the period in which they occur.

IN6 Furthermore, the Standard provides exemptions from application of proportionate consolidation or 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 2(b)), and when the investor, though not such a parent, can satisfy the same type of conditions that exempt such parents (paragraph 2(c)).

Exemptions from applying proportionate consolidation or the equity method

IN7 The Standard does not require proportionate consolidation or the equity method to be applied when an interest in a joint venture 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 interest in a joint venture is not disposed of within twelve months it must be accounted for using proportionate consolidation or the equity method as from the date of acquisition, except in narrowly specified circumstances.*

IN8 The Standard does not permit a venturer that continues to have joint control of an interest in a joint venture not to apply proportionate consolidation or the equity method when the joint venture is operating under severe long-term restrictions that significantly impair its ability to transfer funds to the venturer. Joint control must be lost before proportionate consolidation or the equity method ceases to apply.

* HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* removes this scope exclusion and now eliminates the exemption from applying proportionate consolidation or the equity method when joint control of a joint venture is intended to be temporary. See HKFRS 5 Basis for Conclusions for further discussion.

Separate financial statements

IN9 The requirements for the preparation of an investor's separate financial statements are established by reference to HKAS 27.

Disclosure

IN10 The Standard requires a venturer to disclose the method it uses to recognise its interests in jointly controlled entities (ie proportionate consolidation or the equity method).

Hong Kong Accounting Standard 31
Interests in Joint Ventures

Scope

1 **This Standard shall be applied in accounting for interests in joint ventures and the reporting of joint venture assets, liabilities, income and expenses in the financial statements of venturers and investors, regardless of the structures or forms under which the joint venture activities take place. However, it does not apply to venturers' interests in jointly controlled entities 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. A venturer holding such an interest shall make the disclosures required by paragraphs 55 and 56.

2 **A venturer with an interest in a jointly controlled entity is exempted from paragraphs 30 (proportionate consolidation) and 38 (equity method) when it meets the following conditions:**

(a) the interest 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 *Consolidated and Separate Financial Statements* allowing a parent that also has an interest in a jointly controlled entity not to present consolidated financial statements is applicable; or

(c) all of the following apply:

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

(ii) the venturer'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 venturer 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 venturer produces consolidated financial statements available for public use that comply with Hong Kong Financial Reporting Standards or International Financial Reporting Standards.

Definitions

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

Control **is the power to govern the financial and operating policies of an economic activity so as to obtain benefits from it.**

The *equity method* **is a method of accounting whereby an interest in a jointly controlled entity is initially recorded at cost and adjusted thereafter for the post-acquisition change in the venturer's share of net assets of the jointly controlled entity. The profit or loss of the venturer includes the venturer's share of the profit or loss of the jointly controlled entity.**

An *investor in a joint venture* **is a party to a joint venture and does not have joint control over that joint venture.**

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).**

A *joint venture* **is a contractual arrangement whereby two or more parties undertake an economic activity that is subject to joint control.**

Proportionate consolidation **is a method of accounting whereby a venturer's share of each of the assets, liabilities, income and expenses of a jointly controlled entity is combined line by line with similar items in the venturer's financial statements or reported as separate line items in the venturer's financial statements.**

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.**

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

A *venturer* **is a party to a joint venture and has joint control over that joint venture.**

4 Financial statements in which proportionate consolidation or 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 jointly controlled entity.

5 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 need not be appended to, or accompany, those statements.

6 Entities that are exempted in accordance with paragraph 10 of HKAS 27 from consolidation, paragraph 13(c) of HKAS 28 *Investments in Associates* from applying the equity method or paragraph 2 of this Standard from applying proportionate consolidation or the equity method may present separate financial statements as their only financial statements.

Forms of joint venture

7 Joint ventures take many different forms and structures. This Standard identifies three broad types— jointly controlled operations, jointly controlled assets and jointly controlled entities—that are commonly described as, and meet the definition of, joint ventures. The following characteristics are common to all joint ventures:

(a) two or more venturers are bound by a contractual arrangement; and

(b) the contractual arrangement establishes joint control.

Joint control

8 Joint control may be precluded when an investee is in legal reorganisation or in bankruptcy, or operates under severe long-term restrictions on its ability to transfer funds to the venturer. If joint control is continuing, these events are not enough in themselves to justify not accounting for joint ventures in accordance with this Standard.

Contractual arrangement

9 The existence of a contractual arrangement distinguishes interests that involve joint control from investments in associates in which the investor has significant influence (see HKAS 28). Activities that have no contractual arrangement to establish joint control are not joint ventures for the purposes of this Standard.

10 The contractual arrangement may be evidenced in a number of ways, for example by a contract between the venturers or minutes of discussions between the venturers. In some cases, the arrangement is incorporated in the articles or other by-laws of the joint venture. Whatever its form, the contractual arrangement is usually in writing and deals with such matters as:

(a) the activity, duration and reporting obligations of the joint venture;

(b) the appointment of the board of directors or equivalent governing body of the joint venture and the voting rights of the venturers;

(c) capital contributions by the venturers; and

(d) the sharing by the venturers of the output, income, expenses or results of the joint venture.

11 The contractual arrangement establishes joint control over the joint venture. Such a requirement ensures that no single venturer is in a position to control the activity unilaterally.

12 The contractual arrangement may identify one venturer as the operator or manager of the joint venture. The operator does not control the joint venture but acts within the financial and operating policies that have been agreed by the venturers in accordance with the contractual arrangement and delegated to the operator. If the operator has the power to govern the financial and operating policies of the economic activity, it controls the venture and the venture is a subsidiary of the operator and not a joint venture.

Jointly controlled operations

13 The operation of some joint ventures involves the use of the assets and other resources of the venturers rather than the establishment of a corporation, partnership or other entity, or a financial structure that is separate from the venturers themselves. Each venturer uses its own property, plant and equipment and carries its own inventories. It also incurs its own expenses and liabilities and raises its own finance, which represent its own obligations. The joint venture activities may be carried out by the venturer's employees alongside the venturer's similar activities. The joint venture agreement usually provides a means by which the revenue from the sale of the joint product and any expenses incurred in common are shared among the venturers.

14 An example of a jointly controlled operation is when two or more venturers combine their operations, resources and expertise to manufacture, market and distribute jointly a particular product, such as an aircraft. Different parts of the manufacturing process are carried out by each of the venturers. Each venturer bears its own costs and takes a share of the revenue from the sale of the aircraft, such share being determined in accordance with the contractual arrangement.

15 In respect of its interests in jointly controlled operations, a venturer shall recognise in its financial statements:

(a) the assets that it controls and the liabilities that it incurs; and

(b) the expenses that it incurs and its share of the income that it earns from the sale of goods or services by the joint venture.

16 Because the assets, liabilities, income and expenses are recognised in the financial statements of the venturer, no adjustments or other consolidation procedures are required in respect of these items when the venturer presents consolidated financial statements.

17 Separate accounting records may not be required for the joint venture itself and financial statements may not be prepared for the joint venture. However, the venturers may prepare management accounts so that they may assess the performance of the joint venture.

Jointly controlled assets

18 Some joint ventures involve the joint control, and often the joint ownership, by the venturers of one or more assets contributed to, or acquired for the purpose of, the joint venture and dedicated to the purposes of the joint venture. The assets are used to obtain benefits for the venturers. Each venturer may take a share of the output from the assets and each bears an agreed share of the expenses incurred.

19 These joint ventures do not involve the establishment of a corporation, partnership or other entity, or a financial structure that is separate from the venturers themselves. Each venturer has control over its share of future economic benefits through its share of the jointly controlled asset.

20 Many activities in the oil, gas and mineral extraction industries involve jointly controlled assets. For example, a number of oil production companies may jointly control and operate an oil pipeline. Each venturer uses the pipeline to transport its own product in return for which it bears an agreed proportion of the expenses of operating the pipeline. Another example of a jointly controlled asset is when two entities jointly control a property, each taking a share of the rents received and bearing a share of the expenses.

21 In respect of its interest in jointly controlled assets, a venturer shall recognise in its financial statements:

(a) its share of the jointly controlled assets, classified according to the nature of the assets;

(b) any liabilities that it has incurred;

(c) its share of any liabilities incurred jointly with the other venturers in relation to the joint venture;

(d) any income from the sale or use of its share of the output of the joint venture, together with its share of any expenses incurred by the joint venture; and

(e) any expenses that it has incurred in respect of its interest in the joint venture.

22 In respect of its interest in jointly controlled assets, each venturer includes in its accounting records and recognises in its financial statements:

(a) its share of the jointly controlled assets, classified according to the nature of the assets rather than as an investment. For example, a share of a jointly controlled oil pipeline is classified as property, plant and equipment.

(b) any liabilities that it has incurred, for example those incurred in financing its share of the assets.

(c) its share of any liabilities incurred jointly with other venturers in relation to the joint venture.

(d) any income from the sale or use of its share of the output of the joint venture, together with its share of any expenses incurred by the joint venture.

(e) any expenses that it has incurred in respect of its interest in the joint venture, for example those related to financing the venturer's interest in the assets and selling its share of the output.

Because the assets, liabilities, income and expenses are recognised in the financial statements of the venturer, no adjustments or other consolidation procedures are required in respect of these items when the venturer presents consolidated financial statements.

23 The treatment of jointly controlled assets reflects the substance and economic reality and, usually, the legal form of the joint venture. Separate accounting records for the joint venture itself may be limited to those expenses incurred in common by the venturers and ultimately borne by the venturers according to their agreed shares. Financial statements may not be prepared for the joint venture, although the venturers may prepare management accounts so that they may assess the performance of the joint venture.

Jointly controlled entities

24 A jointly controlled entity is a joint venture that involves the establishment of a corporation, partnership or other entity in which each venturer has an interest. The entity operates in the same way as other entities, except that a contractual arrangement between the venturers establishes joint control over the economic activity of the entity.

25 A jointly controlled entity controls the assets of the joint venture, incurs liabilities and expenses and earns income. It may enter into contracts in its own name and raise finance for the purposes of the joint venture activity. Each venturer is entitled to a share of the profits of the jointly controlled entity, although some jointly controlled entities also involve a sharing of the output of the joint venture.

26 A common example of a jointly controlled entity is when two entities combine their activities in a particular line of business by transferring the relevant assets and liabilities into a jointly controlled entity. Another example is when an entity commences a business in a foreign country in conjunction with the government or other agency in that country, by establishing a separate entity that is jointly controlled by the entity and the government or agency.

27 Many jointly controlled entities are similar in substance to those joint ventures referred to as jointly controlled operations or jointly controlled assets. For example, the venturers may transfer a jointly controlled asset, such as an oil pipeline, into a jointly controlled entity, for tax or other reasons. Similarly, the venturers may contribute into a jointly controlled entity assets that will be operated jointly. Some jointly controlled operations also involve the establishment of a jointly controlled entity to deal with particular aspects of the activity, for example, the design, marketing, distribution or after-sales service of the product.

28 A jointly controlled entity maintains its own accounting records and prepares and presents financial statements in the same way as other entities in conformity with Hong Kong Financial Reporting Standards or International Financial Reporting Standards.

29 Each venturer usually contributes cash or other resources to the jointly controlled entity. These contributions are included in the accounting records of the venturer and recognised in its financial statements as an investment in the jointly controlled entity.

Financial statements of a venturer

Proportionate consolidation

30 A venturer shall recognise its interest in a jointly controlled entity using proportionate consolidation or the alternative method described in paragraph 38. When proportionate consolidation is used, one of the two reporting formats identified below shall be used.

31 A venturer recognises its interest in a jointly controlled entity using one of the two reporting formats for proportionate consolidation irrespective of whether it also has investments in subsidiaries or whether it describes its financial statements as consolidated financial statements.

32 When recognising an interest in a jointly controlled entity, it is essential that a venturer reflects the substance and economic reality of the arrangement, rather than the joint venture's particular structure or form. In a jointly controlled entity, a venturer has control over its share of future economic benefits through its share of the assets and liabilities of the venture. This substance and economic reality are reflected in the consolidated financial statements of the venturer when the venturer recognises its interests in the assets, liabilities, income and expenses of the jointly controlled entity by using one of the two reporting formats for proportionate consolidation described in paragraph 34.

33 The application of proportionate consolidation means that the ~~balance sheet~~statement of financial position of the venturer includes its share of the assets that it controls jointly and its share of the liabilities for which it is jointly responsible. The ~~income~~ statement of comprehensive income of the venturer includes its share of the income and expenses of the jointly controlled entity. Many of the procedures appropriate for the application of proportionate consolidation are similar to the procedures for the consolidation of investments in subsidiaries, which are set out in HKAS 27.

34 Different reporting formats may be used to give effect to proportionate consolidation. The venturer may combine its share of each of the assets, liabilities, income and expenses of the jointly controlled entity with the similar items, line by line, in its financial statements. For example, it may combine its share of the jointly controlled entity's inventory with its inventory and its share of the jointly controlled entity's property, plant and equipment with its property, plant and equipment. Alternatively, the venturer may include separate line items for its share of the assets, liabilities, income and expenses of the jointly controlled entity in its financial statements. For example, it may show its share of a current asset of the jointly controlled entity separately as part of its current assets; it may show its share of the property, plant and equipment of the jointly controlled entity separately as part of its property, plant and equipment. Both these reporting formats result in the reporting of identical amounts of profit or loss and of each major classification of assets, liabilities, income and expenses; both formats are acceptable for the purposes of this Standard.

35 Whichever format is used to give effect to proportionate consolidation, it is inappropriate to offset any assets or liabilities by the deduction of other liabilities or assets or any income or expenses by the deduction of other expenses or income, unless a legal right of set-off exists and the offsetting represents the expectation as to the realisation of the asset or the settlement of the liability.

36 A venturer shall discontinue the use of proportionate consolidation from the date on which it ceases to have joint control over a jointly controlled entity.

37 A venturer discontinues the use of proportionate consolidation from the date on which it ceases to share in the control of a jointly controlled entity. This may happen, for example, when the venturer disposes of its interest or when such external restrictions are placed on the jointly controlled entity that the venturer no longer has joint control.

Equity method

38 As an alternative to proportionate consolidation described in paragraph 30, a venturer shall recognise its interest in a jointly controlled entity using the equity method.

39 A venturer recognises its interest in a jointly controlled entity using the equity method irrespective of whether it also has investments in subsidiaries or whether it describes its financial statements as consolidated financial statements.

40 Some venturers recognise their interests in jointly controlled entities using the equity method, as described in HKAS 28. The use of the equity method is supported by those who argue that it is inappropriate to combine controlled items with jointly controlled items and by those who believe that venturers have significant influence, rather than joint control, in a jointly controlled entity. This Standard does not recommend the use of the equity method because proportionate consolidation better reflects the substance and economic reality of a venturer's interest in a jointly controlled entity, that is to say, control over the venturer's share of the future economic benefits. Nevertheless, this Standard permits the use of the equity method, as an alternative treatment, when recognising interests in jointly controlled entities.

41 A venturer shall discontinue the use of the equity method from the date on which it ceases to have joint control over, or have significant influence in, a jointly controlled entity.

Exceptions to proportionate consolidation and equity method

42 Interests in jointly controlled entities that are classified as held for sale in accordance with HKFRS 5 shall be accounted for in accordance with that HKFRS.

43 When an interest in a jointly controlled entity previously classified as held for sale no longer meets the criteria to be so classified, it shall be accounted for using proportionate consolidation or 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.

44 [Deleted].

45[‡] **When an investor ceases to have joint control over an entity, it shall account for any remaining investment in accordance with HKAS 39 from that date, provided that the former jointly controlled entity does not become a subsidiary or associate. From the date ~~on which~~ when a jointly controlled entity becomes a subsidiary of an investor ~~venturer~~, the ~~venturer~~ investor shall account for its interest in accordance with HKAS 27 and HKFRS 3 *Business Combinations* (as revised in 2008). From the date ~~on which~~when a jointly controlled entity becomes an associate of an investor ~~venturer~~, the ~~venturer~~investor shall account for its interest in accordance with HKAS 28. On the loss of joint control, the investor shall measure at fair value any investment the investor retains in the former jointly controlled entity. 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 jointly controlled entity; and**

(b) **the carrying amount of the investment at the date when joint control is lost.**

45A[†] **When an investment ceases to be a jointly controlled entity and is accounted for in accordance with HKAS 39, the fair value of the investment when it ceases to be a jointly controlled entity shall be regarded as its fair value on initial recognition as a financial asset in accordance with HKAS 39.**

45B[†] If an investor loses joint control of an entity, the investor shall account for all amounts recognised in other comprehensive income in relation to that entity on the same basis as would be required if the jointly controlled entity 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 investor reclassifies the gain or loss from equity to profit or loss (as a reclassification adjustment) when the investor loses joint control of the entity. For example, if a jointly controlled entity has available-for-sale financial assets and the investor loses joint control of the entity, 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 a jointly controlled entity is reduced, but the investment continues to be a jointly controlled entity, the investor shall reclassify to profit or loss only a proportionate amount of the gain or loss previously recognised in other comprehensive income.

Separate financial statements of a venturer

46 **An interest in a jointly controlled entity shall be accounted for in a venturer's separate financial statements in accordance with paragraphs ~~37-42~~38-43 of HKAS 27.**

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

Transactions between a venturer and a joint venture

48 **When a venturer contributes or sells assets to a joint venture, recognition of any portion of a gain or loss from the transaction shall reflect the substance of the transaction. While the assets are retained by the joint venture, and provided the venturer has transferred the significant risks and rewards of ownership, the venturer shall recognise only that portion of the gain or loss that is attributable to the interests of the other venturers.[*] The venturer shall recognise the full amount of any loss when the contribution or sale provides evidence of a reduction in the net realisable value of current assets or an impairment loss.**

49 **When a venturer purchases assets from a joint venture, the venturer shall not recognise its share of the profits of the joint venture from the transaction until it resells the assets to an independent party. A venturer shall recognise its share of the losses resulting from these transactions in the same way as profits except that losses shall be recognised immediately when they represent a reduction in the net realisable value of current assets or an impairment loss.**

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

* See also HKAS-Int-13 *Jointly Controlled Entities — Non-Monetary Contributions by Venturers*.

50 To assess whether a transaction between a venturer and a joint venture provides evidence of impairment of an asset, the venturer determines the recoverable amount of the asset in accordance with HKAS 36 *Impairment of Assets*. In determining value in use, the venturer estimates future cash flows from the asset on the basis of continuing use of the asset and its ultimate disposal by the joint venture.

Reporting interests in joint ventures in the financial statements of an investor

51 An investor in a joint venture that does not have joint control shall account for that investment in accordance with HKAS 39 or, if it has significant influence in the joint venture, in accordance with HKAS 28.

Operators of joint ventures

52 Operators or managers of a joint venture shall account for any fees in accordance with HKAS 18 *Revenue*.

53 One or more venturers may act as the operator or manager of a joint venture. Operators are usually paid a management fee for such duties. The fees are accounted for by the joint venture as an expense.

Disclosure

54 A venturer shall disclose the aggregate amount of the following contingent liabilities, unless the probability of loss is remote, separately from the amount of other contingent liabilities:

(a) any contingent liabilities that the venturer has incurred in relation to its interests in joint ventures and its share in each of the contingent liabilities that have been incurred jointly with other venturers;

(b) its share of the contingent liabilities of the joint ventures themselves for which it is contingently liable; and

(c) those contingent liabilities that arise because the venturer is contingently liable for the liabilities of the other venturers of a joint venture.

55 A venturer shall disclose the aggregate amount of the following commitments in respect of its interests in joint ventures separately from other commitments:

(a) any capital commitments of the venturer in relation to its interests in joint ventures and its share in the capital commitments that have been incurred jointly with other venturers; and

(b) its share of the capital commitments of the joint ventures themselves.

56 A venturer shall disclose a listing and description of interests in significant joint ventures and the proportion of ownership interest held in jointly controlled entities. A venturer that recognises its interests in jointly controlled entities using the line-by-line reporting format for proportionate consolidation or the equity method shall disclose the aggregate amounts of each of current assets, long-term assets, current liabilities, long-term liabilities, income and expenses related to its interests in joint ventures.

57 A venturer shall disclose the method it uses to recognise its interests in jointly controlled entities.

Effective date and transition

58 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.

58~~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.

58A HKAS 27 (as amended in 2008) amended paragraphs 45-46 and added paragraphs 45A and 45B. 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.

58B Paragraph 1 was amended by *Improvements to HKFRSs* issued in October 2008. An entity shall apply that amendment for annual periods beginning on or after 1 January 2009. Earlier application is permitted. If an entity applies the amendment for an earlier period it shall disclose that fact and apply for that earlier period the amendments to paragraph 3 of HKFRS 7 *Financial Instruments: Disclosures*, paragraph 1 of HKAS 28 and paragraph 4 of HKAS 32 *Financial Instruments: Presentation* issued in October 2008. An entity is permitted to apply the amendment prospectively.

Withdrawal of SSAP 21 (revised 2001)

59 This Standard supersedes SSAP 21 *Accounting for Interests in Joint Ventures* (revised in 2001).

Appendix A

Comparison with International Accounting Standards

This comparison appendix, which as prepared as at December 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 31.

The International Accounting Standards comparable with HKAS 31 is IAS 31 *Interests in Joint Ventures.*

There are no major textual differences between HKAS 31 and IAS 31.

Appendix B

Amendments to Other Pronouncements

The amendments in this appendix become effective for annual periods beginning on or after 1 January 2005. If an entity applies this Standard for an earlier period, these amendments become effective 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 amended paragraphs, deleted text is struck through and new text is underlined.

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 Standard does not apply to investments that would otherwise be 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, 45–45B and 51 are amended and paragraph 58C is added as follows:

1 **This Standard shall be applied in accounting for interests in joint ventures and the reporting of joint venture assets, liabilities, income and expenses in the financial statements of venturers and investors, regardless of the structures or forms under which the joint venture activities take place. However, it does not apply to venturers' interests in jointly controlled entities 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~~. A venturer holding such an interest shall make the disclosures required by paragraphs 55 and 56.

45 **When an investor ceases to have joint control over an entity, it shall account for any remaining investment in accordance with HKFRS 9 and HKAS 39 from that date, provided that the former jointly controlled entity does not become a subsidiary or associate. From …**

45A **When an investment ceases to be a jointly controlled entity and is accounted for in accordance with HKFRS 9 and HKAS 39, the fair value of the investment when it ceases to be a jointly controlled entity shall be regarded as its fair value on initial recognition as a financial asset in accordance with HKFRS 9 ~~HKAS 39~~.**

45B If an investor loses joint control of an entity, … For example, if a jointly controlled entity has cumulative exchange differences relating to a foreign operation ~~available-for-sale financial assets~~ and the investor loses joint control of the entity, 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 ...

51 An investor in a joint venture that does not have joint control shall account for that investment in accordance with HKFRS 9 and HKAS 39 or, if it has significant influence in the joint venture, in accordance with HKAS 28.

58C HKFRS 9, issued in November 2009, amended paragraphs 1, 45–45B and 51. An entity shall apply those amendments when it applies HKFRS 9.

Basis for Conclusions on IAS 31 *Interests in Joint Ventures*

This Basis for Conclusions accompanies, but is not part of, IAS 31.

HKAS 31 is based on IAS 31 *Interests in Joint Ventures*. In approving HKAS 31, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IASB's Basis for Conclusions on IAS 31. Accordingly, there are no significant differences between HKAS 31 and IAS 31. The IASB's Basis for Conclusions is reproduced below. The paragraph numbers of IAS 31 referred to below generally correspond with those in HKAS 31.

Introduction

BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching its conclusions on revising IAS 31 *Financial Reporting of Interests in Joint Ventures* 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 27 *Consolidated Financial Statements and Accounting for Investments in Subsidiaries* and IAS 28 *Accounting for Investments in Associates*. 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. Because of the changes that were to be proposed for the revised versions of IAS 27 *Consolidated and Separate Financial Statements* and IAS 28 *Investments in Associates*, the Board also proposed to make some important consequential amendments to IAS 31 *Financial Reporting of Interests in Joint Ventures*.

BC3 Because the Board's intention was not to reconsider the fundamental approach to the accounting for joint ventures established by IAS 31 and to reflect only those changes related to its decisions in the Improvements project, in particular in relation to IAS27 and IAS 28, this Basis for Conclusions does not discuss requirements in IAS 31 that the Board has not reconsidered. However, because of the scale of the amendments to the Standard, the Board believes it will be helpful to users to issue IAS 31 along with the Standards that were previously identified for revision as part of the Improvements project.

Scope exclusion: investments in joint ventures 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*.

BC5 The Board considered whether another approach is appropriate for these investors when they do not have control but have joint control or significant influence over their investees. The Board noted that use of proportionate consolidation or the equity method 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 in these circumstances. As noted in the Basis for Conclusions on IAS 27, the Board 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 and should not be affected by whether management intends to hold an investment in an entity that it controls for the short term. 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.

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 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 31, it should be only when they recognise changes in the fair value of their interests in joint ventures 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 classified as 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 proportionate consolidation or 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 of IAS 28 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 '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 from the scope of IAS 31 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 IAS 31. 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.

Application of proportionate consolidation or the equity method

Temporary joint control

BC13 The Board considered whether to remove the exemption from applying proportionate consolidation or the equity method when joint control in a joint venture 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 proportionate consolidation or the equity method when there is evidence that an interest in a joint venture 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, a joint venture or a subsidiary.*

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

BC14 The Board decided to remove the exemption from applying proportionate consolidation or the equity method for an interest in a joint venture that previously applied when severe long-term restrictions impaired a venture's ability to transfer funds to the venturer. It did so because such circumstances may not preclude the venturer's joint control over the venture. The Board decided that an investor should, when assessing its ability to exercise joint control over an entity, consider restrictions on the transfer of funds from the entity to the investor. In themselves, such restrictions do not preclude the existence of joint control.

Non-coterminous year-ends

BC15 The Exposure Draft of May 2002 proposed to limit to three months any difference between the reporting dates of the venturer and the venture when applying proportionate consolidation or the equity method. Some respondents to that Exposure Draft believed that it could be impracticable for the venturer to prepare financial statements as of the same date when the date of the venturer's and the venture'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.

Loss of joint control over a jointly controlled entity†

BC16 In the second phase of the Board's project on business combinations, the Board observed that the loss of control of an investee and the loss of joint control of an investee are economically similar events; thus they should be accounted for similarly. The loss of joint control represents 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 joint control of an investee. Thus, when an investor loses joint control of an investee, the investor measures any retained investment at fair value. Any difference between the carrying amount of the jointly controlled entity when joint control is lost, the disposal proceeds (if any) and the fair value of any retained interest is recognised in profit or loss.

* 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 proportionate consolidation or the equity method when joint control of a joint venture is intended to be temporary. See IFRS 5 Basis for Conclusions for further discussion.

† This heading and paragraph BC16 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)*

BC17 The Board identified an apparent inconsistency in the disclosure requirements for entities that are eligible and elect to account for their interests in jointly controlled entities at fair value in accordance with IAS 39. Those interests are excluded from the scope of IAS 31 and the 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 interests in jointly controlled entities in accordance with IAS 39 to make the disclosures required by IAS 31 in addition to the disclosures they require.

BC18 The Board decided to remove this inconsistency by deleting from IAS 32 and IFRS 7 the general requirement to make the IAS 31 disclosures, and instead identifying the specific disclosures that should be made. The Board noted that the specific disclosures identified would be relevant because of the significant interest venturers 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.

* This section was added as a consequence of an amendment to IAS 31 by *Improvements to IFRSs* issued in May 2008.

Appendix

Amendments resulting from other Basis for Conclusions

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

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

In paragraph 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 BC17 the first reference to 'IAS 39' is footnoted as follows:

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

Table of Concordance

This table shows how the contents of the superseded SSAP 21 and the current HKAS 31 correspond. Paragraphs are treated as corresponding if they broadly address the same matter even though the guidance may differ.

Superseded SSAP 21 paragraph	**Current HKAS 31 paragraph**
1	1
2	3
3	7
4	9
5	10
6	11
7	12
8	None
9	13
10	14
11	15
12	16
13	17
14	18
15	19
16	20
17	21
18	22
19	23
20	24
21	25
22	26
23	27
24	28
25	29

Superseded SSAP 21 paragraph	**Current HKAS 31 paragraph**
26	38
27	41
28	42
29	None
30	None
31	45
32-33	46
36	48
37	49
38	50
39-41	HKAS-Int-13
42	51
43	52
44	53
45	56
46	None
47	None
48	None
49	None
50	54
51	55
52	None
53	None
54	None
55	58

Superseded SSAP 21 paragraph	Current HKAS 31 paragraph
None	2
None	4-6
None	8
None	30-37

Superseded SSAP 21 paragraph	Current HKAS 31 paragraph
None	39
None	40
None	43,44
None	47
None	57
None	59

HKAS 32
Revised ~~October 2009~~March 2010

Effective for annual periods beginning on or after 1 January 2005

Hong Kong Accounting Standard 32

Financial Instruments: Presentation

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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

Paragraphs 3, 12 and 31 are amended and paragraph 97F is added as follows:

3 The principles in this Standard complement the principles for recognising and measuring financial assets and financial liabilities in HKFRS 9 *Financial Instruments* and HKAS 39 *Financial Instruments: Recognition and Measurement*, and for disclosing information about them in HKFRS 7 *Financial Instruments: Disclosures*.

12 The following terms are defined in paragraph 9 of HKAS 39 and are used in this Standard with the meaning specified in HKAS 39.

- amortised cost of a financial asset or financial liability
- ~~available for sale financial assets~~
- derecognition
- derivative
- effective interest method
- ~~financial asset or~~ financial liability at fair value through profit or loss
- financial guarantee contract
- firm commitment
- forecast transaction
- hedge effectiveness
- hedged item
- hedging instrument
- held for trading
- ~~held to maturity investments~~

- ~~loans and receivables~~
- regular way purchase or sale
- transaction costs.

31 HKFRS 9 and HKAS 39 deal~~s~~ with the measurement of financial assets and financial liabilities respectively. Equity instruments …

97F HKFRS 9, issued in November 2009, amended paragraphs 3, 12, 31, AG2 and AG30. An entity shall apply those amendments when it applies HKFRS 9.

In the Appendix (Application Guidance), paragraphs AG2 and AG30 are amended as follows:

AG2 The Standard does not deal with the recognition or measurement of financial instruments. Requirements about ~~the~~ recognition and measurement are set out in HKFRS 9 for ~~of~~ financial assets and HKAS 39 for financial liabilities ~~are set out in HKAS 39~~.

AG30 Paragraph 28 applies only to issuers of non-derivative compound financial instruments. Paragraph 28 does not deal with compound financial instruments from the perspective of holders. HKFRS 9 deals with the classification and measurement of financial assets that are compound instruments from the holder's perspective. ~~HKAS 39 deals with the separation of embedded derivatives from the perspective of holders of compound financial instruments that contain debt and equity features.~~

Effective for annual periods
beginning on or after 1 January 2005

Basis for Conclusions on
Hong Kong Accounting Standard 32

Financial Instruments:

Presentation

Hong Kong Institute of
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香港會計師公會

Appendix C

Amendments resulting from other Basis for Conclusions

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

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

In paragraph BC2 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 paragraph BC25 the reference to 'IAS 39, paragraph 43' is footnoted as follows:

> * In November 2009 the requirements of IAS 39, paragraph 43 relating to the initial measurement of financial assets were relocated to paragraph 5.1.1 of IFRS 9 *Financial Instruments*.

In paragraphs BC26, BC29 and BC53(a), the references to 'IAS 39' are footnoted as follows:

> * In November 2009 the requirements on measurement of assets within the scope of IAS 39 were moved from IAS 39 to IFRS 9 *Financial Instruments*.

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Illustrative Examples
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paragraphs

IAS 32 *FINANCIAL INSTRUMENTS: PRESENTATION* ILLUSTRATIVE EXAMPLES

IAS 32 *Financial Instruments: Presentation* Illustrative examples

These examples accompany, but are not part of, IAS 32.

Accounting for contracts on equity instruments of an entity

IE1 The following examples* illustrate the application of paragraphs 15 – 27 and IAS 39 to the accounting for contracts on an entity's own equity instruments (other than the financial instruments specified in paragraphs 16A and 16B or paragraphs 16C and 16D).

Example 1: Forward to buy shares

IE2 This example illustrates the journal entries for forward purchase contracts on an entity's own shares that will be settled (a) net in cash, (b) net in shares or (c) by delivering cash in exchange for shares. It also discusses the effect of settlement options (see (d) below). To simplify the illustration, it is assumed that no dividends are paid on the underlying shares (i.e. the 'carry return' is zero) so that the present value of the forward price equals the spot price when the fair value of the forward contract is zero. The fair value of the forward has been computed as the difference between the market share price and the present value of the fixed forward price.

Assumptions:

Contract date	1 February 20X2
Maturity date	31 January 20X3
Market price per share on 1 February 20X2	CU100
Market price per share on 31 December 20X2	CU110
Market price per share on 31 January 20X3	CU106
Fixed forward price to be paid on 31 January 20X3	CU104
Present value of forward price on 1 February 20X2	CU100
Number of shares under forward contract	1,000
Fair value of forward on 1 February 20X2	CU0
Fair value of forward on 31 December 20X2	CU6,300
Fair value of forward on 31 January 20X3	CU2,000

(a) Cash for cash ('net cash settlement')

IE3 In this subsection, the forward purchase contract on the entity's own shares will be settled net in cash, i.e. there is no receipt or delivery of the entity's own shares upon settlement of the forward contract.

On 1 February 20X2, Entity A enters into a contract with Entity B to receive the fair value of 1,000 of Entity A's own outstanding ordinary shares as of 31 January 20X3 in exchange for a payment of CU104,000 in cash (i.e. CU104 per share) on 31 January 20X3. The contract will be settled net in cash. Entity A records the following journal entries.

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

1 February 20X2

The price per share when the contract is agreed on 1 February 20X2 is CU100. The initial fair value of the forward contract on 1 February 20X2 is zero.

No entry is required because the fair value of the derivative is zero and no cash is paid or received.

31 December 20X2

On 31 December 20X2, the market price per share has increased to CU110 and, as a result, the fair value of the forward contract has increased to CU6,300.

Dr	Forward asset		CU6,300	
	Cr	Gain		CU6,300

To record the increase in the fair value of the forward contract.

31 January 20X3

On 31 January 20X3, the market price per share has decreased to CU106. The fair value of the forward contract is CU2,000 ([CU106 x 1,000] – CU104,000).

On the same day, the contract is settled net in cash. Entity A has an obligation to deliver CU104,000 to Entity B and Entity B has an obligation to deliver CU106,000 (CU106 x 1,000) to Entity A, so Entity B pays the net amount of CU2,000 to Entity A.

Dr	Loss		CU4,300	
	Cr	Forward asset		CU4,300

To record the decrease in the fair value of the forward contract (ie CU4,300 = CU6,300 – CU2,000).

Dr	Cash		CU2,000	
	Cr	Forward asset		CU2,000

To record the settlement of the forward contract.

(b) Shares for shares ('net share settlement')

IE4 Assume the same facts as in (a) except that settlement will be made net in shares instead of net in cash. Entity A's journal entries are the same as those shown in (a) above, except for recording the settlement of the forward contract, as follows:

31 January 20X3

The contract is settled net in shares. Entity A has an obligation to deliver CU104,000 (CU104 x 1,000) worth of its shares to Entity B and Entity B has an obligation to deliver CU106,000 (CU106 x 1,000) worth of shares to Entity A. Thus, Entity B delivers a net amount of CU2,000 (CU106,000 – CU104,000) worth of shares to Entity A, i.e. 18.9 shares (CU2,000 / CU106).

Dr	Equity		CU2,000	
	Cr	Forward asset		CU2,000

To record the settlement of the forward contract.

(c) Cash for shares ('gross physical settlement')

IE5 Assume the same facts as in (a) except that settlement will be made by delivering a fixed amount of cash and receiving a fixed number of Entity A's shares. Similarly to (a) and (b) above, the price per share that Entity A will pay in one year is fixed at CU104. Accordingly, Entity A has an obligation to pay CU104,000 in cash to Entity B (CU104 x 1,000) and Entity B has an obligation to deliver 1,000 of Entity A's outstanding shares to Entity A in one year. Entity A records the following journal entries.

1 February 20X2

Dr	Equity		CU100,000	
	Cr	Liability		CU100,000

To record the obligation to deliver CU104,000 in one year at its present value of CU100,000 discounted using an appropriate interest rate (see IAS 39, paragraph AG64).

31 December 20X2

Dr	Interest expense		CU3,660	
	Cr	Liability		CU3,660

To accrue interest in accordance with the effective interest method on the liability for the share redemption amount.

31 January 20X3

Dr	Interest expense		CU340	
	Cr	Liability		CU340

To accrue interest in accordance with the effective interest method on the liability for the share redemption amount.

Entity A delivers CU104,000 in cash to Entity B and Entity B delivers 1,000 of Entity A's shares to Entity A.

Dr	Liability		CU104,000	
	Cr	Cash		CU104,000

To record the settlement of the obligation to redeem Entity A's own shares for cash.

(d) Settlement options

IE6 The existence of settlement options (such as net in cash, net in shares or by an exchange of cash and shares) has the result that the forward repurchase contract is a financial asset or a financial liability. If one of the settlement alternatives is to exchange cash for shares ((c) above), Entity A recognises a liability for the obligation to deliver cash, as illustrated in (c) above. Otherwise, Entity A accounts for the forward contract as a derivative.

Example 2: Forward to sell shares

IE7 This example illustrates the journal entries for forward sale contracts on an entity's own shares that will be settled (a) net in cash, (b) net in shares or (c) by receiving cash in exchange for shares. It also discusses the effect of settlement options (see (d) below). To simplify the illustration, it is assumed that no dividends are paid on the underlying shares (i.e. the 'carry return' is zero) so that the present value of the forward price equals the spot price when the fair value of the forward contract is zero. The fair value of the forward has been computed as the difference between the market share price and the present value of the fixed forward price.

Assumptions:

Contract date	1 February 20X2
Maturity date	31 January 20X3
Market price per share on 1 February 20X2	CU100
Market price per share on 31 December 20X2	CU110
Market price per share on 31 January 20X3	CU106
Fixed forward price to be paid on 31 January 20X3	CU104
Present value of forward price on 1 February 20X2	CU100
Number of shares under forward contract	1,000
Fair value of forward on 1 February 20X2	CU0
Fair value of forward on 31 December 20X2	CU(6,300)
Fair value of forward on 31 January 20X3	CU(2,000)

(a) Cash for cash ('net cash settlement')

IE8 On 1 February 20X2, Entity A enters into a contract with Entity B to pay the fair value of 1,000 of Entity A's own outstanding ordinary shares as of 31 January 20X3 in exchange for CU104,000 in cash (i.e. CU104 per share) on 31 January 20X3. The contract will be settled net in cash. Entity A records the following journal entries.

1 February 20X2

No entry is required because the fair value of the derivative is zero and no cash is paid or received.

31 December 20X2

Dr	Loss	CU6,300	
	Cr Forward liability		CU6,300

To record the decrease in the fair value of the forward contract.

31 January 20X3

Dr	Forward liability	CU4,300	
	Cr Gain		CU4,300

To record the increase in the fair value of the forward contract (i.e. CU4,300 = CU6,300 – CU2,000).

The contract is settled net in cash. Entity B has an obligation to deliver CU104,000 to Entity A, and Entity A has an obligation to deliver CU106,000 (CU106 x 1,000) to Entity B. Thus, Entity A pays the net amount of CU2,000 to Entity B.

Dr	Forward liability	CU2,000	
	Cr Cash		CU2,000

To record the settlement of the forward contract.

(b) Shares for shares ('net share settlement')

IE9 Assume the same facts as in (a) except that settlement will be made net in shares instead of net in cash. Entity A's journal entries are the same as those shown in (a), except:

31 January 20X3

The contract is settled net in shares. Entity A has a right to receive CU104,000 (CU104 x 1,000) worth of its shares and an obligation to deliver CU106,000 (CU106 x 1,000) worth of its shares to Entity A. Thus, Entity A delivers a net amount of CU2,000 (CU106,000 – CU104,000) worth of its shares to Entity B, i.e. 18.9 shares (CU2,000 / CU106).

Dr	Forward liability	CU2,000	
	Cr Equity		CU2,000

To record the settlement of the forward contract. The issue of the entity's own shares is treated as an equity transaction.

(c) Shares for cash ('gross physical settlement')

IE10 Assume the same facts as in (a), except that settlement will be made by receiving a fixed amount of cash and delivering a fixed number of the entity's own shares. Similarly to (a) and (b) above, the price per share that Entity A will ~~pay~~receive in one year is fixed at CU104. Accordingly, Entity A has a right to receive CU104,000 in cash (CU104 x 1,000) and an obligation to deliver 1,000 of its own shares in one year. Entity A records the following journal entries.

1 February 20X2

No entry is made on 1 February. No cash is paid or received because the forward has an initial fair value of zero. A forward contract to deliver a fixed number of Entity A's own shares in exchange for a fixed amount of cash or another financial asset meets the definition of an equity instrument because it cannot be settled otherwise than through the delivery of shares in exchange for cash.

31 December 20X2

No entry is made on 31 December because no cash is paid or received and a contract to deliver a fixed number of Entity A's own shares in exchange for a fixed amount of cash meets the definition of an equity instrument of the entity.

31 January 20X3

On 31 January 20X3, Entity A receives CU104,000 in cash and delivers 1,000 shares.

Dr	Cash		CU104,000	
	Cr	Equity		CU104,000

To record the settlement of the forward contract

(d) Settlement options

IE11 The existence of settlement options (such as net in cash, net in shares or by an exchange of cash and shares) has the result that the forward contract is a financial asset or a financial liability. It does not meet the definition of an equity instrument because it can be settled otherwise than by Entity A repurchasing a fixed number of its own shares in exchange for paying a fixed amount of cash or another financial asset. Entity A recognises a derivative asset or liability, as illustrated in (a) and (b) above. The accounting entry to be made on settlement depends on how the contract is actually settled.

Example 3: Purchased call option on shares

IE12 This example illustrates the journal entries for a purchased call option right on the entity's own shares that will be settled (a) net in cash, (b) net in shares or (c) by delivering cash in exchange for the entity's own shares. It also discusses the effect of settlement options (see (d) below):

Assumptions:

Contract date	1 February 20X2
Exercise date	31 January 20X3 (European terms, ie it can be exercised only at maturity)
Exercise right holder	Reporting entity (Entity A)
Market price per share on 1 February 20X2	CU100
Market price per share on 31 December 20X2	CU104
Market price per share on 31 January 20X3	CU104
Fixed exercise price to be paid on 31 January 20X3	CU102
Number of shares under option contract	1,000
Fair value of option on 1 February 20X2	CU5,000
Fair value of option on 31 December 20X2	CU3,000
Fair value of option on 31 January 20X3	CU2,000

(a) Cash for cash ('net cash settlement')

IE13 On 1 February 20X2, Entity A enters into a contract with Entity B that gives Entity B the obligation to deliver, and Entity A the right to receive the fair value of 1,000 of Entity A's own ordinary shares as of 31 January 20X3 in exchange for CU102,000 in cash (i.e. CU102 per share) on 31 January 20X3, if Entity A exercises that right. The contract will be settled net in cash. If Entity A does not exercise its right, no payment will be made. Entity A records the following journal entries.

1 February 20X2

The price per share when the contract is agreed on 1 February 20X2 is CU100. The initial fair value of the option contract on 1 February 20X2 is CU5,000, which Entity A pays to Entity B in cash on that date. On that date, the option has no intrinsic value, only time value, because the exercise price of CU102 exceeds the market price per share of CU100 and it would therefore not be economic for Entity A to exercise the option. In other words, the call option is out of the money.

Dr	Call option asset		CU5,000	
	Cr	Cash		CU5,000

To recognise the purchased call option.

31 December 20X2

On 31 December 20X2, the market price per share has increased to CU104. The fair value of the call option has decreased to CU3,000, of which CU2,000 is intrinsic value ([CU104 – CU102] x 1,000), and CU1,000 is the remaining time value.

Dr	Loss		CU2,000	
	Cr	Call option asset		CU2,000

To record the decrease in the fair value of the call option.

31 January 20X3

On 31 January 20X3, the market price per share is still CU104. The fair value of the call option has decreased to CU2,000, which is all intrinsic value ([CU104 – CU102] x 1,000) because no time value remains.

Dr	Loss		CU1,000	
	Cr	Call option asset		CU1,000

To record the decrease in the fair value of the call option.

On the same day, Entity A exercises the call option and the contract is settled net in cash. Entity B has an obligation to deliver CU104,000 (CU104 x 1,000) to Entity A in exchange for CU102,000 (CU102 x 1,000) from Entity A, so Entity A receives a net amount of CU2,000.

Dr	Cash		CU2,000	
	Cr	Call option asset		CU2,000

To record the settlement of the option contract.

(b) Shares for shares ('net share settlement')

IE14 Assume the same facts as in (a) except that settlement will be made net in shares instead of net in cash. Entity A's journal entries are the same as those shown in (a) except for recording the settlement of the option contract as follows:

31 January 20X3

Entity A exercises the call option and the contract is settled net in shares. Entity B has an obligation to deliver CU104,000 (CU104 x 1,000) worth of Entity A's shares to Entity A in exchange for CU102,000 (CU102 x 1,000) worth of Entity A's shares. Thus, Entity B delivers the net amount of CU2,000 worth of shares to Entity A, i.e. 19.2 shares (CU2,000 / CU104).

Dr	Equity		CU2,000	
	Cr	Call option asset		CU2,000

To record the settlement of the option contract. The settlement is accounted for as a treasury share transaction (ie no gain or loss).

(c) Cash for shares ('gross physical settlement')

IE15 Assume the same facts as in (a) except that settlement will be made by receiving a fixed number of shares and paying a fixed amount of cash, if Entity A exercises the option. Similarly to (a) and (b) above, the exercise price per share is fixed at CU102. Accordingly, Entity A has a right to receive 1,000 of Entity A's own outstanding shares in exchange for CU102,000 (CU102 x 1,000) in cash, if Entity A exercises its option. Entity A records the following journal entries.

1 February 20X2

Dr	Equity		CU5,000	
	Cr	Cash		CU5,000

To record the cash paid in exchange for the right to receive Entity A's own shares in one year for a fixed price. The premium paid is recognised in equity.

31 December 20X2

No entry is made on 31 December because no cash is paid or received and a contract that gives a right to receive a fixed number of Entity A's own shares in exchange for a fixed amount of cash meets the definition of an equity instrument of the entity.

31 January 20X3

Entity A exercises the call option and the contract is settled gross. Entity B has an obligation to deliver 1,000 of Entity A's shares in exchange for CU102,000 in cash.

Dr	Equity		CU102,000	
	Cr	Cash		CU102,000

To record the settlement of the option contract.

(d) Settlement options

IE16 The existence of settlement options (such as net in cash, net in shares or by an exchange of cash and shares) has the result that the call option is a financial asset. It does not meet the definition of an equity instrument because it can be settled otherwise than by Entity A repurchasing a fixed number of its own shares in exchange for paying a fixed amount of cash or another financial asset. Entity A recognises a derivative asset, as illustrated in (a) and (b) above. The accounting entry to be made on settlement depends on how the contract is actually settled.

Example 4: Written call option on shares

IE17 This example illustrates the journal entries for a written call option obligation on the entity's own shares that will be settled (a) net in cash, (b) net in shares or (c) by delivering cash in exchange for shares. It also discusses the effect of settlement options (see (d) below).

Assumptions:

Contract date	1 February 20X2
Exercise date	31 January 20X3 (European terms, ie it can be exercised only at maturity)
Exercise right holder	Counterparty (Entity B)
Market price per share on 1 February 20X2	CU100
Market price per share on 31 December 20X2	CU104
Market price per share on 31 January 20X3	CU104
Fixed exercise price to be ~~received~~ paid on 31 January 20X3	CU102
Number of shares under option contract	1,000
Fair value of option on 1 February 20X2	CU5,000
Fair value of option on 31 December 20X2	CU3,000
Fair value of option on 31 January 20X3	CU2,000

(a) Cash for cash ("net cash settlement")

IE18 Assume the same facts as in Example 3(a) above except that Entity A has written a call option on its own shares instead of having purchased a call option on them. Accordingly, on 1 February 20X2 Entity A enters into a contract with Entity B that gives Entity B the right to receive and Entity A the obligation to pay the fair value of 1,000 of Entity A's own ordinary shares as of 31 January 20X3 in exchange for CU102,000 in cash (i.e. CU102 per share) on 31 January 20X3, if Entity B exercises that right. The contract will be settled net in cash. If Entity B does not exercise its right, no payment will be made. Entity A records the following journal entries.

1 February 20X2

Dr	Cash	CU5,000	
Cr	Call option obligation		CU5,000

To recognise the written call option.

31 December 20X2

Dr	Call option obligation	CU2,000	
	Cr Gain		CU2,000

To record the decrease in the fair value of the call option.

31 January 20X3

Dr	Call option obligation	CU1,000	
	Cr Gain		CU1,000

To record the decrease in the fair value of the option.

On the same day, Entity B exercises the call option and the contract is settled net in cash. Entity A has an obligation to deliver CU104,000 (CU104 x 1,000) to Entity B in exchange for CU102,000 (CU102 x 1,000) from Entity B, so Entity A pays a net amount of CU2,000.

Dr	Call option obligation	CU2,000	
	Cr Cash		CU2,000

To record the settlement of the option contract.

(b) Shares for shares ('net share settlement')

IE19 Assume the same facts as in (a) except that settlement will be made net in shares instead of net in cash. Entity A's journal entries are the same as those shown in (a), except for recording the settlement of the option contract, as follows:

31 January 20X3

Entity B exercises the call option and the contract is settled net in shares. Entity A has an obligation to deliver CU104,000 (CU104 x 1,000) worth of Entity A's shares to Entity B in exchange for CU102,000 (CU102 x 1,000) worth of Entity A's shares. Thus, Entity A delivers the net amount of CU2,000 worth of shares to Entity B, i.e. 19.2 shares (CU2,000 / CU104).

Dr	Call option obligation	CU2,000	
	Cr Equity		CU2,000

To record the settlement of the option contract. The settlement is accounted for as an equity transaction.

(c) Cash for shares ('gross physical settlement')

IE20 Assume the same facts as in (a) except that settlement will be made by delivering a fixed number of shares and receiving a fixed amount of cash, if Entity B exercises the option. Similarly to (a) and (b) above, the exercise price per share is fixed at CU102. Accordingly, Entity B has a right to receive 1,000 of Entity A's own outstanding shares in exchange for CU102,000 (CU102 x 1,000) in cash, if Entity B exercises its option. Entity A records the following journal entries.

1 February 20X2

Dr	Cash	CU5,000	
	Cr Equity		CU5,000

To record the cash received in exchange for the obligation to deliver a fixed number of Entity A's own shares in one year for a fixed price. The premium received is recognised in equity. Upon exercise, the call would result in the issue of a fixed number of shares in exchange for a fixed amount of cash.

31 December 20X2

No entry is made on 31 December because no cash is paid or received and a contract to deliver a fixed number of Entity A's own shares in exchange for a fixed amount of cash meets the definition of an equity instrument of the entity.

31 January 20X3

Entity B exercises the call option and the contract is settled gross. Entity A has an obligation to deliver 1,000 shares in exchange for CU102,000 in cash.

Dr	Cash	CU102,000	
	Cr Equity		CU102,000

To record the settlement of the option contract.

(d) Settlement options

IE21 The existence of settlement options (such as net in cash, net in shares or by an exchange of cash and shares) has the result that the call option is a financial liability. It does not meet the definition of an equity instrument because it can be settled otherwise than by Entity A issuing a fixed number of its own shares in exchange for receiving a fixed amount of cash or another financial asset. Entity A recognises a derivative liability, as illustrated in (a) and (b) above. The accounting entry to be made on settlement depends on how the contract is actually settled.

Example 5: Purchased put option on shares

IE22 This example illustrates the journal entries for a purchased put option on the entity's own shares that will be settled (a) net in cash, (b) net in shares or (c) by delivering cash in exchange for shares. It also discusses the effect of settlement options (see (d) below).

Assumptions:

Contract date	1 February 20X2
Exercise date	31 January 20X3 (European terms, ie it can be exercised only at maturity)

Exercise right holder	Reporting entity (Entity A)
Market price per share on 1 February 20X2	CU100
Market price per share on 31 December 20X2	CU95
Market price per share on 31 January 20X3	CU95
Fixed exercise price to be ~~received~~ paid on 31 January 20X3	CU98
Number of shares under option contract	1,000
Fair value of option on 1 February 20X2	CU5,000
Fair value of option on 31 December 20X2	CU4,000
Fair value of option on 31 January 20X3	CU3,000

(a) Cash for cash ('net cash settlement')

IE23 On 1 February 20X2, Entity A enters into a contract with Entity B that gives Entity A the right to sell, and Entity B the obligation to buy the fair value of 1,000 of Entity A's own outstanding ordinary shares as of 31 January 20X3 at a strike price of CU98,000 (i.e. CU98 per share) on 31 January 2003, if Entity A exercises that right. The contract will be settled net in cash. If Entity A does not exercise its right, no payment will be made. Entity A records the following journal entries.

1 February 20X2

The price per share when the contract is agreed on 1 February 20X2 is CU100. The initial fair value of the option contract on 1 February 20X2 is CU5,000, which Entity A pays to Entity B in cash on that date. On that date, the option has no intrinsic value, only time value, because the exercise price of CU98 is less than the market price per share of CU100. Therefore it would not be economic for Entity A to exercise the option. In other words, the put option is out of the money.

Dr	Put option asset	CU5,000	
	Cr Cash		CU5,000

To recognise the purchased put option.

31 December 20X2

On 31 December 20X2 the market price per share has decreased to CU95. The fair value of the put option has decreased to CU4,000, of which CU3,000 is intrinsic value ([CU98 – CU95] x 1,000) and CU1,000 is the remaining time value.

Dr	Loss	CU1,000	
	Cr Put option asset		CU1,000

To record the decrease in the fair value of the put option.

31 January 20X3

On 31 January 20X3 the market price per share is still CU95. The fair value of the put option has decreased to CU3,000, which is all intrinsic value ([CU98 – CU95] x 1,000) because no time value remains.

Dr	Loss		CU1,000	
	Cr	Put option asset		CU1,000

To record the decrease in the fair value of the option.

On the same day, Entity A exercises the put option and the contract is settled net in cash. Entity B has an obligation to deliver CU98,000 to Entity A and Entity A has an obligation to deliver CU95,000 (CU95 x 1,000) to Entity B, so Entity B pays the net amount of CU3,000 to Entity A.

Dr	Cash		CU3,000	
	Cr	Put option asset		CU3,000

To record the settlement of the option contract.

(b) Shares for shares ('net share settlement')

IE24 Assume the same facts as in (a) except that settlement will be made net in shares instead of net in cash. Entity A's journal entries are the same as shown in (a), except:

31 January 20X3

Entity A exercises the put option and the contract is settled net in shares. In effect, Entity B has an obligation to deliver CU98,000 worth of Entity A's shares to Entity A, and Entity A has an obligation to deliver CU95,000 worth of Entity A's shares (CU95 x 1,000) to Entity B, so Entity B delivers the net amount of CU3,000 worth of shares to Entity A, ie 31.6 shares (CU3,000 / CU95).

Dr	Equity		CU3,000	
	Cr	Put option asset		CU3,000

To record the settlement of the option contract.

(c) Cash for shares ('gross physical settlement')

IE25 Assume the same facts as in (a) except that settlement will be made by receiving a fixed amount of cash and delivering a fixed number of Entity A's shares, if Entity A exercises the option. Similarly to (a) and (b) above, the exercise price per share is fixed at CU98. Accordingly, Entity B has an obligation to pay CU98,000 in cash to Entity A (CU98 x 1,000) in exchange for 1,000 of Entity A's outstanding shares, if Entity A exercises its option. Entity A records the following journal entries.

1 February 20X2

Dr	Equity		CU5,000	
	Cr	Cash		CU5,000

To record the cash received in exchange for the right to deliver Entity A's own shares in one year for a fixed price. The premium paid is recognised directly in equity. Upon exercise, it results in the issue of a fixed number of shares in exchange for a fixed price.

31 December 20X2

No entry is made on 31 December because no cash is paid or received and a contract to deliver a fixed number of Entity A's own shares in exchange for a fixed amount of cash meets the definition of an equity instrument of Entity A.

31 January 20X3

Entity A exercises the put option and the contract is settled gross. Entity B has an obligation to deliver CU98,000 in cash to Entity A in exchange for 1,000 shares.

Dr	Cash		CU98,000	
	Cr	Equity		CU98,000

To record the settlement of the option contract.

(d) Settlement options

IE26 The existence of settlement options (such as net in cash, net in shares or by an exchange of cash and shares) has the result that the put option is a financial asset. It does not meet the definition of an equity instrument because it can be settled otherwise than by Entity A issuing a fixed number of its own shares in exchange for receiving a fixed amount of cash or another financial asset. Entity A recognises a derivative asset, as illustrated in (a) and (b) above. The accounting entry to be made on settlement depends on how the contract is actually settled.

Example 6: Written put option on shares

IE27 This example illustrates the journal entries for a written put option on the entity's own shares that will be settled (a) net in cash, (b) net in shares or (c) by delivering cash in exchange for shares. It also discusses the effect of settlement options (see (d) below).

Assumptions:

Contract date	1 February 20X2
Exercise date	31 January 20X3 (European terms, i.e. it can be exercised only at maturity)
Exercise right holder	Counterparty (Entity B)
Market price per share on 1 February 20X2	CU100
Market price per share on 31 December 20X2	CU95
Market price per share on 31 January 20X3	CU95
Fixed exercise price to be paid on 31 January 20X3	CU98
Present value of exercise price on 1 February 20X2	CU95
Number of shares under option contract	1,000

Fair value of option on 1 February 20X2	CU5,000
Fair value of option on 31 December 20X2	CU4,000
Fair value of option on 31 January 20X3	CU3,000

(a) Cash for cash ('net cash settlement')

IE28 Assume the same facts as in Example 5(a) above, except that Entity A has written a put option on its own shares instead of having purchased a put option on its own shares. Accordingly, on 1 February 20X2, Entity A enters into a contract with Entity B that gives Entity B the right to receive and Entity A the obligation to pay the fair value of 1,000 of Entity A's outstanding ordinary shares as of 31 January 20X3 in exchange for CU98,000 in cash (ie CU98 per share) on 31 January 20X3, if Entity B exercises that right. The contract will be settled net in cash. If Entity B does not exercise its right, no payment will be made. Entity A records the following journal entries.

1 February 20X2

Dr	Cash		CU5,000	
	Cr	Put option liability		CU5,000

To recognise the written put option.

31 December 20X2

Dr	Put option liability		CU1,000	
	Cr	Gain		CU1,000

To record the decrease in the fair value of the put option.

31 January 20X3

Dr	Put option liability		CU1,000	
	Cr	Gain		CU1,000

To record the decrease in the fair value of the put option.

On the same day, Entity B exercises the put option and the contract is settled net in cash. Entity A has an obligation to deliver CU98,000 to Entity B, and Entity B has an obligation to deliver CU95,000 (CU95 x 1,000) to Entity A. Thus, Entity A pays the net amount of CU3,000 to Entity B.

Dr	Put option liability		CU3,000	
	Cr	Cash		CU3,000

To record the settlement of the option contract.

(b) Shares for shares ('net share settlement')

IE29 Assume the same facts as in (a) except that settlement will be made net in shares instead of net in cash. Entity A's journal entries are the same as those in (a), except for the following:

31 January 20X3

Entity B exercises the put option and the contract is settled net in shares. In effect, Entity A has an obligation to deliver CU98,000 worth of shares to Entity B, and Entity B has an obligation to deliver CU95,000 worth of Entity A's shares (CU95 x 1,000) to Entity A. Thus, Entity A delivers the net amount of CU3,000 worth of Entity A's shares to Entity B, ie 31.6 shares (3,000 / 95).

Dr	Put option liability		CU3,000	
	Cr	Equity		CU3,000

To record the settlement of the option contract. The issue of Entity A's own shares is accounted for as an equity transaction.

(c) Cash for shares ('gross physical settlement')

IE30 Assume the same facts as in (a) except that settlement will be made by delivering a fixed amount of cash and receiving a fixed number of shares, if Entity B exercises the option. Similarly to (a) and (b) above, the exercise price per share is fixed at CU98. Accordingly, Entity A has an obligation to pay CU98,000 in cash to Entity B (CU98 x 1,000) in exchange for 1,000 of Entity A's outstanding shares, if Entity B exercises its option. Entity A records the following journal entries.

1 February 20X2

Dr	Cash		CU5,000	
	Cr	Equity		CU5,000

To recognise the option premium received of CU5,000 in equity.

Dr	Equity		CU95,000	
	Cr	Liability		CU95,000

To recognise the present value of the obligation to deliver CU98,000 in one year, i.e. CU95,000, as a liability.

31 December 20X2

Dr	Interest expense		CU2,750	
	Cr	Liability		CU2,750

To accrue interest in accordance with the effective interest method on the liability for the share redemption amount.

31 January 20X3

Dr	Interest expense	CU250	
	Cr Liability		CU250

To accrue interest in accordance with the effective interest method on the liability for the share redemption amount.

On the same day, Entity B exercises the put option and the contract is settled gross. Entity A has an obligation to deliver CU98,000 in cash to Entity B in exchange for CU95,000 worth of shares (CU95 x1,000).

Dr	Liability	CU98,000	
	Cr Cash		CU98,000

To record the settlement of the option contract.

(d) Settlement options

IE31 The existence of settlement options (such as net in cash, net in shares or by an exchange of cash and shares) has the result that the written put option is a financial liability. If one of the settlement alternatives is to exchange cash for shares ((c) above), Entity A recognises a liability for the obligation to deliver cash, as illustrated in (c) above. Otherwise, Entity A accounts for the put option as a derivative liability.

Entities such as mutual funds and Co-operatives whose share capital is not equity as Defined in IAS 32

Example 7: Entities with no equity

IE32 The following example illustrates ~~an income statement and balance sheet format~~ a format of a statement of comprehensive income and statement of financial position that may be used by entities such as mutual funds that do not have equity as defined in IAS 32. Other formats are possible.

Statement of comprehensive income for the year ended 31 December 20X1

		20X1	**20X0**
		CU	CU
Revenue		2,956	1,718
Expenses (classified by nature or function)		(644)	(614)
Profit from operating activities		2,312	1,104
Finance costs	– other finance costs	(47)	(47)
	– distributions to unitholders	(50)	(50)
Change in net assets attributable to unitholders		2,215	1,007

Statement of financial position at 31 December 20X1

	20X1		20X0	
	CU	CU	CU	CU
ASSETS				
Non-current assets (classified in accordance with IAS 1)	91,374		78,484	
Total non-current assets		91,374		78,484
Current assets (classified in accordance with IAS 1)	1,422		1,769	
Total current assets		1,422		1,769
Total assets		92,796		80,253
LIABILITIES				
Current liabilities (classified in accordance with IAS 1)	647		66	
Total current liabilities		(647)		(66)
Non-current liabilities excluding net assets attributable to unitholders (classified in accordance with IAS 1)	280		136	
		(280)		(136)
Net assets attributable to unitholders		91,869		80,051

Example 8: Entities with some equity

IE33 The following example illustrates ~~an income statement and balance sheet format~~ a format of a statement of comprehensive income and statement of financial position that may be used by entities whose share capital is not equity as defined in IAS 32 because the entity has an obligation to repay the share capital on demand but does not have all the features or meet the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D. Other formats are possible.

Statement of comprehensive income for the year ended 31 December 20X1

	20X1	20X0
	CU	CU
Revenue	472	498
Expenses (classified by nature or function)	(367)	(396)
Profit from operating activities	105	102
Finance costs – other finance costs	(4)	(4)
– distributions to members	(50)	(50)
Change in net assets attributable to members	51	48

Statement of financial position at 31 December 20X1

	20X1		20X0	
	CU	CU	CU	CU
ASSETS				
Non-current assets (classified in accordance with IAS 1)	908		830	
Total non-current assets		908		830
Current assets (classified in accordance with IAS 1)	383		350	
Total current assets		383		350
Total assets		1,291		1,180
LIABILITIES				
Current liabilities (classified in accordance with IAS 1)	372		338	
Share capital repayable on demand	202		161	
Total current liabilities		(574)		(499)
Total assets less current liabilities		717		681
Non-current liabilities (classified in accordance with IAS 1)	187		196	
		187		196
~~RESERVES~~OTHER COMPONENTS OF EQUITY[a]				
Reserves e.g. revaluation surplus, retained earnings etc	530		485	
		530		485
		717		681
MEMORANDUM NOTE – Total members' interests				
Share capital repayable on demand		202		161
Reserves		530		485
		732		646

[a] In this example, the entity has no obligation to deliver a share of its reserves to its members.

Accounting for compound financial instruments

Example 9: Separation of a compound financial instrument on initial recognition

IE34 Paragraph 28 describes how the components of a compound financial instrument are separated by the entity on initial recognition. The following example illustrates how such a separation is made.

IE35 An entity issues 2,000 convertible bonds at the start of year 1. The bonds have a three-year term, and are issued at par with a face value of CU1,000 per bond, giving total proceeds of CU2,000,000. Interest is payable annually in arrears at a nominal annual interest rate of 6 per cent. Each bond is convertible at any time up to maturity into 250 ordinary shares. When the bonds are issued, the prevailing market interest rate for similar debt without conversion options is 9 per cent.

IE36 The liability component is measured first, and the difference between the proceeds of the bond issue and the fair value of the liability is assigned to the equity component. The present value of the liability component is calculated using a discount rate of 9 per cent, the market interest rate for similar bonds having no conversion rights, as shown below.

	CU
Present value of the principal – CU2,000,000 payable at the end of three years	1,544,367
Present value of the interest – CU120,000 payable annually in arrears for three years	303,755
Total liability component	1,848,122
Equity component (by deduction)	151,878
Proceeds of the bond issue	2,000,000

Example 10: Separation of a compound financial instrument with multiple embedded derivative features

IE37 The following example illustrates the application of paragraph 31 to the separation of the liability and equity components of a compound financial instrument with multiple embedded derivative features.

IE38 Assume that the proceeds received on the issue of a callable convertible bond are CU60. The value of a similar bond without a call or equity conversion option is CU57. Based on an option pricing model, it is determined that the value to the entity of the embedded call feature in a similar bond without an equity conversion option is CU2. In this case, the value allocated to the liability component under paragraph 31 is CU55 (CU57 – CU2) and the value allocated to the equity component is CU5 (CU60 – CU55).

Example 11: Repurchase of a convertible instrument

IE39 The following example illustrates how an entity accounts for a repurchase of a convertible instrument. For simplicity, at inception, the face amount of the instrument is assumed to be equal to the aggregate carrying amount of its liability and equity components in the financial statements, i.e. no original issue premium or discount exists. Also, for simplicity, tax considerations have been omitted from the example.

IE40 On 1 January 20X0, Entity A issued a 10 per cent convertible debenture with a face value of CU1,000 maturing on 31 December 20X9. The debenture is convertible into ordinary shares of Entity A at a conversion price of CU25 per share. Interest is payable half-yearly in cash. At the date of issue, Entity A could have issued non-convertible debt with a ten-year term bearing a coupon interest rate of 11 per cent.

IE41 In the financial statements of Entity A the carrying amount of the debenture was allocated on issue as follows:

	CU
Liability component	
Present value of 20 half-yearly interest payments of CU50, discounted at 11%	597
Present value of CU1,000 due in 10 years, discounted at 11%, compounded half-yearly	343
	940
Equity component	
(difference between CU1,000 total proceeds and CU940 allocated above)	60
Total proceeds	1,000

IE42 On 1 January 20X5, the convertible debenture has a fair value of CU1,700.

IE43 Entity A makes a tender offer to the holder of the debenture to repurchase the debenture for CU1,700, which the holder accepts. At the date of repurchase, Entity A could have issued non-convertible debt with a five-year term bearing a coupon interest rate of 8 per cent.

IE44 The repurchase price is allocated as follows:

	Carrying value	**Fair value**	**Difference**
Liability component:	CU	CU	CU
Present value of 10 remaining half-yearly interest payments of CU50, discounted at 11% and 8%, respectively	377	405	
Present value of CU1,000 due in 5 years, discounted at 11% and 8%, compounded half-yearly, respectively	585	676	
	962	1,081	(119)
Equity component	60	619[(a)]	(559)
Total	1,022	1,700	(678)

[(a)] This amount represents the difference between the fair value amount allocated to the liability component and the repurchase price of CU1,700.

IE45 Entity A recognises the repurchase of the debenture as follows:

Dr	Liability component	CU962	
Dr	Debt settlement expense (~~income statement~~profit or loss)	CU119	
	Cr Cash		CU1,081

To recognise the repurchase of the liability component.

Dr	Equity	CU619	
	Cr Cash		CU619

To recognise the cash paid for the equity component.

IE46 The equity component remains as equity, but may be transferred from one line item within equity to another.

Example 12: Amendment of the terms of a convertible instrument to induce early conversion

IE47 The following example illustrates how an entity accounts for the additional consideration paid when the terms of a convertible instrument are amended to induce early conversion.

IE48 On 1 January 20X0, Entity A issued a 10 per cent convertible debenture with a face value of CU1,000 with the same terms as described in Example 11. On 1 January 20X1, to induce the holder to convert the convertible debenture promptly, Entity A reduces the conversion price to CU20 if the debenture is converted before 1 March 20X1 (i.e. within 60 days).

IE49 Assume the market price of Entity A's ordinary shares on the date the terms are amended is CU40 per share. The fair value of the incremental consideration paid by Entity A is calculated as follows:

Number of ordinary shares to be issued to debenture holders under **amended** *conversion terms:*

Face amount	CU1,000	
New conversion price	/CU20	per share
Number of ordinary shares to be issued on conversion	50	shares

Number of ordinary shares to be issued to debenture holders under **original** *conversion terms:*

Face amount	CU1,000	
Original conversion price	/CU25	per share
Number of ordinary shares to be issued on Conversion	40	shares

Number of incremental ordinary shares issued upon conversion	10	shares

Value of **incremental** *ordinary shares issued upon conversion*

CU40 per share x 10 incremental shares	CU400

IE50 The incremental consideration of CU400 is recognised as a loss in profit or loss.

HKAS 33
~~Issued March 2004~~Revised March 2010

Hong Kong Accounting Standard 33

Earnings per Share

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

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Introduction

IN1 Hong Kong Accounting Standard 33 *Earnings per Share* (HKAS 33) replaces SSAP 5 *Earnings per Shares* (revised in 1998), and should be applied for annual periods beginning on or after 1 January 2005. Earlier application is encouraged. The standard also replaces Interpretation 10 *Earnings Per Share – Financial Instruments and Other Contracts that May Be Settled in Shares*.

Reasons for issuing HKAS 33

IN2 The objectives of the Hong Kong Institute of Certified Public Accountants (HKICPA) issuing HKAS 33 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 33 the HKICPA's main objective was to provide additional guidance and illustrative examples on selected complex matters, such as the effects of contingently issuable shares; potential ordinary shares of subsidiaries, joint ventures or associates; participating equity instruments; written put options; purchased put and call options; and mandatorily convertible instruments. The HKICPA did not reconsider the fundamental approach to the determination and presentation of earnings per share contained in HKAS 33.

Hong Kong Accounting Standard 33
Earnings per Share

Objective

1 The objective of this Standard is to prescribe principles for the determination and presentation of earnings per share, so as to improve performance comparisons between different entities in the same reporting period and between different reporting periods for the same entity. Even though earnings per share data have limitations because of the different accounting policies that may be used for determining 'earnings', a consistently determined denominator enhances financial reporting. The focus of this Standard is on the denominator of the earnings per share calculation.

Scope

2 ~~This Standard shall be applied by entities whose ordinary shares or potential ordinary shares are publicly traded and by entities that are in the process of issuing ordinary shares or potential ordinary shares in public markets.~~**This Standard shall apply to:**

(a) the separate or individual financial statements of an entity:

(i) whose ordinary shares or potential ordinary shares are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets) or

(ii) that files, or is in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing ordinary shares in a public market; and

(b) the consolidated financial statements of a group with a parent:

(i) whose ordinary shares or potential ordinary shares are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets) or

(ii) that files, or is in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing ordinary shares in a public market.

3 An entity that discloses earnings per share shall calculate and disclose earnings per share in accordance with this Standard.

4 When an entity presents both consolidated financial statements and separate financial statements prepared in accordance with HKAS 27 *Consolidated and Separate Financial Statements*, the disclosures required by this Standard need be presented only on the basis of the consolidated information. An entity that chooses to disclose earnings per share based on its separate financial statements shall present such earnings per share information only ~~on the face of its separate~~

~~income statement~~ in its statement of comprehensive income. An entity shall not present such earnings per share information in the consolidated financial statements.

4A If an entity presents the components of profit or loss in a separate income statement as described in paragraph 81 of HKAS 1 *Presentation of Financial Statements* (as revised in 2007), it presents earnings per share only in that separate statement.

Definitions

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

Antidilution **is an increase in earnings per share or a reduction in loss per share resulting from the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued upon the satisfaction of specified conditions.**

A *contingent share agreement* **is an agreement to issue shares that is dependent on the satisfaction of specified conditions.**

Contingently issuable ordinary shares **are ordinary shares issuable for little or no cash or other consideration upon the satisfaction of specified conditions in a contingent share agreement.**

Dilution **is a reduction in earnings per share or an increase in loss per share resulting from the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued upon the satisfaction of specified conditions.**

Options, warrants and their equivalents **are financial instruments that give the holder the right to purchase ordinary shares.**

An *ordinary share* **is an equity instrument that is subordinate to all other classes of equity instruments.**

A *potential ordinary share* **is a financial instrument or other contract that may entitle its holder to ordinary shares.**

Put options **on ordinary shares are contracts that give the holder the right to sell ordinary shares at a specified price for a given period.**

6 Ordinary shares participate in profit for the period only after other types of shares such as preference shares have participated. An entity may have more than one class of ordinary shares. Ordinary shares of the same class have the same rights to receive dividends.

7 Examples of potential ordinary shares are:

(a) financial liabilities or equity instruments, including preference shares, that are convertible into ordinary shares;

(b) options and warrants;

(c) shares that would be issued upon the satisfaction of conditions resulting from contractual arrangements, such as the purchase of a business or other assets.

8 Terms defined in HKAS 32 *Financial Instruments: ~~Disclosure and~~ Presentation* are used in this Standard with the meanings specified in paragraph 11 of HKAS 32, unless otherwise noted. HKAS 32 defines financial instrument, financial asset, financial liability, equity instrument, and fair value, and provides guidance on applying those definitions.

Measurement

Basic earnings per share

9 An entity shall calculate basic earnings per share amounts for profit or loss attributable to ordinary equity holders of the parent entity and, if presented, profit or loss from continuing operations attributable to those equity holders.

10 Basic earnings per share shall be calculated by dividing profit or loss attributable to ordinary equity holders of the parent entity (the numerator) by the weighted average number of ordinary shares outstanding (the denominator) during the period.

11 The objective of basic earnings per share information is to provide a measure of the interests of each ordinary share of a parent entity in the performance of the entity over the reporting period.

Earnings

12 For the purpose of calculating basic earnings per share, the amounts attributable to ordinary equity holders of the parent entity in respect of:

(a) profit or loss from continuing operations attributable to the parent entity; and

(b) profit or loss attributable to the parent entity

shall be the amounts in (a) and (b)adjusted for the after-tax amounts of preference dividends, differences arising on the settlement of preference shares, and other similar effects of preference shares classified as equity.

13 All items of income and expense attributable to ordinary equity holders of the parent entity that are recognised in a period, including tax expense and dividends on preference shares classified as liabilities are included in the determination of profit or loss for the period attributable to ordinary equity holders of the parent entity (see HKAS 1 ~~*Presentation of Financial Statements*~~).

14 The after-tax amount of preference dividends that is deducted from profit or loss is:

(a) the after-tax amount of any preference dividends on non-cumulative preference shares declared in respect of the period; and

(b) the after-tax amount of the preference dividends for cumulative preference shares required for the period, whether or not the dividends have been declared. The amount of preference dividends for the period does not include the amount of any preference dividends for cumulative preference shares paid or declared during the current period in respect of previous periods.

15 Preference shares that provide for a low initial dividend to compensate an entity for selling the preference shares at a discount, or an above-market dividend in later periods to compensate investors for purchasing preference shares at a premium, are sometimes referred to as increasing rate preference shares. Any original issue discount or premium on increasing rate preference shares is amortised to retained earnings using the effective interest method and treated as a preference dividend for the purposes of calculating earnings per share.

16 Preference shares may be repurchased under an entity's tender offer to the holders. The excess of the fair value of the consideration paid to the preference shareholders over the carrying amount of the preference shares represents a return to the holders of the preference shares and a charge to retained earnings for the entity. This amount is deducted in calculating profit or loss attributable to ordinary equity holders of the parent entity.

17 Early conversion of convertible preference shares may be induced by an entity through favourable changes to the original conversion terms or the payment of additional consideration. The excess of the fair value of the ordinary shares or other consideration paid over the fair value of the ordinary shares issuable under the original conversion terms is a return to the preference shareholders, and is deducted in calculating profit or loss attributable to ordinary equity holders of the parent entity.

18 Any excess of the carrying amount of preference shares over the fair value of the consideration paid to settle them is added in calculating profit or loss attributable to ordinary equity holders of the parent entity.

Shares

19 For the purpose of calculating basic earnings per share, the number of ordinary shares shall be the weighted average number of ordinary shares outstanding during the period.

20 Using the weighted average number of ordinary shares outstanding during the period reflects the possibility that the amount of shareholders' capital varied during the period as a result of a larger or smaller number of shares being outstanding at any time. The weighted average number of ordinary shares outstanding during the period is the number of ordinary shares outstanding at the beginning of the period, adjusted by the number of ordinary shares bought back or issued during the period multiplied by a time-weighting factor. The time-weighting factor is the number of days that the shares are outstanding as a proportion of the total number of days in the period; a reasonable approximation of the weighted average is adequate in many circumstances.

21 Shares are usually included in the weighted average number of shares from the date consideration is receivable (which is generally the date of their issue), for example:

(a) ordinary shares issued in exchange for cash are included when cash is receivable;

(b) ordinary shares issued on the voluntary reinvestment of dividends on ordinary or preference shares are included when dividends are reinvested;

(c) ordinary shares issued as a result of the conversion of a debt instrument to ordinary shares are included from the date that interest ceases to accrue;

(d) ordinary shares issued in place of interest or principal on other financial instruments are included from the date that interest ceases to accrue;

(e) ordinary shares issued in exchange for the settlement of a liability of the entity are included from the settlement date;

(f) ordinary shares issued as consideration for the acquisition of an asset other than cash are included as of the date on which the acquisition is recognised; and

(g) ordinary shares issued for the rendering of services to the entity are included as the services are rendered.

The timing of the inclusion of ordinary shares is determined by the terms and conditions attaching to their issue. Due consideration is given to the substance of any contract associated with the issue.

22[†] Ordinary shares issued as part of the ~~cost of~~ consideration transferred in a business combination are included in the weighted average number of shares from the acquisition date. This is because the acquirer incorporates into its ~~income~~ statement of comprehensive income the acquiree's profits and losses from that date.

23 Ordinary shares that will be issued upon the conversion of a mandatorily convertible instrument are included in the calculation of basic earnings per share from the date the contract is entered into.

24 Contingently issuable shares are treated as outstanding and are included in the calculation of basic earnings per share only from the date when all necessary conditions are satisfied (ie the events have occurred). Shares that are issuable solely after the passage of time are not contingently issuable shares, because the passage of time is a certainty. Outstanding ordinary shares that are contingently returnable (ie subject to recall) are not treated as outstanding and are excluded from the calculation of basic earnings per share until the date the shares are no longer subject to recall.

25 [Deleted]

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

26 The weighted average number of ordinary shares outstanding during the period and for all periods presented shall be adjusted for events, other than the conversion of potential ordinary shares, that have changed the number of ordinary shares outstanding without a corresponding change in resources.

27 Ordinary shares may be issued, or the number of ordinary shares outstanding may be reduced, without a corresponding change in resources. Examples include:

(a) a capitalisation or bonus issue (sometimes referred to as a stock dividend);

(b) a bonus element in any other issue, for example a bonus element in a rights issue to existing shareholders;

(c) a share split; and

(d) a reverse share split (consolidation of shares).

28 In a capitalisation or bonus issue or a share split, ordinary shares are issued to existing shareholders for no additional consideration. Therefore, the number of ordinary shares outstanding is increased without an increase in resources. The number of ordinary shares outstanding before the event is adjusted for the proportionate change in the number of ordinary shares outstanding as if the event had occurred at the beginning of the earliest period presented. For example, on a two-for-one bonus issue, the number of ordinary shares outstanding before the issue is multiplied by three to obtain the new total number of ordinary shares, or by two to obtain the number of additional ordinary shares.

29 A consolidation of ordinary shares generally reduces the number of ordinary shares outstanding without a corresponding reduction in resources. However, when the overall effect is a share repurchase at fair value, the reduction in the number of ordinary shares outstanding is the result of a corresponding reduction in resources. An example is a share consolidation combined with a special dividend. The weighted average number of ordinary shares outstanding for the period in which the combined transaction takes place is adjusted for the reduction in the number of ordinary shares from the date the special dividend is recognised.

Diluted earnings per share

30 An entity shall calculate diluted earnings per share amounts for profit or loss attributable to ordinary equity holders of the parent entity and, if presented, profit or loss from continuing operations attributable to those equity holders.

31 For the purpose of calculating diluted earnings per share, an entity shall adjust profit or loss attributable to ordinary equity holders of the parent entity, and the weighted average number of shares outstanding, for the effects of all dilutive potential ordinary shares.

32 The objective of diluted earnings per share is consistent with that of basic earnings per share—to provide a measure of the interest of each ordinary share in the performance of an entity—while giving effect to all dilutive potential ordinary shares outstanding during the period. As a result:

(a) profit or loss attributable to ordinary equity holders of the parent entity is increased by the after-tax amount of dividends and interest recognised in the period in respect of the dilutive potential ordinary shares and is adjusted for any other changes in income or expense that would result from the conversion of the dilutive potential ordinary shares; and

(b) the weighted average number of ordinary shares outstanding is increased by the weighted average number of additional ordinary shares that would have been outstanding assuming the conversion of all dilutive potential ordinary shares.

Earnings

33 For the purpose of calculating diluted earnings per share, an entity shall adjust profit or loss attributable to ordinary equity holders of the parent entity, as calculated in accordance with paragraph 12, by the after-tax effect of:

(a) any dividends or other items related to dilutive potential ordinary shares deducted in arriving at profit or loss attributable to ordinary equity holders of the parent entity as calculated in accordance with paragraph 12;

(b) any interest recognised in the period related to dilutive potential ordinary shares; and

(c) any other changes in income or expense that would result from the conversion of the dilutive potential ordinary shares.

34 After the potential ordinary shares are converted into ordinary shares, the items identified in paragraph 33(a)-(c) no longer arise. Instead, the new ordinary shares are entitled to participate in profit or loss attributable to ordinary equity holders of the parent entity. Therefore, profit or loss attributable to ordinary equity holders of the parent entity calculated in accordance with paragraph 12 is adjusted for the items identified in paragraph 33(a)-(c) and any related taxes. The expenses associated with potential ordinary shares include transaction costs and discounts accounted for in accordance with the effective interest method (see paragraph 9 of HKAS 39 *Financial Instruments: Recognition and Measurement*).

35 The conversion of potential ordinary shares may lead to consequential changes in income or expenses. For example, the reduction of interest expense related to potential ordinary shares and the resulting increase in profit or reduction in loss may lead to an increase in the expense related to a non-discretionary employee profit-sharing plan. For the purpose of calculating diluted earnings per share, profit or loss attributable to ordinary equity holders of the parent entity is adjusted for any such consequential changes in income or expense.

Shares

36 For the purpose of calculating diluted earnings per share, the number of ordinary shares shall be the weighted average number of ordinary shares calculated in accordance with paragraphs 19 and 26, plus the weighted average number of ordinary shares that would be issued on the conversion of all the dilutive potential ordinary shares into ordinary shares. Dilutive potential ordinary shares shall be deemed to have been converted into ordinary shares at the beginning of the period or, if later, the date of the issue of the potential ordinary shares.

37 Dilutive potential ordinary shares shall be determined independently for each period presented. The number of dilutive potential ordinary shares included in the year-to-date period is not a weighted average of the dilutive potential ordinary shares included in each interim computation.

38 Potential ordinary shares are weighted for the period they are outstanding. Potential ordinary shares that are cancelled or allowed to lapse during the period are included in the calculation of diluted earnings per share only for the portion of the period during which they are outstanding. Potential ordinary shares that are converted into ordinary shares during the period are included in the calculation of diluted earnings per share from the beginning of the period to the date of conversion; from the date of conversion, the resulting ordinary shares are included in both basic and diluted earnings per share.

39 The number of ordinary shares that would be issued on conversion of dilutive potential ordinary shares is determined from the terms of the potential ordinary shares. When more than one basis of conversion exists, the calculation assumes the most advantageous conversion rate or exercise price from the standpoint of the holder of the potential ordinary shares.

40 A subsidiary, joint venture or associate may issue to parties other than the parent, venturer or investor potential ordinary shares that are convertible into either ordinary shares of the subsidiary, joint venture or associate, or ordinary shares of the parent, venturer or investor (the reporting entity). If these potential ordinary shares of the subsidiary, joint venture or associate have a dilutive effect on the basic earnings per share of the reporting entity, they are included in the calculation of diluted earnings per share.

Dilutive potential ordinary shares

41 Potential ordinary shares shall be treated as dilutive when, and only when, their conversion to ordinary shares would decrease earnings per share or increase loss per share from continuing operations.

42 An entity uses profit or loss from continuing operations attributable to the parent entity as the control number to establish whether potential ordinary shares are dilutive or antidilutive. Profit or loss from continuing operations attributable to the parent entity is adjusted in accordance with paragraph 12 and excludes items relating to discontinued operations.

43 Potential ordinary shares are antidilutive when their conversion to ordinary shares would increase earnings per share or decrease loss per share from continuing operations. The calculation of diluted earnings per share does not assume conversion, exercise, or other issue of potential ordinary shares that would have an antidilutive effect on earnings per share.

44 In determining whether potential ordinary shares are dilutive or antidilutive, each issue or series of potential ordinary shares is considered separately rather than in aggregate. The sequence in which potential ordinary shares are considered may affect whether they are dilutive. Therefore, to maximise the dilution of basic earnings per share, each issue or series of potential ordinary shares is considered in sequence from the most dilutive to the least dilutive, ie dilutive potential ordinary shares with the lowest 'earnings per incremental share' are included in the diluted earnings per share calculation before those with a higher earnings per incremental share. Options and warrants are generally included first because they do not affect the numerator of the calculation.

Options, warrants and their equivalents

45 For the purpose of calculating diluted earnings per share, an entity shall assume the exercise of dilutive options and warrants of the entity. The assumed proceeds from these instruments shall be regarded as having been received from the issue of ordinary shares at the average market price of ordinary shares during the period. The difference between the number of ordinary shares issued and the number of ordinary shares that would have been issued at the average market price of ordinary shares during the period shall be treated as an issue of ordinary shares for no consideration.

46 Options and warrants are dilutive when they would result in the issue of ordinary shares for less than the average market price of ordinary shares during the period. The amount of the dilution is the average market price of ordinary shares during the period minus the issue price. Therefore, to calculate diluted earnings per share, potential ordinary shares are treated as consisting of both the following:

(a) a contract to issue a certain number of the ordinary shares at their average market price during the period. Such ordinary shares are assumed to be fairly priced and to be neither dilutive nor antidilutive. They are ignored in the calculation of diluted earnings per share.

(b) a contract to issue the remaining ordinary shares for no consideration. Such ordinary shares generate no proceeds and have no effect on profit or loss attributable to ordinary shares outstanding. Therefore, such shares are dilutive and are added to the number of ordinary shares outstanding in the calculation of diluted earnings per share.

47 Options and warrants have a dilutive effect only when the average market price of ordinary shares during the period exceeds the exercise price of the options or warrants (ie they are 'in the money'). Previously reported earnings per share are not retroactively adjusted to reflect changes in prices of ordinary shares.

47A For share options and other share-based payment arrangements to which HKFRS 2 *Share-based Payment* applies, the issue price referred to in paragraph 46 and the exercise price referred to in paragraph 47 shall include the fair value of any goods or services to be supplied to the entity in the future under the share option or other share-based payment arrangement.

48 Employee share options with fixed or determinable terms and non-vested ordinary shares are treated as options in the calculation of diluted earnings per share, even though they may be contingent on vesting. They are treated as outstanding on the grant date. Performance-based employee share options are treated as contingently issuable shares because their issue is contingent upon satisfying specified conditions in addition to the passage of time.

Convertible instruments

49 The dilutive effect of convertible instruments shall be reflected in diluted earnings per share in accordance with paragraphs 33 and 36.

50 Convertible preference shares are antidilutive whenever the amount of the dividend on such shares declared in or accumulated for the current period per ordinary share obtainable on conversion exceeds basic earnings per share. Similarly, convertible debt is antidilutive whenever its interest (net of tax and other changes in income or expense) per ordinary share obtainable on conversion exceeds basic earnings per share.

51 The redemption or induced conversion of convertible preference shares may affect only a portion of the previously outstanding convertible preference shares. In such cases, any excess consideration referred to in paragraph 17 is attributed to those shares that are redeemed or converted for the purpose of determining whether the remaining outstanding preference shares are dilutive. The shares redeemed or converted are considered separately from those shares that are not redeemed or converted.

Contingently issuable shares

52 As in the calculation of basic earnings per share, contingently issuable ordinary shares are treated as outstanding and included in the calculation of diluted earnings per share if the conditions are satisfied (ie the events have occurred). Contingently issuable shares are included from the beginning of the period (or from the date of the contingent share agreement, if later). If the conditions are not satisfied, the number of contingently issuable shares included in the diluted earnings per share calculation is based on the number of shares that would be issuable if the end of the period were the end of the contingency period. Restatement is not permitted if the conditions are not met when the contingency period expires.

53 If attainment or maintenance of a specified amount of earnings for a period is the condition for contingent issue and if that amount has been attained at the end of the reporting period but must be maintained beyond the end of the reporting period for an additional period, then the additional ordinary shares are treated as outstanding, if the effect is dilutive, when calculating diluted earnings per share. In that case, the calculation of diluted earnings per share is based on the number of ordinary shares that would be issued if the amount of earnings at the end of the reporting period were the amount of earnings at the end of the contingency period. Because earnings may change in a future period, the calculation of basic earnings per share does not include such contingently issuable ordinary shares until the end of the contingency period because not all necessary conditions have been satisfied.

54 The number of ordinary shares contingently issuable may depend on the future market price of the ordinary shares. In that case, if the effect is dilutive, the calculation of diluted earnings per share is based on the number of ordinary shares that would be issued if the market price at the end of the reporting period were the market price at the end of the contingency period. If the condition is based on an average of market prices over a period of time that extends beyond the end of the reporting period, the average for the period of time that has lapsed is used. Because the market price may change in a future period, the calculation of basic earnings per share does not include such contingently issuable ordinary shares until the end of the contingency period because not all necessary conditions have been satisfied.

55 The number of ordinary shares contingently issuable may depend on future earnings and future prices of the ordinary shares. In such cases, the number of ordinary shares included in the diluted earnings per share calculation is based on both conditions (ie earnings to date and the current market price at the end of the reporting period). Contingently issuable ordinary shares are not included in the diluted earnings per share calculation unless both conditions are met.

56 In other cases, the number of ordinary shares contingently issuable depends on a condition other than earnings or market price (for example, the opening of a specific number of retail stores). In such cases, assuming that the present status of the condition remains unchanged until the end of the contingency period, the contingently issuable ordinary shares are included in the calculation of diluted earnings per share according to the status at the end of the reporting period.

57 Contingently issuable potential ordinary shares (other than those covered by a contingent share agreement, such as contingently issuable convertible instruments) are included in the diluted earnings per share calculation as follows:

(a) an entity determines whether the potential ordinary shares may be assumed to be issuable on the basis of the conditions specified for their issue in accordance with the contingent ordinary share provisions in paragraphs 52-56; and

(b) if those potential ordinary shares should be reflected in diluted earnings per share, an entity determines their impact on the calculation of diluted earnings per share by following the provisions for options and warrants in paragraphs 45-48, the provisions for convertible instruments in paragraphs 49-51, the provisions for contracts that may be settled in ordinary shares or cash in paragraphs 58-61, or other provisions, as appropriate.

However, exercise or conversion is not assumed for the purpose of calculating diluted earnings per share unless exercise or conversion of similar outstanding potential ordinary shares that are not contingently issuable is assumed.

Contracts that may be settled in ordinary shares or cash

58 When an entity has issued a contract that may be settled in ordinary shares or in cash at the entity's option, the entity shall presume that the contract will be settled in ordinary shares, and the resulting potential ordinary shares shall be included in diluted earnings per share if the effect is dilutive.

59 When such a contract is presented for accounting purposes as an asset or a liability, or has an equity component and a liability component, the entity shall adjust the numerator for any changes in profit or loss that would have resulted during the period if the contract had been classified wholly as an equity instrument. That adjustment is similar to the adjustments required in paragraph 33.

60 For contracts that may be settled in ordinary shares or cash at the holder's option, the more dilutive of cash settlement and share settlement shall be used in calculating diluted earnings per share.

61 An example of a contract that may be settled in ordinary shares or cash is a debt instrument that, on maturity, gives the entity the unrestricted right to settle the principal amount in cash or in its own ordinary shares. Another example is a written put option that gives the holder a choice of settling in ordinary shares or cash.

Purchased options

62 Contracts such as purchased put options and purchased call options (ie options held by the entity on its own ordinary shares) are not included in the calculation of diluted earnings per share because including them would be antidilutive. The put option would be exercised only if the exercise price were higher than the market price and the call option would be exercised only if the exercise price were lower than the market price.

Written put options

63 Contracts that require the entity to repurchase its own shares, such as written put options and forward purchase contracts, are reflected in the calculation of diluted earnings per share if the effect is dilutive. If these contracts are ‘in the money’ during the period (ie the exercise or settlement price is above the average market price for that period), the potential dilutive effect on earnings per share shall be calculated as follows:

(a) it shall be assumed that at the beginning of the period sufficient ordinary shares will be issued (at the average market price during the period) to raise proceeds to satisfy the contract;

(b) it shall be assumed that the proceeds from the issue are used to satisfy the contract (ie to buy back ordinary shares); and

(c) the incremental ordinary shares (the difference between the number of ordinary shares assumed issued and the number of ordinary shares received from satisfying the contract) shall be included in the calculation of diluted earnings per share.

Retrospective adjustments

64 If the number of ordinary or potential ordinary shares outstanding increases as a result of a capitalisation, bonus issue or share split, or decreases as a result of a reverse share split, the calculation of basic and diluted earnings per share for all periods presented shall be adjusted retrospectively. If these changes occur after the ~~balance sheet date~~ reporting period but before the financial statements are authorised for issue, the per share calculations for those and any prior period financial statements presented shall be based on the new number of shares. The fact that per share calculations reflect such changes in the number of shares shall be disclosed. In addition, basic and diluted earnings per share of all periods presented shall be adjusted for the effects of errors and adjustments resulting from changes in accounting policies accounted for retrospectively.

65 An entity does not restate diluted earnings per share of any prior period presented for changes in the assumptions used in earnings per share calculations or for the conversion of potential ordinary shares into ordinary shares.

Presentation

66 An entity shall present in the ~~income~~ statement of comprehensive income basic and diluted earnings per share for profit or loss from continuing operations attributable to the ordinary equity holders of the parent entity and for profit or loss attributable to the ordinary equity holders of the parent entity for the period for each class of ordinary shares that has a different right to share in profit for the period. An entity shall present basic and diluted earnings per share with equal prominence for all periods presented.

67 Earnings per share is presented for every period for which a ~~income~~ statement of comprehensive income is presented. If diluted earnings per share is reported for at least one period, it shall be reported for all periods presented, even if it equals basic earnings per share. If basic and diluted earnings per share are equal, dual presentation can be accomplished in one line ~~on~~in the ~~income~~ statement of comprehensive income.

67A If an entity presents the components of profit or loss in a separate income statement as described in paragraph 81 of HKAS 1 (as revised in 2007), it presents basic and diluted earnings per share, as required in paragraphs 66 and 67, in that separate statement.

68 An entity that reports a discontinued operation shall disclose the basic and diluted amounts per share for the discontinued operation either in the ~~income~~ statement of comprehensive income or in the notes.

68A If an entity presents the components of profit or loss in a separate income statement as described in paragraph 81 of HKAS 1 (as revised in 2007), it presents basic and diluted earnings per share for the discontinued operation, as required in paragraph 68, in that separate statement or in the notes.

69 An entity shall present basic and diluted earnings per share, even if the amounts are negative (ie a loss per share).

Disclosure

70 An entity shall disclose the following:

(a) the amounts used as the numerators in calculating basic and diluted earnings per share, and a reconciliation of those amounts to profit or loss attributable to the parent entity for the period. The reconciliation shall include the individual effect of each class of instruments that affects earnings per share.

(b) the weighted average number of ordinary shares used as the denominator in calculating basic and diluted earnings per share, and a reconciliation of these denominators to each other. The reconciliation shall include the individual effect of each class of instruments that affects earnings per share.

(c) instruments (including contingently issuable shares) that could potentially dilute basic earnings per share in the future, but were not included in the calculation of diluted earnings per share because they are antidilutive for the period(s) presented.

(d) a description of ordinary share transactions or potential ordinary share transactions, other than those accounted for in accordance with paragraph 64, that occur after the ~~balance sheet date~~ reporting period and that would have changed significantly the number of ordinary shares or potential ordinary shares outstanding at the end of the period if those transactions had occurred before the end of the reporting period.

71 Examples of transactions in paragraph 70(d) include:

(a) an issue of shares for cash;

(b) an issue of shares when the proceeds are used to repay debt or preference shares outstanding at the ~~balance sheet date~~ end of the reporting period;

(c) the redemption of ordinary shares outstanding;

(d) the conversion or exercise of potential ordinary shares outstanding at the ~~balance sheet date~~ end of the reporting period into ordinary shares;

(e) an issue of options, warrants, or convertible instruments; and

(f) the achievement of conditions that would result in the issue of contingently issuable shares.

Earnings per share amounts are not adjusted for such transactions occurring after the ~~balance sheet date~~ reporting period because such transactions do not affect the amount of capital used to produce profit or loss for the period.

72 Financial instruments and other contracts generating potential ordinary shares may incorporate terms and conditions that affect the measurement of basic and diluted earnings per share. These terms and conditions may determine whether any potential ordinary shares are dilutive and, if so, the effect on the weighted average number of

shares outstanding and any consequent adjustments to profit or loss attributable to ordinary equity holders. The disclosure of the terms and conditions of such financial instruments and other contracts is encouraged, if not otherwise required (see HKFRS 7 *Financial Instruments: Disclosures*).

73 If an entity discloses, in addition to basic and diluted earnings per share, amounts per share using a reported component of the ~~income~~ statement comprehensive income of other than one required by this Standard, such amounts shall be calculated using the weighted average number of ordinary shares determined in accordance with this Standard. Basic and diluted amounts per share relating to such a component shall be disclosed with equal prominence and presented in the notes. An entity shall indicate the basis on which the numerator(s) is (are) determined, including whether amounts per share are before tax or after tax. If a component of the ~~income~~ statement of comprehensive income is used that is not reported as a line item in the ~~income~~ statement of comprehensive income, a reconciliation shall be provided between the component used and a line item that is reported in the ~~income~~ statement of comprehensive income.

73A Paragraph 73 applies also to an entity that discloses, in addition to basic and diluted earnings per share, amounts per share using a reported component of the separate income statement (as described in paragraph 81 of HKAS 1 (as revised in 2007)), other than one required by this Standard.

Effective date

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

74~~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.

74A HKAS 1 (as revised in 2007) amended the terminology used throughout HKFRSs. In addition it added paragraphs 4A, 67A, 68A and 73A. An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. If an entity applies HKAS 1 (revised 2007) for an earlier period, the amendments shall be applied for that earlier period.

Withdrawal of other pronouncements

75 This Standard supersedes SSAP 5 *Earnings Per Share* revised in 1998.

76 This Standard supersedes Interpretation 10 *Earnings Per Share—Financial Instruments and Other Contracts that May Be Settled in Shares.*

Appendix

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 33.

The International Accounting Standard comparable with HKAS 33 is IAS 33 *Earnings Per Share*.

There are no major textual differences between HKAS 33 and IAS 33.

Appendix A
Application guidance

This appendix is an integral part of the Standard.

Profit or loss attributable to the parent entity

A1[♦] For the purpose of calculating earnings per share based on the consolidated financial statements, profit or loss attributable to the parent entity refers to profit or loss of the consolidated entity after adjusting for ~~minority interests~~ non-controlling interests.

Rights issues

A2 The issue of ordinary shares at the time of exercise or conversion of potential ordinary shares does not usually give rise to a bonus element. This is because the potential ordinary shares are usually issued for full value, resulting in a proportionate change in the resources available to the entity. In a rights issue, however, the exercise price is often less than the fair value of the shares. Therefore, as noted in paragraph 27(b), such a rights issue includes a bonus element. If a rights issue is offered to all existing shareholders, the number of ordinary shares to be used in calculating basic and diluted earnings per share for all periods before the rights issue is the number of ordinary shares outstanding before the issue, multiplied by the following factor:

$$\frac{\text{Fair value per share immediately before the exercise of rights}}{\text{Theoretical ex-rights fair value per share}}$$

The theoretical ex-rights fair value per share is calculated by adding the aggregate market value of the shares immediately before the exercise of the rights to the proceeds from the exercise of the rights, and dividing by the number of shares outstanding after the exercise of the rights. Where the rights are to be publicly traded separately from the shares before the exercise date, fair value for the purposes of this calculation is established at the close of the last day on which the shares are traded together with the rights.

Control number

A3 To illustrate the application of the control number notion described in paragraphs 42 and 43, assume that an entity has profit from continuing operations attributable to the parent entity of CU4,800[*], a loss from discontinued operations attributable to the parent entity of (CU7,200), a loss attributable to the parent entity of (CU2,400), and 2,000 ordinary shares and 400 potential ordinary shares outstanding. The entity's basic earnings per share is CU2.40 for continuing operations, (CU3.60) for discontinued operations and (CU1.20) for the loss. The 400 potential ordinary shares are included in the diluted earnings per share calculation because the resulting CU2.00 earnings per share for continuing operations is dilutive, assuming no profit or

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

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

loss impact of those 400 potential ordinary shares. Because profit from continuing operations attributable to the parent entity is the control number, the entity also includes those 400 potential ordinary shares in the calculation of the other earnings per share amounts, even though the resulting earnings per share amounts are antidilutive to their comparable basic earnings per share amounts, ie the loss per share is less [(CU3.00) per share for the loss from discontinued operations and (CU1.00) per share for the loss].

Average market price of ordinary shares

A4 For the purpose of calculating diluted earnings per share, the average market price of ordinary shares assumed to be issued is calculated on the basis of the average market price of the ordinary shares during the period. Theoretically, every market transaction for an entity's ordinary shares could be included in the determination of the average market price. As a practical matter, however, a simple average of weekly or monthly prices is usually adequate.

A5 Generally, closing market prices are adequate for calculating the average market price. When prices fluctuate widely, however, an average of the high and low prices usually produces a more representative price. The method used to calculate the average market price is used consistently unless it is no longer representative because of changed conditions. For example, an entity that uses closing market prices to calculate the average market price for several years of relatively stable prices might change to an average of high and low prices if prices start fluctuating greatly and the closing market prices no longer produce a representative average price.

Options, warrants and their equivalents

A6 Options or warrants to purchase convertible instruments are assumed to be exercised to purchase the convertible instrument whenever the average prices of both the convertible instrument and the ordinary shares obtainable upon conversion are above the exercise price of the options or warrants. However, exercise is not assumed unless conversion of similar outstanding convertible instruments, if any, is also assumed.

A7 Options or warrants may permit or require the tendering of debt or other instruments of the entity (or its parent or a subsidiary) in payment of all or a portion of the exercise price. In the calculation of diluted earnings per share, those options or warrants have a dilutive effect if (a) the average market price of the related ordinary shares for the period exceeds the exercise price or (b) the selling price of the instrument to be tendered is below that at which the instrument may be tendered under the option or warrant agreement and the resulting discount establishes an effective exercise price below the market price of the ordinary shares obtainable upon exercise. In the calculation of diluted earnings per share, those options or warrants are assumed to be exercised and the debt or other instruments are assumed to be tendered. If tendering cash is more advantageous to the option or warrant holder and the contract permits tendering cash, tendering of cash is assumed. Interest (net of tax) on any debt assumed to be tendered is added back as an adjustment to the numerator.

A8 Similar treatment is given to preference shares that have similar provisions or to other instruments that have conversion options that permit the investor to pay cash for a more favourable conversion rate.

A9 The underlying terms of certain options or warrants may require the proceeds received from the exercise of those instruments to be applied to redeem debt or other instruments of the entity (or its parent or a subsidiary). In the calculation of diluted earnings per share, those options or warrants are assumed to be exercised and the proceeds applied to purchase the debt at its average market price rather than to purchase ordinary shares. However, the excess proceeds received from the assumed exercise over the amount used for the assumed purchase of debt are considered (ie assumed to be used to buy back ordinary shares) in the diluted earnings per share calculation. Interest (net of tax) on any debt assumed to be purchased is added back as an adjustment to the numerator.

Written put options

A10 To illustrate the application of paragraph 63, assume that an entity has outstanding 120 written put options on its ordinary shares with an exercise price of CU35. The average market price of its ordinary shares for the period is CU28. In calculating diluted earnings per share, the entity assumes that it issued 150 shares at CU28 per share at the beginning of the period to satisfy its put obligation of CU4,200. The difference between the 150 ordinary shares issued and the 120 ordinary shares received from satisfying the put option (30 incremental ordinary shares) is added to the denominator in calculating diluted earnings per share.

Instruments of subsidiaries, joint ventures or associates

A11 Potential ordinary shares of a subsidiary, joint venture or associate convertible into either ordinary shares of the subsidiary, joint venture or associate, or ordinary shares of the parent, venturer or investor (the reporting entity) are included in the calculation of diluted earnings per share as follows:

(a) instruments issued by a subsidiary, joint venture or associate that enable their holders to obtain ordinary shares of the subsidiary, joint venture or associate are included in calculating the diluted earnings per share data of the subsidiary, joint venture or associate. Those earnings per share are then included in the reporting entity's earnings per share calculations based on the reporting entity's holding of the instruments of the subsidiary, joint venture or associate.

(b) instruments of a subsidiary, joint venture or associate that are convertible into the reporting entity's ordinary shares are considered among the potential ordinary shares of the reporting entity for the purpose of calculating diluted earnings per share. Likewise, options or warrants issued by a subsidiary, joint venture or associate to purchase ordinary shares of the reporting entity are considered among the potential ordinary shares of the reporting entity in the calculation of consolidated diluted earnings per share.

A12 For the purpose of determining the earnings per share effect of instruments issued by a reporting entity that are convertible into ordinary shares of a subsidiary, joint venture or associate, the instruments are assumed to be converted and the numerator (profit or loss attributable to ordinary equity holders of the parent entity) adjusted as necessary in accordance with paragraph 33. In addition to those adjustments, the numerator is adjusted for any change in the profit or loss recorded by the reporting entity (such as dividend income or equity method income) that is attributable to the increase in the number of ordinary shares of the subsidiary, joint venture or associate outstanding as a result of the assumed conversion. The denominator of the diluted earnings per share calculation is not affected because the number of ordinary shares of the reporting entity outstanding would not change upon assumed conversion.

Participating equity instruments and two-class ordinary shares

A13 The equity of some entities includes:

(a) instruments that participate in dividends with ordinary shares according to a predetermined formula (for example, two for one) with, at times, an upper limit on the extent of participation (for example, up to, but not beyond, a specified amount per share).

(b) a class of ordinary shares with a different dividend rate from that of another class of ordinary shares but without prior or senior rights.

A14 For the purpose of calculating diluted earnings per share, conversion is assumed for those instruments described in paragraph A13 that are convertible into ordinary shares if the effect is dilutive. For those instruments that are not convertible into a class of ordinary shares, profit or loss for the period is allocated to the different classes of shares and participating equity instruments in accordance with their dividend rights or other rights to participate in undistributed earnings. To calculate basic and diluted earnings per share:

(a) profit or loss attributable to ordinary equity holders of the parent entity is adjusted (a profit reduced and a loss increased) by the amount of dividends declared in the period for each class of shares and by the contractual amount of dividends (or interest on participating bonds) that must be paid for the period (for example, unpaid cumulative dividends).

(b) the remaining profit or loss is allocated to ordinary shares and participating equity instruments to the extent that each instrument shares in earnings as if all of the profit or loss for the period had been distributed. The total profit or loss allocated to each class of equity instrument is determined by adding together the amount allocated for dividends and the amount allocated for a participation feature.

(c) the total amount of profit or loss allocated to each class of equity instrument is divided by the number of outstanding instruments to which the earnings are allocated to determine the earnings per share for the instrument.

For the calculation of diluted earnings per share, all potential ordinary shares assumed to have been issued are included in outstanding ordinary shares.

Partly paid shares

A15 Where ordinary shares are issued but not fully paid, they are treated in the calculation of basic earnings per share as a fraction of an ordinary share to the extent that they were entitled to participate in dividends during the period relative to a fully paid ordinary share.

A16 To the extent that partly paid shares are not entitled to participate in dividends during the period they are treated as the equivalent of warrants or options in the calculation of diluted earnings per share. The unpaid balance is assumed to represent proceeds used to purchase ordinary shares. The number of shares included in diluted earnings per share is the difference between the number of shares subscribed and the number of shares assumed to be purchased.

Appendix B

Amendments to other pronouncements

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

* * *

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

Basis for Conclusions on IAS 33 *Earnings per Share*

This Basis for Conclusions accompanies, but is not part of, HKAS 33.

HKAS 33 is based on IAS 33 *Earnings per Share*. In approving HKAS 33, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IASB's Basis for Conclusions on IAS 33 (as revised 2003). Accordingly, there are no significant differences between HKAS 33 and IAS 33. The IASB's Basis for Conclusions is reproduced below for reference. The paragraph numbers of IAS 33 referred to below generally correspond with those in HKAS 33.

Introduction

BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching its conclusions on revising IAS 33 *Earnings Per Share* 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 33. 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 determination and presentation of earnings per share established by IAS 33, this Basis for Conclusions does not discuss requirements in IAS 33 that the Board has not reconsidered.

Presentation of parent's separate earnings per share

BC4 The Exposure Draft published in May 2002 proposed deleting paragraphs 2 and 3 of the previous version of IAS 33, which stated that when the parent's separate financial statements and consolidated financial statements are presented, earnings per share need be presented only on the basis of consolidated information.

BC5 Some respondents expressed concern that the presentation of two earnings per share figures (one for the parent's separate financial statements and one for the consolidated financial statements) might be misleading.

BC6 The Board noted that disclosing the parent's separate earnings per share amount is useful in limited situations, and therefore decided to retain the option. However, the Board decided that the Standard should prohibit presentation of the parent's separate earnings per share amounts in the consolidated financial statements (either on the face of the financial statements or in the notes).

Contracts that may be settled in ordinary shares or cash

BC7 The Exposure Draft proposed that an entity should include in the calculation of the number of potential ordinary shares in the diluted earnings per share calculation contracts that may be settled in ordinary shares or cash, at the issuer's option, based on a rebuttable presumption that the contracts will be settled in shares. This proposed presumption could be rebutted if the issuer had acted through an established pattern of past practice, published policies, or by having made a sufficiently specific current statement indicating to other parties the manner in which it expected to settle, and, as a result, the issuer had created a valid expectation on the part of those other parties that it would settle in a manner other than by issuing shares.

BC8 The majority of the respondents on the Exposure Draft agreed with the proposed treatment of contracts that may be settled in ordinary shares or cash at the issuer's option. However, the Board decided to withdraw the notion of a rebuttable presumption and to incorporate into the Standard the requirements of SIC-24 *Earnings Per Share—Financial Instruments and Other Contracts that May Be Settled in Shares.* SIC-24 requires financial instruments or other contracts that may result in the issue of ordinary shares of the entity to be considered potential ordinary shares of the entity.

BC9 Although the proposed treatment would have converged with that required by several liaison standard-setters, for example in US SFAS 128 *Earnings per Share*, the Board concluded that the notion of a rebuttable presumption is inconsistent with the stated objective of diluted earnings per share. The US Financial Accounting Standards Board has agreed to consider this difference as part of the joint short-term convergence project with the IASB.

Calculation of year-to-date diluted earnings per share

BC10 The Exposure Draft proposed the following approach to the year-to-date calculation of diluted earnings per share:

(a) The number of potential ordinary shares is a year-to-date weighted average of the number of potential ordinary shares included in each interim diluted earnings per share calculation, rather than a year-to-date weighted average of the number of potential ordinary shares weighted for the period they were outstanding (ie without regard for the diluted earnings per share information reported during the interim periods).

(b) The number of potential ordinary shares is computed using the average market price during the interim periods, rather than using the average market price during the year-to-date period.

(c) Contingently issuable shares are weighted for the interim periods in which they were included in the computation of diluted earnings per share, rather than being included in the computation of diluted earnings per share (if the conditions are satisfied) from the beginning of the year-to-date reporting period (or from the date of the contingent share agreement, if later).

BC11 The majority of the respondents on the Exposure Draft disagreed with the proposed approach to the year-to-date calculation of diluted earnings per share. The most significant argument against the proposed approach was that the proposed calculation of diluted earnings per share could result in an amount for year-to-date diluted earnings per share that was different for entities that report more frequently, for example, on a quarterly or half-yearly basis, and for entities that report only annually. It was also noted that this problem would be exacerbated for entities with seasonal businesses.

BC12 The Board considered whether to accept that differences in the frequency of interim reporting would result in different earnings per share amounts being reported. However, IAS 34 *Interim Financial Reporting* states 'the frequency of an entity's reporting (annual, half-yearly, or quarterly) should not affect the measurement of its annual results. To achieve that objective, measurements for interim reporting purposes should be made on a year-to-date basis.'

BC13 The Board also considered whether it could mandate the frequency of interim reporting to ensure consistency between all entities preparing financial statements in accordance with IFRSs, ie those that are brought within the scope of IAS 33 by virtue of issuing publicly traded instruments or because they elect to present earnings per share. However, IAS 34 states that, 'This Standard does not mandate which entities should be required to publish interim financial reports, how frequently, or how soon after the end of an interim period.' The frequency of interim reporting is mandated by securities regulators, stock exchanges, governments, and accountancy bodies, and varies by jurisdiction.

BC14 Although the proposed approach for the calculation of year-to-date diluted earnings per share would have converged with US SFAS 128, the Board concluded that the approach was inconsistent with IAS 34 and that it could not mandate the frequency of interim reporting. The US Financial Accounting Standards Board has agreed to consider this difference as part of the joint short-term convergence project with the IASB as well as the issue noted in paragraph BC9.

Other changes

BC15 Implementation questions have arisen since the previous version of IAS 33 was issued, typically concerning the application of the Standard to complex capital structures and arrangements. In response, the Board decided to provide additional application guidance in the Appendix as well as illustrative examples on more complex matters that were not addressed in the previous version of IAS 33. These matters include the effects of contingently issuable shares, potential ordinary shares of subsidiaries, joint ventures or associates, participating equity instruments, written put options, and purchased put and call options.

Illustrative Examples

These examples accompany, but are not part of, IAS 33.

Contents

Example 1 Increasing rate preference shares

Reference: IAS 33, paragraphs 12 and 15

Entity D issued non-convertible, non-redeemable class A cumulative preference shares of CU100 par value on 1 January 20X1. The class A preference shares are entitled to a cumulative annual dividend of CU7 per share starting in 20X4.

At the time of issue, the market rate dividend yield on the class A preference shares was 7 per cent a year. Thus, Entity D could have expected to receive proceeds of approximately CU100 per class A preference share if the dividend rate of CU7 per share had been in effect at the date of issue.

In consideration of the dividend payment terms, however, the class A preference shares were issued at CU81.63 per share, ie at a discount of CU18.37 per share. The issue price can be calculated by taking the present value of CU100, discounted at 7 per cent over a three-year period.

Because the shares are classified as equity, the original issue discount is amortised to retained earnings using the effective interest method and treated as a preference dividend for earnings per share purposes. To calculate basic earnings per share, the following imputed dividend per class A preference share is deducted to determine the profit or loss attributable to ordinary equity holders of the parent entity:

Year	*Carrying amount of class A preference shares 1 January*	*Imputed dividend*[(a)]	*Carrying amount of class A preference shares 31 December*[(b)]	*Dividend paid*
	CU	*CU*	*CU*	*CU*
20X1	81.63	5.71	87.34	-
20X2	87.34	6.12	93.46	-
20X3	93.46	6.54	100.00	-
Thereafter:	100.00	7.00	107.00	(7.00)

[(a)] At 7%.
[(b)] This is before dividend payment.

Example 2 Weighted average number of ordinary shares

Reference: IAS 33, paragraphs 19-21

		Shares issued	*Treasury shares*[(a)]	*Shares outstanding*
1 January 20X1	Balance at beginning of year	2,000	300	1,700
31 May 20X1	Issue of new shares for cash	800	-	2,500
1 December 20X1	Purchase of treasury shares for cash	-	250	2,250
31 December 20X1	Balance at year-end	2,800	550	2,250

Calculation of weighted average:

(1,700 *x* 5/12) + (2,500 *x* 6/12) + (2,250 *x* 1/12) = 2,146 shares *or*
(1,700 *x* 12/12) + (800 *x* 7/12) - (250 *x* 1/12) = 2,146 shares

(a) Treasury shares are equity instruments reacquired and held by the issuing entity itself or by its subsidiaries.

Example 3 Bonus issue

Reference: IAS 33, paragraphs 26, 27(a) and 28

Profit attributable to ordinary equity holders of the parent entity 20X0	CU180
Profit attributable to ordinary equity holders of the parent entity 20X1	CU600
Ordinary shares outstanding until 30 September 20X1	200
Bonus issue 1 October 20X1	2 ordinary shares for each ordinary share outstanding at 30 September 20X1 200 *x* 2 = 400
Basic earnings per share 20X1	$\frac{\text{CU600}}{(200 + 400)}$ = CU1.00
Basic earnings per share 20X0	$\frac{\text{CU180}}{(200 + 400)}$ = CU0.30

Because the bonus issue was without consideration, it is treated as if it had occurred before the beginning of 20X0, the earliest period presented.

Example 4 Rights issue

Reference: IAS 33, paragraphs 26, 27(b) and A2

	20X0	20X1	20X2
Profit attributable to ordinary equity holders of the parent entity	CU1,100	CU1,500	CU1,800

Shares outstanding before rights issue	500 shares
Rights issue	One new share for each five outstanding shares (100 new shares total) Exercise price: CU5.00 Date of rights issue: 1 January 20X1 Last date to exercise rights: 1 March 20X1
Market price of one ordinary share immediately before exercise on 1 March 20X1:	CU11.00
Reporting date	31 December

Calculation of theoretical ex-rights value per share

$$\frac{\text{Fair value of all outstanding shares before the exercise of rights + total amount received from exercise of rights}}{\text{Number of shares outstanding before exercise + number of shares issued in the exercise}}$$

$$\frac{(\text{CU11.00 } x \text{ 500 shares}) + (\text{CU5.00 } x \text{ 100 shares})}{\text{500 shares + 100 shares}}$$

Theoretical ex-rights value per share = CU10.00

Calculation of adjustment factor

$$\frac{\text{Fair value per share before exercise of rights}}{\text{Theoretical ex-rights value per share}} \qquad \frac{\text{CU11.00}}{\text{CU10.00}} \qquad = 1.10$$

Calculation of basic earnings per share

		20X0	20X1	20X2
20X0 basic EPS as originally reported:	CU1,100÷500 shares	CU2.20		
20X0 basic EPS restated for rights issue:	$\frac{\text{CU1,100}}{(500 \text{ shares } x \ 1.1)}$	CU2.00		
20X1 basic EPS including effects of rights issue:	$\frac{\text{CU1,500}}{(500 \ x \ 1.1 \ x \ 2 \div 12) + (600 \ x \ 10 \div 12)}$		CU2.54	
20X2 basic EPS:	CU1,800÷600 shares			CU3.00

Example 5 Effects of share options on diluted earnings per share

Reference: IAS 33, paragraphs 45-47

Profit attributable to ordinary equity holders of the parent entity for year 20X1	CU1,200,000
Weighted average number of ordinary shares outstanding during year 20X1	500,000 shares
Average market price of one ordinary share during year 20X1	CU20.00
Weighted average number of shares under option during year 20X1	100,000 shares
Exercise price for shares under option during year 20X1	CU15.00

Calculation of earnings per share

	Earnings	*Shares*	*Per share*
Profit attributable to ordinary equity holders of the parent entity for year 20X1	CU1,200,000		
Weighted average shares outstanding during year 20X1		500,000	
Basic earnings per share			CU2.40
Weighted average number of shares under option		100,000	
Weighted average number of shares that would have been issued at average market price: (100,000 *x* CU15.00) ÷CU20.00	[a]	(75,000)	
Diluted earnings per share	CU1,200,000	525,000	CU2.29

[a] Earnings have not increased because the total number of shares has increased only by the number of shares (25,000) deemed to have been issued for no consideration (see paragraph 46(b) of the Standard).

Example 5A Determining the exercise price of employee share options

Weighted average number of unvested share options per employee	1,000
Weighted average amount per employee to be recognised over the remainder of the vesting period for employee services to be rendered as consideration for the share options, determined in accordance with IFRS 2 *Share-based Payment*	CU1,200
Cash exercise price of unvested share options	CU15

Calculation of adjusted exercise price

Fair value of services yet to be rendered per employee:	CU1,200
Fair value of services yet to be rendered per option: (CU1,200 ÷ 1,000)	CU1.20
Total exercise price of share options: (CU15.00 + CU1.20)	CU16.20

Example 6 Convertible bonds*

Reference: IAS 33, paragraphs 33, 34, 36 and 49

Profit attributable to ordinary equity holders of the parent entity	CU1,004
Ordinary shares outstanding	1,000
Basic earnings per share	CU1.00
Convertible bonds	100
Each block of 10 bonds is convertible into three ordinary shares	
Interest expense for the current year relating to the liability component of the convertible bonds	CU10
Current and deferred tax relating to that interest expense	CU4

Note: the interest expense includes amortisation of the discount arising on initial recognition of the liability component (see IAS 32 Financial Instruments: Presentation*).*

Adjusted profit attributable to ordinary equity holders of the parent entity	CU1,004 + CU10 - CU4 = CU1,010
Number of ordinary shares resulting from conversion of bonds	30
Number of ordinary shares used to calculate diluted earnings per share	1,000 + 30 = 1,030
Diluted earnings per share	$\frac{\text{CU1,010}}{\text{1,030}}$ = CU0.98

* This example does not illustrate the classification of the components of convertible financial instruments as liabilities and equity or the classification of related interest and dividends as expenses and equity as required by IAS 32.

Example 7 - Contingently issuable shares

Reference: IAS 33, paragraphs 19, 24, 36, 37, 41-43 and 52

Ordinary shares outstanding during 20X1	1,000,000 (there were no options, warrants or convertible instruments outstanding during the period)

An agreement related to a recent business combination provides for the issue of additional ordinary shares based on the following conditions:

	5,000 additional ordinary shares for each new retail site opened during 20X1
	1,000 additional ordinary shares for each CU1,000 of consolidated profit in excess of CU2,000,000 for the year ended 31 December 20X1
Retail sites opened during the year:	one on 1 May 20X1
	one on 1 September 20X1
Consolidated year-to-date profit attributable to ordinary equity holders of the parent entity:	CU1,100,000 as of 31 March 20X1
	CU2,300,000 as of 30 June 20X1
	CU1,900,000 as of 30 September 20X1 (including a CU450,000 loss from a discontinued operation)
	CU2,900,000 as of 31 December 20X1

Basic earnings per share

	First quarter	*Second quarter*	*Third quarter*	*Fourth quarter*	*Full year*
Numerator (CU)	1,100,000	1,200,000	(400,000)	1,000,000	2,900,000
Denominator:					
Ordinary shares outstanding	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
Retail site contingency	--	3,333 [(a)]	6,667 [(b)]	10,000	5,000 [(c)]
Earnings contingency [(d)]	--	---	--	---	---
Total shares	1,000,000	1,003,333	1,006,667	1,010,000	1,005,000
Basic earnings per share (CU)	1.10	1.20	(0.40)	0.99	2.89

(a) 5,000 shares *x* 2/3

(b) 5,000 shares + (5,000 shares *x* 1/3)

(c) (5,000 shares *x* 8/12) + (5,000 shares *x* 4/12)

(d) The earnings contingency has no effect on basic earnings per share because it is not certain that the condition is satisfied until the end of the contingency period. The effect is negligible for the fourth-quarter and full-year calculations because it is not certain that the condition is met until the last day of the period.

Diluted earnings per share

	First quarter	Second quarter	Third quarter	Fourth quarter	Full year
Numerator (CU)	1,100,000	1,200,000	(400,000)	1,000,000	2,900,000
Denominator:					
Ordinary shares outstanding	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
Retail site contingency	--	5,000	10,000	10,000	10,000
Earnings contingency	-- [(a)]	300,000 [(b)]	-- [(c)]	900,000 [(d)]	900,000 [(d)]
Total shares	1,000,000	1,305,000	1,010,000	1,910,000	1,910,000
Diluted earnings per share (CU)	1.10	0.92	(0.40) [(e)]	0.52	1.52

(a) Company A does not have year-to-date profit exceeding CU2,000,000 at 31 March 20X1. The Standard does not permit projecting future earnings levels and including the related contingent shares.

(b) [(CU2,300,000 - CU2,000,000) ÷ 1,000] *x* 1,000 shares = 300,000 shares.

(c) Year-to-date profit is less than CU2,000,000.

(d) [(CU2,900,000 - CU2,000,000) ÷ 1,000] *x* 1,000 shares = 900,000 shares.

(e) Because the loss during the third quarter is attributable to a loss from a discontinued operation, the antidilution rules do not apply. The control number (ie profit or loss from continuing operations attributable to the equity holders of the parent entity) is positive. Accordingly, the effect of potential ordinary shares is included in the calculation of diluted earnings per share.

Example 8 Convertible bonds settled in shares or cash at the issuer's option

Reference: IAS 33, paragraphs 31-33, 36, 58 and 59

An entity issues 2,000 convertible bonds at the beginning of Year 1. The bonds have a three-year term, and are issued at par with a face value of CU1,000 per bond, giving total proceeds of CU2,000,000. Interest is payable annually in arrears at a nominal annual interest rate of 6 per cent. Each bond is convertible at any time up to maturity into 250 ordinary shares. The entity has an option to settle the principal amount of the convertible bonds in ordinary shares or in cash.

When the bonds are issued, the prevailing market interest rate for similar debt without a conversion option is 9 per cent. At the issue date, the market price of one ordinary share is CU3. Income tax is ignored.

Profit attributable to ordinary equity holders of the parent entity Year 1	CU1,000,000
Ordinary shares outstanding	1,200,000
Convertible bonds outstanding	2,000
Allocation of proceeds of bond issue:	
Liability component	CU1,848,122*
Equity component	CU151,878
	CU2,000,000

The liability and equity components would be determined in accordance with IAS 32 *Financial Instruments: Presentation*. These amounts are recognised as the initial carrying amounts of the liability and equity components. The amount assigned to the issuer conversion option equity element is an addition to equity and is not adjusted.

Basic earnings per share Year 1:

$$\frac{CU1{,}000{,}000}{1{,}200{,}000} = CU0.83 \text{ per ordinary share}$$

* This represents the present value of the principal and interest discounted at 9% - CU2,000,000 payable at the end of three years; CU120,000 payable annually in arrears for three years.

Diluted earnings per share Year 1:

It is presumed that the issuer will settle the contract by the issue of ordinary shares. The dilutive effect is therefore calculated in accordance with paragraph 59 of the Standard.

$$\frac{CU1{,}000{,}000 + CU166{,}331^{(a)}}{1{,}200{,}000 + 500{,}000^{(b)}} = CU0.69 \text{ per ordinary share}$$

(a) Profit is adjusted for the accretion of CU166,331 (CU1,848,122 *x* 9%) of the liability because of the passage of time.

(b) 500,000 ordinary shares = 250 ordinary shares *x* 2000 convertible bonds

Example 9 Calculation of weighted average number of shares: determining the order in which to include dilutive instruments*

Primary reference: IAS 33, paragraph 44

Secondary reference: IAS 33, paragraphs 10, 12, 19, 31-33, 36, 41-47, 49 and 50

Earnings	CU
Profit from continuing operations attributable to the parent entity	16,400,000
Less dividends on preference shares	(6,400,000)
Profit from continuing operations attributable to ordinary equity holders of the parent entity	10,000,000
Loss from discontinued operations attributable to the parent entity	(4,000,000)
Profit attributable to ordinary equity holders of the parent entity	6,000,000
Ordinary shares outstanding	2,000,000
Average market price of one ordinary share during year	CU75.00

Potential Ordinary Shares

Options	100,000 with exercise price of CU60
Convertible preference shares	800,000 shares with a par value of CU100 entitled to a cumulative dividend of CU8 per share. Each preference share is convertible to two ordinary shares.
5% convertible bonds	Nominal amount CU100,000,000. Each CU1,000 bond is convertible to 20 ordinary shares. There is no amortisation of premium or discount affecting the determination of interest expense.
Tax rate	40%

* This example does not illustrate the classification of the components of convertible financial instruments as liabilities and equity or the classification of related interest and dividends as expenses and equity as required by IAS 32.

Increase in earnings attributable to ordinary equity holders on conversion of potential ordinary shares

		Increase in earnings	*Increase in number of ordinary shares*	*Earnings per incremental share*
		CU		*CU*
Options				
Increase in earnings		Nil		
Incremental shares issued for no consideration	100,000 *x* (CU75-CU60) ÷CU75		20,000	Nil
Convertible preference shares				
Increase in profit	CU800,000 *x* 100 *x*0.08	6,400,000		
Incremental shares	2 *x* 800,000		1,600,000	4.00
5% convertible bonds				
Increase in profit	CU100,000,000 *x* 0.05 *x* (1 – 0.40)	3,000,000		
Incremental shares	100,000 *x* 20		2,000,000	1.50

The order in which to include the dilutive instruments is therefore:

1 Options
2 5% convertible bonds
3 Convertible preference shares

Calculation of diluted earnings per share

	Profit from continuing operations attributable to ordinary equity holders of the parent entity (control number)	*Ordinary shares*	*Per share*	
	CU		*CU*	
As reported	10,000,000	2,000,000	5.00	
Options	--	20,000		
	10,000,000	2,020,000	4.95	Dilutive
5% convertible bonds	3,000,000	2,000,000		
	13,000,000	4,020,000	3.23	Dilutive
Convertible preference shares	6,400,000	1,600,000		
	19,400,000	5,620,000	3.45	Antidilutive

Because diluted earnings per share is increased when taking the convertible preference shares into account (from CU3.23 to CU3.45), the convertible preference shares are antidilutive and are ignored in the calculation of diluted earnings per share. Therefore, diluted earnings per share for profit from continuing operations is CU3.23:

	Basic EPS	*Diluted EPS*
	CU	*CU*
Profit from continuing operations attributable to ordinary equity holders of the parent entity	5.00	3.23
Loss from discontinued operations attributable to ordinary equity holders of the parent entity	(2.00) [(a)]	(0.99) [(b)]
Profit attributable to ordinary equity holders of the parent entity	3.00 [(c)]	2.24 [(d)]

(a) (CU4,000,000) ÷ 2,000,000 = (CU2.00)
(b) (CU4,000,000)÷ 4,020,000 = (CU0.99)
(c) CU6,000,000 ÷ 2,000,000 = CU3.00
(d) (CU6,000,000 + CU3,000,000) ÷ 4,020,000 = CU2.24

Example 10 Instruments of a subsidiary: calculation of basic and diluted earnings per share*

Reference: IAS 33, paragraphs 40, A11 and A12

Parent:

Profit attributable to ordinary equity holders of the parent entity	CU12,000 (excluding any earnings of, or dividends paid by, the subsidiary)
Ordinary shares outstanding	10,000
Instruments of subsidiary owned by the parent	800 ordinary shares 30 warrants exercisable to purchase ordinary shares of subsidiary 300 convertible preference shares

Subsidiary:

Profit	CU5,400
Ordinary shares outstanding	1,000
Warrants	150, exercisable to purchase ordinary shares of the subsidiary
Exercise price	CU10
Average market price of one ordinary share	CU20
Convertible preference shares	400, each convertible into one ordinary share
Dividends on preference shares	CU1 per share

No inter-company eliminations or adjustments were necessary except for dividends. For the purposes of this illustration, income taxes have been ignored.

* This example does not illustrate the classification of the components of convertible financial instruments as liabilities and equity or the classification of related interest and dividends as expenses and equity as required by IAS 32.

Subsidiary's earnings per share

Basic EPS CU5.00 calculated: $\dfrac{\text{CU5,400}^{(a)} - \text{CU400}^{(b)}}{1{,}000^{(c)}}$

Diluted EPS CU3.66 calculated: $\dfrac{\text{CU5,400}^{(d)}}{(1{,}000 + 75^{(e)} + 400^{(f)})}$

(a) Subsidiary's profit attributable to ordinary equity holders.

(b) Dividends paid by subsidiary on convertible preference shares.

(c) Subsidiary's ordinary shares outstanding.

(d) Subsidiary's profit attributable to ordinary equity holders (CU5,000) increased by CU400 preference dividends for the purpose of calculating diluted earnings per share.

(e) Incremental shares from warrants, calculated: [(CU20 - CU10) ÷ CU20] *x* 150.

(f) Subsidiary's ordinary shares assumed outstanding from conversion of convertible preference shares, calculated: 400 convertible preference shares *x* conversion factor of 1.

Consolidated earnings per share

Basic EPS CU1.63 calculated: $\dfrac{\text{CU12,000}^{(a)} + \text{CU4,300}^{(b)}}{10{,}000^{(c)}}$

Diluted EPS CU1.61 calculated: $\dfrac{\text{CU12,000} + \text{CU2,928}^{(d)} + \text{CU55}^{(e)} + \text{CU1,098}^{(f)}}{10{,}000}$

(a) Parent's profit attributable to ordinary equity holders of the parent entity.

(b) Portion of subsidiary's profit to be included in consolidated basic earnings per share, calculated: (800 *x* CU5.00) + (300 *x* CU1.00).

(c) Parent's ordinary shares outstanding.

(d) Parent's proportionate interest in subsidiary's earnings attributable to ordinary shares, calculated: (800 ÷ 1,000) *x* (1,000 shares *x* CU3.66 per share).

(e) Parent's proportionate interest in subsidiary's earnings attributable to warrants, calculated: (30 ÷ 150) *x* (75 incremental shares *x* CU3.66 per share).

(f) Parent's proportionate interest in subsidiary's earnings attributable to convertible preference shares, calculated: (300 ÷ 400) *x* (400 shares from conversion *x* CU3.66 per share).

Example 11 Participating equity instruments and two-class ordinary shares*

Reference: IAS 33, paragraphs A13 and A14

Profit attributable to equity holders of the parent entity	CU100,000
Ordinary shares outstanding	10,000
Non-convertible preference shares	6,000
Non-cumulative annual dividend on preference shares (before any dividend is paid on ordinary shares)	CU5.50 per share

After ordinary shares have been paid a dividend of CU2.10 per share, the preference shares participate in any additional dividends on a 20:80 ratio with ordinary shares (ie after preference and ordinary shares have been paid dividends of CU5.50 and CU2.10 per share, respectively, preference shares participate in any additional dividends at a rate of one-fourth of the amount paid to ordinary shares on a per-share basis).

Dividends on preference shares paid	CU33,000	(CU5.50 per share)
Dividends on ordinary shares paid	CU21,000	(CU2.10 per share)

* This example does not illustrate the classification of the components of convertible financial instruments as liabilities and equity or the classification of related interest and dividends as expenses and equity as required by IAS 32.

Basic earnings per share is calculated as follows:

	CU	CU
Profit attributable to equity holders of the parent entity		100,000
Less dividends paid:		
Preference	33,000	
Ordinary	21,000	
		(54,000)
Undistributed earnings		46,000

Allocation of undistributed earnings:

Allocation per ordinary share = A

Allocation per preference share = B; B = 1/4 A

(A *x* 10,000) + (1/4 *x* A *x* 6,000) = CU46,000
A = CU46,000÷ (10,000 + 1,500)
A = CU4.00
B = 1/4 A
B = CU1.00

Basic per share amounts:

	Preference shares	*Ordinary Shares*
Distributed earnings	CU5.50	CU2.10
Undistributed earnings	CU1.00	CU4.00
Totals	CU6.50	CU6.10

Example 12 ~~Calculation of Basic and Diluted Earnings per Share and Income Statement Presentation (Comprehensive Example)~~Calculation and presentation of basic and diluted earnings per share (comprehensive example)*

This example illustrates the quarterly and annual calculations of basic and diluted earnings per share in the year 20X1 for Company A, which has a complex capital structure. The control number is profit or loss from continuing operations attributable to the parent entity. Other facts assumed are as follows:

Average market price of ordinary shares: The average market prices of ordinary shares for the calendar year 20X1 were as follows:

First quarter	CU49
Second quarter	CU60
Third quarter	CU67
Fourth quarter	CU67

The average market price of ordinary shares from 1 July to 1 September 20X1 was CU65.

Ordinary shares: The number of ordinary shares outstanding at the beginning of 20X1 was 5,000,000. On 1 March 20X1, 200,000 ordinary shares were issued for cash.

Convertible bonds: In the last quarter of 20X0, 5 per cent convertible bonds with a principal amount of CU12,000,000 due in 20 years were sold for cash at CU1,000 (par). Interest is payable twice a year, on 1 November and 1 May. Each CU1,000 bond is convertible into 40 ordinary shares. No bonds were converted in 20X0. The entire issue was converted on 1 April 20X1 because the issue was called by Company A.

Convertible preference shares: In the second quarter of 20X0, 800,000 convertible preference shares were issued for assets in a purchase transaction. The quarterly dividend on each convertible preference share is CU0.05, payable at the end of the quarter for shares outstanding at that date. Each share is convertible into one ordinary share. Holders of 600,000 convertible preference shares converted their preference shares into ordinary shares on 1 June 20X1.

Warrants: Warrants to buy 600,000 ordinary shares at CU55 per share for a period of five years were issued on 1 January 20X1. All outstanding warrants were exercised on 1 September 20X1.

Options: Options to buy 1,500,000 ordinary shares at CU75 per share for a period of 10 years were issued on 1 July 20X1. No options were exercised during 20X1 because the exercise price of the options exceeded the market price of the ordinary shares.

Tax rate: The tax rate was 40 per cent for 20X1.

* This example does not illustrate the classification of the components of convertible financial instruments as liabilities and equity or the classification of related interest and dividends as expenses and equity as required by IAS 32

20X1	*Profit (loss) from continuing operations attributable to the parent entity*[(a)]	*Profit (loss) attributable to the parent entity*
	CU	CU
First quarter	5,000,000	5,000,000
Second quarter	6,500,000	6,500,000
Third quarter	1,000,000	(1,000,000) [(b)]
Fourth quarter	(700,000)	(700,000)
Full year	11,800,000	9,800,000

(a) This is the control number (before adjusting for preference dividends).

(b) Company A had a CU2,000,000 loss (net of tax) from discontinuing operations in the third quarter.

First Quarter 20X1

Basic EPS calculation	CU
Profit from continuing operations attributable to the parent entity	5,000,000
Less: preference shares dividends	(40,000)[(a)]
Profit attributable to ordinary equity holders of the parent entity	4,960,000

Dates	*Shares outstanding*	*Fraction of period*	*Weighted-average shares*
1 January - 28 February	5,000,000	2/3	3,333,333
Issue of ordinary shares on 1 March	200,000		
1 March - 31 March	5,200,000	1/3	1,733,333
Weighted-average shares			5,066,666
Basic EPS			***CU0.98***

(a) 800,000 shares *x* CU0.05

Diluted EPS calculation

Profit attributable to ordinary equity holders of the parent entity		CU4,960,000
Plus: profit impact of assumed conversions		
Preference share dividends	CU40,000[(b)]	
Interest on 5% convertible bonds	CU90,000 [(c)]	
Effect of assumed conversions		CU130,000
Profit attributable to ordinary equity holders of the parent entity including assumed conversions		CU5,090,000
Weighted-average shares		5,066,666
Plus: incremental shares from assumed conversions		
Warrants	0[(d)]	
Convertible preference shares	800,000	
5% convertible bonds	480,000	
Dilutive potential ordinary shares		1,280,000
Adjusted weighted-average shares		6,346,666
Diluted EPS		***CU0.80***

(b) 800,000 shares *x* CU0.05

(c) (CU12,000,000 *x* 5%) ÷ 4; less taxes at 40%

(d) The warrants were not assumed to be exercised because they were antidilutive in the period (CU55 [exercise price] > CU49 [average price])

Second Quarter 20X1

Basic EPS calculation	*CU*
Profit from continuing operations attributable to the parent entity	CU6,500,000
Less: preference shares dividends	(CU10,000)[a]
Profit attributable to ordinary equity holders of the parent entity	CU6,490,000

Dates	*Shares outstanding*	*Fraction of period*	*Weighted-average* shares
1 April	5,200,000		
Conversion of 5% bonds on 1 April	480,000		
1 April-31 May	5,680,000	2/3	3,786,666
Conversion of preference shares on 1 June	600,000		
1 June-30 June	6,280,000	1/3	2,093,333
Weighted-average shares			5,880,000
Basic EPS			***CU1.10***

(a) 200,000 shares *x* CU0.05

Diluted EPS calculation

Profit attributable to ordinary equity holders of the parent entity		CU6,490,000
Plus: profit impact of assumed conversions		
Preference share dividends	CU10,000 [(b)]	
Effect of assumed conversions		CU10,000
Profit attributable to ordinary equity holders of the parent entity including assumed conversions		CU6,500,000
Weighted-average shares		5,880,000
Plus: incremental shares from assumed conversions		
Warrants	50,000 [(c)]	
Convertible preference shares	600,000 [(d)]	
Dilutive potential ordinary shares		650,000
Adjusted weighted-average shares		6,530,000
Diluted EPS		***CU1.00***

(b) 200,000 shares *x* CU0.05

(c) CU55 *x* 600,000 = CU33,000,000; CU33,000,000 ÷ CU60 = 550,000; 600,000 – 550,000 = 50,000 shares
OR [(CU60 - CU55) ÷ CU60] *x* 600,000 shares = 50,000 shares

(d) (800,000 shares *x* 2/3) + (200,000 shares *x* 1/3)

Third Quarter 20X1

Basic EPS calculation	CU
Profit from continuing operations attributable to the parent entity	1,000,000
Less: preference shares dividends	(10,000)
Profit from continuing operations attributable to ordinary equity holders of the parent entity	990,000
Loss from discontinued operations attributable to the parent entity	(2,000,000)
Loss attributable to ordinary equity holders of the parent entity	(1,010,000)

Dates	*Shares outstanding*	*Fraction of period*	*Weighted-Average shares*
1 July–31 August	6,280,000	2/3	4,186,666
Exercise of warrants on 1 September	600,000		
1 September–30 September	6,880,000	1/3	2,293,333
Weighted-average shares			6,480,000

Basic EPS

Profit from continuing operations	***CU0.15***
Loss from discontinued operations	***(CU0.31)***
Loss	***(CU0.16)***

Diluted EPS calculation

Profit from continuing operations attributable to ordinary equity holders of the parent entity		CU990,000
Plus: profit impact of assumed conversions		
Preference shares dividends	CU10,000	
Effect of assumed conversions		CU10,000
Profit from continuing operations attributable to ordinary equity holders of the parent entity including assumed conversions		CU1,000,000
Loss from discontinued operations attributable to the parent entity		(CU2,000,000)
Loss attributable to ordinary equity holders of the parent entity including assumed conversions		(CU1,000,000)
Weighted-average shares		6,480,000
Plus: incremental shares from assumed conversions		
Warrants	61,538 [(a)]	
Convertible preference shares	200,000	
Dilutive potential ordinary shares		261,538
Adjusted weighted-average shares		6,741,538
Diluted EPS		
Profit from continuing operations		***CU0.15***
Loss from discontinued operations		***(CU0.30)***
Loss		***(CU0.15)***

(a) [(CU65 - CU55) ÷ CU65] *x* 600,000 = 92,308 shares; 92,308 *x* 2/3 = 61,538 shares

Note: The incremental shares from assumed conversions are included in calculating the diluted per-share amounts for the loss from discontinued operations and loss even though they are antidilutive. This is because the control number (profit from continuing operations attributable to ordinary equity holders of the parent entity, adjusted for preference dividends) was positive (ie profit, rather than loss).

Fourth Quarter 20X1

Basic EPS calculation			CU
Loss from continuing operations attributable to the parent entity			(700,000)
Add: preference shares dividends			(10,000)
Loss attributable to ordinary equity holders of the parent entity			(710,000)

Dates	*Shares outstanding*	*Fraction of period*	*Weighted-average shares*
1 October–31 December	6,880,000	3/3	6,880,000
Weighted-average shares			6,880,000

Basic and diluted EPS

Loss attributable to ordinary equity holders of the parent entity	***(CU0.10)***

Note: The incremental shares from assumed conversions are not included in calculating the diluted per-share amounts because the control number (loss from continuing operations attributable to ordinary equity holders of the parent entity adjusted for preference dividends) was negative (ie a loss, rather than profit).

Full year 20X1

Basic EPS calculation	*CU*
Profit from continuing operations attributable to the parent entity	11,800,000
Less: preference shares dividends	(70,000)
Profit from continuing operations attributable to ordinary equity holders of the parent entity	11,730,000
Loss from discontinuing operations attributable to the parent entity	(2,000,000)
Profit attributable to ordinary equity holders of the parent entity	9,730,000

Dates	*Shares outstanding*	*Fraction of period*	*Weighted-average shares*
1 January-28 February	5,000,000	2/12	833,333
Issue of ordinary shares on 1 March	200,000		
1 March-31 March	5,200,000	1/12	433,333
Conversion of 5% bonds on 1 April	480,000		
1 April-31 May	5,680,000	2/12	946,667
Conversion of preference shares on 1 June	600,000		
1 June–31 August	6,280,000	3/12	1,570,000
Exercise of warrants on 1 September	600,000		
1 September–31December	6,880,000	4/12	2,293,333
Weighted-average shares			6,076,667

Basic EPS	
Profit from continuing operations	***CU1.93***
Loss from discontinued operations	***(CU0.33)***
Profit	***CU1.60***

Diluted EPS calculation

Profit from continuing operations attributable to ordinary equity holders of the parent entity		CU11,730,000
Plus: profit impact of assumed conversions		
Preference share dividends	CU70,000	
Interest on 5% convertible bonds	CU90,000 [(a)]	
Effect of assumed conversions		CU160,000
Profit from continuing operations attributable to ordinary equity holders of the parent entity including assumed conversions		CU11,890,000
Loss from discontinued operations attributable to the parent entity		(CU2,000,000)
Profit attributable to ordinary equity holders of the parent entity including assumed conversions		CU9,890,000
Weighted-average shares		6,076,667
Plus: incremental shares from assumed conversions		
Warrants	14,880 [(b)]	
Convertible preference shares	450,000 [(c)]	
5% convertible bonds	120,000 [(d)]	
Dilutive potential ordinary shares		584,880
Adjusted weighted-average shares		6,661,547
Diluted EPS		
Profit from continuing operations		***CU1.78***
Loss from discontinued operations		***(CU0.30)***
Profit		***CU1.48***

(a) (CU12,000,000 *x* 5%) ÷ 4; less taxes at 40%

(b) [(CU57.125* – CU55) ÷ CU57.125] *x* 600,000 = 22,320 shares;
22,320 *x* 8/12 = 14,880 shares
* The average market price from 1 January 20X1 to 1 September 20X1

(c) (800,000 shares *x* 5/12) + (200,000 shares *x* 7/12)

(d) 480,000 shares *x* 3/12

The following illustrates how Company A might present its earnings per share data ~~on its income statement~~ in its statement of comprehensive income. Note that the amounts per share for the loss from discontinuing operations are not required to be presented ~~on the face of the income statement~~ in the statement of comprehensive income.

	For the year ended 20X1 (CU)
Earnings per ordinary share	
Profit from continuing operations	1.93
Loss from discontinued operations	(0.33)
Profit	1.60
Diluted earnings per ordinary share	
Profit from continuing operations	1.78
Loss from discontinued operations	(0.30)
Profit	1.48

The following table includes the quarterly and annual earnings per share data for Company A. The purpose of this table is to illustrate that the sum of the four quarters' earnings per share data will not necessarily equal the annual earnings per share data. The Standard does not require disclosure of this information.

	First quarter CU	*Second quarter* CU	*Third quarter* CU	*Fourth quarter* CU	*Full year* CU
Basic EPS					
Profit (loss) from continuing operations	0.98	1.10	0.15	(0.10)	1.93
Loss from discontinued operations	--	--	(0.31)	--	(0.33)
Profit (loss)	0.98	1.10	(0.16)	(0.10)	1.60
Diluted EPS					
Profit (loss) from continuing operations	0.80	1.00	0.15	(0.10)	1.78
Loss from discontinued operations	--	--	(0.30)	--	(0.30)
Profit (loss)	0.80	1.00	(0.15)	(0.10)	1.48

Table of Concordance

This table shows how the contents of the superseded SSAP 5 and the current HKAS 33 correspond. Paragraphs are treated as corresponding if they broadly address the same matter even though the guidance may differ.

This table also shows how the requirements of Interpretation 10 have been incorporated into the current HKAS 33.

Superseded SSAP 5 paragraph	**Current HKAS 33 paragraph**
Objective	1
1	2
2	4
3	None
4	3
5	3
6	5, 8
7	6
8	7
9	10
10	12
11	13
12	14
13	19
14	20
Example following paragraph 14	Illustrative Example 2
15	21
16	22
17	A15
18	24, 25

Superseded SSAP 5 paragraph	**Current HKAS 33 paragraph**
19	26
20	27
21	28
22	A2
Example following paragraph 22	Illustrative Examples 3 and 4
23	31
24	32
25	33
26	34
Example following paragraph 26	Illustrative Example 6
27	35
28	36
29	39
30	52
31	40
32	45
33	45, A4
34	46
35	None
Example following paragraph 34	Illustrative Example 5

Superseded SSAP 5 paragraph	**Current HKAS 33 paragraph**
36	A 16
37	41
38	42
39	43
40	44
Example following paragraph 40	Illustrative Example 9
41	38
42	64
43	65
44	70(d), 71
45	71
46	66
47	69
48	70(a), (b)
49	72
50	73
51	None
Example following paragraph 34	Illustrative Example 5

Superseded SSAP 5 paragraph or Interpretation	**Current HKAS 33 paragraph**
52	74
Interpretation 10	58-61
None	9
None	11
None	15-18
None	23
None	29, 30
None	37
None	47-51
None	53-57
None	62, 63
None	67, 68
None	70 (c)
None	75, 76
None	A1
None	A3
None	A5-A14
None	Illustrative Examples 1, 7, 8, 10, 11, 12

HKAS 34
Revised ~~October 2008~~March 2010

Effective for annual periods
beginning on or after 1 January 2005

Hong Kong Accounting Standard 34

Interim Financial Reporting

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

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CONTENTS

Hong Kong Accounting Standard 34 *Interim Financial Reporting* (HKAS 34) is set out in paragraphs 1-4~~6~~8. All the paragraphs have equal authority. HKAS 34 should be read in the context of its objective, the *Preface to Hong Kong Financial Reporting Standards* and the *Framework for the Preparation and Presentation of Financial Statements*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Introduction

IN1 This Standard (HKAS 34) addresses interim financial reporting. HKAS 34 is effective for accounting periods beginning on or after 1 January 2005.

IN2 An interim financial report is a financial report that contains either a complete or condensed set of financial statements for a period shorter than an entity's full financial year.

IN3 This Standard does not mandate which entities should publish interim financial reports, how frequently, or how soon after the end of an interim period. This Standard applies if a company is required or elects to publish an interim financial report in accordance with Standards.

IN4 This Standard:

(a) defines the minimum content of an interim financial report, including disclosures; and

(b) identifies the accounting recognition and measurement principles that should be applied in an interim financial report.

IN5 The minimum content of an interim financial report is a condensed statement of financial position, a condensed statement of comprehensive income, a condensed statement of cash flows, a condensed statement of changes in equity, and selected explanatory notes. If an entity presents the components of profit or loss in a separate income statement as described in paragraph 81 of HKAS 1 *Presentation of Financial Statements* (as revised in 2007), it presents interim condensed information from that separate statement.

IN6 On the presumption that anyone who reads an entity's interim report will also have access to its most recent annual report, virtually none of the notes to the annual financial statements are repeated or updated in the interim report. Instead, the interim notes include primarily an explanation of the events and changes that are significant to an understanding of the changes in financial position and performance of the entity since the end of the last annual reporting period.

IN7 An entity should apply the same accounting policies in its interim financial report as are applied in its annual financial statements, except for accounting policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements. The frequency of an entity's reporting—annual, half-yearly, or quarterly—should not affect the measurement of its annual results. To achieve that objective, measurements for interim reporting purposes are made on a year-to-date basis.

IN8 An appendix to this Standard provides guidance for applying the basic recognition and measurement principles at interim dates to various types of asset, liability, income, and expense. Income tax expense for an interim period is based on an estimated average annual effective income tax rate, consistent with the annual assessment of taxes.

IN9 In deciding how to recognise, classify, or disclose an item for interim financial reporting purposes, materiality is to be assessed in relation to the interim period financial data, not forecast annual data.

Hong Kong Accounting Standard 34
Interim Financial Reporting

Objective

The objective of this Standard is to prescribe the minimum content of an interim financial report and to prescribe the principles for recognition and measurement in complete or condensed financial statements for an interim period. Timely and reliable interim financial reporting improves the ability of investors, creditors, and others to understand an entity's capacity to generate earnings and cash flows and its financial condition and liquidity.

Scope

1 This Standard does not mandate which entities should be required to publish interim financial reports, how frequently, or how soon after the end of an interim period. However, governments, securities regulators, stock exchanges, and accountancy bodies often require entities whose debt or equity securities are publicly traded to publish interim financial reports. This Standard applies if an entity is required or elects to publish an interim financial report in accordance with Hong Kong Financial Reporting Standards (HKFRSs). The Hong Kong Institute of Certified Public Accountants encourages publicly traded entities to provide interim financial reports that conform to the recognition, measurement, and disclosure principles set out in this Standard. Specifically, publicly traded entities are encouraged:

(a) to provide interim financial reports at least as of the end of the first half of their financial year; and

(b) to make their interim financial reports available not later than 60 days after the end of the interim period.

2 Each financial report, annual or interim, is evaluated on its own for conformity to ~~Hong Kong Financial Reporting Standards~~ HKFRSs. The fact that an entity may not have provided interim financial reports during a particular financial year or may have provided interim financial reports that do not comply with this Standard does not prevent the entity's annual financial statements from conforming to ~~Hong Kong Financial Reporting Standards~~ HKFRSs if they otherwise do so.

3 If an entity's interim financial report is described as complying with ~~Hong Kong Financial Reporting Standards~~ HKFRSs, it must comply with all of the requirements of this Standard. Paragraph 19 requires certain disclosures in that regard.

Definitions

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

Interim period **is a financial reporting period shorter than a full financial year.**

Interim financial report **means a financial report containing either a complete set of financial statements (as described in HKAS 1 *Presentation of Financial Statements* (as revised in 2007)) or a set of condensed financial statements (as described in this Standard) for an interim period.**

Content of an interim financial report

5 HKAS 1 (as revised in 2007) defines a complete set of financial statements as including the following components:

(a) ~~a balance sheet~~a statement of financial position as at the end of the period;

(b) ~~an income statement~~a statement of comprehensive income for the period;

(c) a statement of changes in equity for the period;~~showing either:~~

~~(i) all changes in equity, or~~

~~(ii) changes in equity other than those arising from transactions with equity holders acting in their capacity as equity holders;~~

(d) a ~~cash flow~~ statement of cash flows for the period; ~~and~~

(e) notes, comprising a summary of significant accounting policies and other explanatory ~~notes.~~ information; and

(f) a statement of financial position as at the beginning of the earliest comparative period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements.

6 In the interest of timeliness and cost considerations and to avoid repetition of information previously reported, an entity may be required to or may elect to provide less information at interim dates as compared with its annual financial statements. This Standard defines the minimum content of an interim financial report as including condensed financial statements and selected explanatory notes. The interim financial report is intended to provide an update on the latest complete set of annual financial statements. Accordingly, it focuses on new activities, events, and circumstances and does not duplicate information previously reported.

7 Nothing in this Standard is intended to prohibit or discourage an entity from publishing a complete set of financial statements (as described in HKAS 1) in its interim financial report, rather than condensed financial statements and selected explanatory notes. Nor does this Standard prohibit or discourage an entity from including in condensed interim financial statements more than the minimum line items or selected explanatory notes as set out in this Standard. The recognition and measurement guidance in this Standard applies also to complete financial statements for an interim period, and such statements would include all of the disclosures required by this Standard (particularly the selected note disclosures in paragraph 16) as well as those required by other ~~Standards~~ HKFRSs.

Minimum components of an interim financial report

8 **An interim financial report shall include, at a minimum, the following components:**

(a) a condensed ~~balance sheet~~ statement of financial position;

(b) a condensed ~~income~~ statement of comprehensive income, presented as either:~~;~~

(i) a condensed single statement; or

(ii) a condensed separate income statement and a condensed statement of comprehensive income;

(c) a condensed statement of changes in equity~~showing either (i) all changes in equity or (ii) changes in equity other than those arising from capital transactions with owners and distributions to owners~~;

(d) a condensed ~~cash flow~~ statement of cash flows; and

(e) selected explanatory notes.

8A If an entity presents the components of profit or loss in a separate income statement as described in paragraph 81 of HKAS 1 (as revised in 2007), it presents interim condensed information from that separate statement.

Form and content of interim financial statements

9 If an entity publishes a complete set of financial statements in its interim financial report, the form and content of those statements shall conform to the requirements of HKAS 1 for a complete set of financial statements.

10 If an entity publishes a set of condensed financial statements in its interim financial report, those condensed statements shall include, at a minimum, each of the headings and subtotals that were included in its most recent annual financial statements and the selected explanatory notes as required by this Standard. Additional line items or notes

shall be included if their omission would make the condensed interim financial statements misleading.

11 **In the statement that presents the components of profit or loss for an interim period, an entity shall present ~~B~~basic and diluted earnings per share ~~shall be presented on the face of an income statement, complete or condensed,~~ for ~~an interim~~ that period when the entity is within the scope of HKAS 33 *Earnings per share*.****

11A **If an entity presents the components of profit or loss in a separate income statement as described in paragraph 81 of HKAS 1 (as revised in 2007), it presents basic and diluted earnings per share in that separate statement.**

12 HKAS 1 (as revised in 2007) provides guidance on the structure of financial statements. The Implementation Guidance for HKAS 1 illustrates ways in which the statement of financial position, statement of comprehensive income and statement of changes in equity may be presented.

13 ~~HKAS 1 requires a statement of changes in equity to be presented as a separate component of an entity's financial statements, and permits information about changes in equity arising from transactions with equity holders acting in their capacity as equity holders (including distributions to equity holders) to be shown either on the face of the statement or in the notes. An entity follows the same format in its interim statement of changes in equity as it did in its most recent annual statement.~~[Deleted]

14 An interim financial report is prepared on a consolidated basis if the entity's most recent annual financial statements were consolidated statements. The parent's separate financial statements are not consistent or comparable with the consolidated statements in the most recent annual financial report. If an entity's annual financial report included the parent's separate financial statements in addition to consolidated financial statements, this Standard neither requires nor prohibits the inclusion of the parent's separate ~~financial~~ statements in the entity's interim financial report.

Selected explanatory notes

15 A user of an entity's interim financial report will also have access to the most recent annual financial report of that entity. It is unnecessary, therefore, for the notes to an interim financial report to provide relatively insignificant updates to the information that was already reported in the notes in the most recent annual report. At an interim date, an explanation of events and transactions that are significant to an understanding of the changes in financial position and performance of the entity since the end of the last annual reporting period is more useful.

16 **An entity shall include the following information, as a minimum, in the notes to its interim financial statements, if material and if not disclosed elsewhere in the interim financial report. The information shall normally be reported on a financial year-to-date basis. However, the entity shall also disclose any events or transactions that are material to an understanding of the current interim period:**

(a) **a statement that the same accounting policies and methods of computation are followed in the interim financial statements as compared with the most recent annual financial statements or, if those policies or methods have been changed, a description of the nature and effect of the change;**

(b) **explanatory comments about the seasonality or cyclicality of interim operations;**

(c) **the nature and amount of items affecting assets, liabilities, equity, net income, or cash flows that are unusual because of their nature, size, or incidence;**

(d) **the nature and amount of changes in estimates of amounts reported in prior interim periods of the current financial year or changes in estimates of amounts reported in prior financial years, if those changes have a material effect in the current interim period;**

(e) **issuances, repurchases, and repayments of debt and equity securities;**

* This paragraph was amended by *Improvements to HKFRSs* issued in October 2008 to clarify the scope of HKAS 34.

(f) **dividends paid (aggregate or per share) separately for ordinary shares and other shares;**

(g) **the following segment ~~revenue and segment result for business segments or geographical segments, whichever is the entity's primary basis of segment reporting~~ information (disclosure of segment ~~data~~ information is required in an entity's interim financial report only if ~~HKAS 14~~ *~~Segment Reporting~~* HKFRS 8** *Operating Segments* **requires that entity to disclose segment ~~data~~ information in its annual financial statements)~~;~~:**

(i) **revenues from external customers, if included in the measure of segment profit or loss reviewed by the chief operating decision maker or otherwise regularly provided to the chief operating decision maker;**

(ii) **intersegment revenues, if included in the measure of segment profit or loss reviewed by the chief operating decision maker or otherwise regularly provided to the chief operating decision maker;**

(iii) **a measure of segment profit or loss;**

(iv) **total assets for which there has been a material change from the amount disclosed in the last annual financial statements;**

(v) **a description of differences from the last annual financial statements in the basis of segmentation or in the basis of measurement of segment profit or loss;**

(vi) **a reconciliation of the total of the reportable segments' measures of profit or loss to the entity's profit or loss before tax expense (tax income) and discontinued operations. However, if an entity allocates to reportable segments items such as tax expense (tax income), the entity may reconcile the total of the segments' measures of profit or loss to profit or loss after those items. Material reconciling items shall be separately identified and described in that reconciliation;**

(h) **material events subsequent to the end of the interim period that have not been reflected in the financial statements for the interim period;**

(i)[♦] **the effect of changes in the composition of the entity during the interim period, including business combinations, obtaining or losing control ~~acquisition or disposal~~ of subsidiaries and long-term investments, restructurings, and discontinued operations. In the case of business combinations, the entity shall disclose the information required ~~to be disclosed under~~ by ~~paragraphs 66 – 73 of~~ HKFRS 3** *Business Combinations***; and**

(j) **changes in contingent liabilities or contingent assets since the ~~last annual balance sheet date~~ end of the last annual reporting period.**

17 Examples of the kinds of disclosures that are required by paragraph 16 are set out below. Individual ~~Standards and Interpretations~~ HKFRSs provide guidance regarding disclosures for many of these items:

(a) the write-down of inventories to net realisable value and the reversal of such a write-down;

(b) recognition of a loss from the impairment of property, plant and equipment, intangible assets, or other assets, and the reversal of such an impairment loss;

(c) the reversal of any provisions for the costs of restructuring;

(d) acquisitions and disposals of items of property, plant and equipment;

(e) commitments for the purchase of property, plant and equipment;

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

(f) litigation settlements;

(g) corrections of prior period errors;

(h) [Not used];

(i) any loan default or breach of a loan agreement that has not been remedied on or before the ~~balance sheet date~~ end of the reporting period; and

(j) related party transactions.

18 Other ~~Standards~~ HKFRSs specify disclosures that shall be made in financial statements. In that context, financial statements means complete sets of financial statements of the type normally included in an annual financial report and sometimes included in other reports. Except as required by paragraph 16(i), the disclosures required by those other ~~Standards~~ HKFRSs are not required if an entity's interim financial report includes only condensed financial statements and selected explanatory notes rather than a complete set of financial statements.

Disclosure of compliance with HKFRSs

19 If an entity's interim financial report is in compliance with this Standard, that fact shall be disclosed. An interim financial report shall not be described as complying with ~~Standards~~ HKFRSs unless it complies with all ~~of~~ the requirements of ~~Hong Kong Financial Reporting Standards~~ HKFRSs.

Periods for which interim financial statements are required to be presented

20 Interim reports shall include interim financial statements (condensed or complete) for periods as follows:

(a) ~~balance sheet~~ statement of financial position as of the end of the current interim period and a comparative ~~balance sheet~~ statement of financial position as of the end of the immediately preceding financial year~~;~~.

(b) ~~income~~ statements of comprehensive income for the current interim period and cumulatively for the current financial year to date, with comparative ~~income~~ statements of comprehensive income for the comparable interim periods (current and year-to-date) of the immediately preceding financial year~~;~~. As permitted by HKAS 1 (as revised in 2007), an interim report may present for each period either a single statement of comprehensive income, or a statement displaying components of profit or loss (separate income statement) and a second statement beginning with profit or loss and displaying components of other comprehensive income (statement of comprehensive income).

(c) statement ~~showing~~ of changes in equity cumulatively for the current financial year to date, with a comparative statement for the comparable year-to-date period of the immediately preceding financial year~~; and~~.

(d) ~~cash flow~~ statement of cash flows cumulatively for the current financial year to date, with a comparative statement for the comparable year-to-date period of the immediately preceding financial year.

21 For an entity whose business is highly seasonal, financial information for the twelve months ~~ending on the interim reporting date~~ up to the end of the interim period and comparative information for the prior twelve-month period may be useful. Accordingly, entities whose business is highly seasonal are encouraged to consider reporting such information in addition to the information called for in the preceding paragraph.

22 Appendix A illustrates the periods required to be presented by an entity that reports half-yearly and an entity that reports quarterly.

Materiality

23 **In deciding how to recognise, measure, classify, or disclose an item for interim financial reporting purposes, materiality shall be assessed in relation to the interim period financial data. In making assessments of materiality, it shall be recognised that interim measurements may rely on estimates to a greater extent than measurements of annual financial data.**

24 HKAS 1 and HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* define an item as material if its omission or misstatement could influence the economic decisions of users of the financial statements. HKAS 1 requires separate disclosure of material items, including (for example) discontinued operations, and HKAS 8 requires disclosure of changes in accounting estimates, errors and changes in accounting policies. The two Standards do not contain quantified guidance as to materiality.

25 While judgement is always required in assessing materiality, this Standard bases the recognition and disclosure decision on data for the interim period by itself for reasons of understandability of the interim figures. Thus, for example, unusual items, changes in accounting policies or estimates, and errors are recognised and disclosed on the basis of materiality in relation to interim period data to avoid misleading inferences that might result from non-disclosure. The overriding goal is to ensure that an interim financial report includes all information that is relevant to understanding an entity's financial position and performance during the interim period.

Disclosure in annual financial statements

26 **If an estimate of an amount reported in an interim period is changed significantly during the final interim period of the financial year but a separate financial report is not published for that final interim period, the nature and amount of that change in estimate shall be disclosed in a note to the annual financial statements for that financial year.**

27 HKAS 8 requires disclosure of the nature and (if practicable) the amount of a change in estimate that either has a material effect in the current period or is expected to have a material effect in subsequent periods. Paragraph 16(d) of this Standard requires similar disclosure in an interim financial report. Examples include changes in estimate in the final interim period relating to inventory write-downs, restructurings, or impairment losses that were reported in an earlier interim period of the financial year. The disclosure required by the preceding paragraph is consistent with the HKAS 8 requirement and is intended to be narrow in scope—relating only to the change in estimate. An entity is not required to include additional interim period financial information in its annual financial statements.

Recognition and measurement

Same accounting policies as annual

28 **An entity shall apply the same accounting policies in its interim financial statements as are applied in its annual financial statements, except for accounting policy changes made after the date of the most recent annual financial statements that are to be reflected in the next annual financial statements. However, 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.**

29 Requiring that an entity apply the same accounting policies in its interim financial statements as in its annual statements may seem to suggest that interim period measurements are made as if each interim period stands alone as an independent reporting period. However, by providing that the frequency of an entity's reporting shall not affect the measurement of its annual results, paragraph 28 acknowledges that an interim period is a part of a larger financial year. Year-to-date measurements may involve changes in estimates of amounts reported in prior interim periods of the current financial year. But the principles for recognising assets, liabilities, income, and expenses for interim periods are the same as in annual financial statements.

30 To illustrate:

(a) the principles for recognising and measuring losses from inventory write-downs, restructurings, or impairments in an interim period are the same as those that an entity would follow if it prepared only annual financial statements. However, if such items are recognised and measured in one interim period and the estimate changes in a subsequent interim period of that financial year, the original estimate is changed in the subsequent interim period either by accrual of an additional amount of loss or by reversal of the previously recognised amount;

(b) a cost that does not meet the definition of an asset at the end of an interim period is not deferred ~~on the balance sheet~~ in the statement of financial position either to await future information as to whether it has met the definition of an asset or to smooth earnings over interim periods within a financial year; and

(c) income tax expense is recognised in each interim period based on the best estimate of the weighted average annual income tax rate expected for the full financial year. Amounts accrued for income tax expense in one interim period may have to be adjusted in a subsequent interim period of that financial year if the estimate of the annual income tax rate changes.

31 Under the *Framework for the Preparation and Presentation of Financial Statements* (the *Framework*), recognition is the 'process of incorporating in the balance sheet or income statement an item that meets the definition of an element and satisfies the criteria for recognition'. The definitions of assets, liabilities, income, and expenses are fundamental to recognition, ~~both at annual and interim financial reporting dates~~ at the end of both annual and interim financial reporting periods.

32 For assets, the same tests of future economic benefits apply at interim dates and at the end of an entity's financial year. Costs that, by their nature, would not qualify as assets at financial year-end would not qualify at interim dates either. Similarly, a liability ~~at an interim reporting date~~ at the end of an interim reporting period must represent an existing obligation at that date, just as it must ~~at an annual reporting date~~ at the end of an annual reporting period.

33 An essential characteristic of income (revenue) and expenses is that the related inflows and outflows of assets and liabilities have already taken place. If those inflows or outflows have taken place, the related revenue and expense are recognised; otherwise they are not recognised. The *Framework* says that 'expenses are recognised in the income statement when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably.... [The] *Framework* does not allow the recognition of items in the balance sheet which do not meet the definition of assets or liabilities.'

34 In measuring the assets, liabilities, income, expenses, and cash flows reported in its financial statements, an entity that reports only annually is able to take into account information that becomes available throughout the financial year. Its measurements are, in effect, on a year-to-date basis.

35 An entity that reports half-yearly uses information available by mid-year or shortly thereafter in making the measurements in its financial statements for the first six-month period and information available by year-end or shortly thereafter for the twelve-month period. The twelve-month measurements will reflect possible changes in estimates of amounts reported for the first six-month period. The amounts reported in the interim financial report for the first six-month period are not retrospectively adjusted. Paragraphs 16(d) and 26 require, however, that the nature and amount of any significant changes in estimates be disclosed.

36 An entity that reports more frequently than half-yearly measures income and expenses on a year-to-date basis for each interim period using information available when each set of financial statements is being prepared. Amounts of income and expenses reported in the current interim period will reflect any changes in estimates of amounts reported in prior interim periods of the financial year. The amounts reported in prior interim periods are not retrospectively adjusted. Paragraphs 16(d) and 26 require, however, that the nature and amount of any significant changes in estimates be disclosed.

Revenues received seasonally, cyclically, or occasionally

37 **Revenues that are received seasonally, cyclically, or occasionally within a financial year shall not be anticipated or deferred as of an interim date if anticipation or deferral would not be appropriate at the end of the entity's financial year.**

38 Examples include dividend revenue, royalties, and government grants. Additionally, some entities consistently earn more revenues in certain interim periods of a financial year than in other interim periods, for example, seasonal revenues of retailers. Such revenues are recognised when they occur.

Costs incurred unevenly during the financial year

39 **Costs that are incurred unevenly during an entity's financial year shall be anticipated or deferred for interim reporting purposes if, and only if, it is also appropriate to anticipate or defer that type of cost at the end of the financial year.**

Applying the recognition and measurement principles

40 Appendix B provides examples of applying the general recognition and measurement principles set out in paragraphs 28-39.

Use of estimates

41 **The measurement procedures to be followed in an interim financial report shall be designed to ensure that the resulting information is reliable and that all material financial information that is relevant to an understanding of the financial position or performance of the entity is appropriately disclosed. While measurements in both annual and interim financial reports are often based on reasonable estimates, the preparation of interim financial reports generally will require a greater use of estimation methods than annual financial reports.**

42 Appendix C provides examples of the use of estimates in interim periods.

Restatement of previously reported interim periods

43 **A change in accounting policy, other than one for which the transition is specified by a new HKFRSs, shall be reflected by:**

- **(a) restating the financial statements of prior interim periods of the current financial year and the comparable interim periods of any prior financial years that will be restated in the annual financial statements in accordance with HKAS 8; or**

- **(b) when it is impracticable to determine the cumulative effect at the beginning of the financial year of applying a new accounting policy to all prior periods, adjusting the financial statements of prior interim periods of the current financial year, and comparable interim periods of prior financial years to apply the new accounting policy prospectively from the earliest date practicable.**

44 One objective of the preceding principle is to ensure that a single accounting policy is applied to a particular class of transactions throughout an entire financial year. Under HKAS 8, a change in accounting policy is reflected by retrospective application, with restatement of prior period financial data as far back as is practicable. However, if the cumulative amount of the adjustment relating to prior financial years is impracticable to determine, then under HKAS 8 the new policy is applied prospectively from the earliest date practicable. The effect of the principle in paragraph 43 is to require that within the current financial year any change in accounting policy is applied either retrospectively or, if that is not practicable, prospectively, from no later than the beginning of the financial year.

45 To allow accounting changes to be reflected as of an interim date within the financial year would allow two differing accounting policies to be applied to a particular class of transactions within a single financial year. The result would be interim allocation difficulties, obscured operating results, and complicated analysis and understandability of interim period information.

Withdrawal of SSAP 25

45A This Standard supersedes SSAP 25 *Interim Financial Reporting* (revised in 2001).

Effective date

46 This Standard becomes operative for financial statements covering periods beginning on or after 1 January 2005. Earlier application is encouraged.

47 HKAS 1 (as revised in 2007) amended the terminology used throughout HKFRSs. In addition it amended paragraphs 4, 5, 8, 11, 12 and 20, deleted paragraph 13 and added paragraphs 8A and 11A. An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. If an entity applies HKAS 1 (revised 2007) for an earlier period, the amendments shall be applied for that earlier period.

48[⌖] HKFRS 3 (as revised in 2008) amended paragraph 16(i). An entity shall apply that amendment for annual periods beginning on or after 1 July 2009. If an entity applies HKFRS 3 (revised 2008) for an earlier period, the amendment shall also be applied for that earlier period.

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

Appendix A
Illustration of periods required to be presented

This appendix, which accompanies, but is not part of, IAS 34, provides examples to illustrate application of the principle in paragraph 20.

Entity publishes interim financial reports half-yearly

A1 The entity's financial year ends 31 December (calendar year). The entity will present the following financial statements (condensed or complete) in its half-yearly interim financial report as of 30 June 20X1:

Statement of financial position:		
At	30 June 20X1	31 December 20X0
Statement of comprehensive income:		
6 months ending	30 June 20X1	30 June 20X0
Statement of cash flows:		
6 months ending	30 June 20X1	30 June 20X0
Statement of changes in equity:		
6 months ending	30 June 20X1	30 June 20X0

Entity publishes interim financial reports quarterly

A2 The entity's financial year ends 31 December (calendar year). The entity will present the following financial statements (condensed or complete) in its quarterly interim financial report as of 30 June 2001:

Statement of financial position:		
At	30 June 20X1	31 December 20X0
Statement of comprehensive income:		
6 months ending	30 June 20X1	30 June 20X0
3 months ending	30 June 20X1	30 June 20X0
Statement of cash flow:		
6 months ending	30 June 20X1	30 June 20X0
Statement of changes in equity:		
6 months ending	30 June 20X1	30 June 20X0

Appendix B
Examples of applying the recognition and measurement principles

This appendix, which accompanies, but is not part of, IAS 34, provides examples of applying the general recognition and measurement principles set out in paragraphs 28-39.

Employer payroll taxes and insurance contributions

B1 If employer payroll taxes or contributions to government-sponsored insurance funds are assessed on an annual basis, the employer's related expense is recognised in interim periods using an estimated average annual effective payroll tax or contribution rate, even though a large portion of the payments may be made early in the financial year. A common example is an employer payroll tax or insurance contribution that is imposed up to a certain maximum level of earnings per employee. For higher income employees, the maximum income is reached before the end of the financial year, and the employer makes no further payments through the end of the year.

Major planned periodic maintenance or overhaul

B2 The cost of a planned major periodic maintenance or overhaul or other seasonal expenditure that is expected to occur late in the year is not anticipated for interim reporting purposes unless an event has caused the entity to have a legal or constructive obligation. The mere intention or necessity to incur expenditure related to the future is not sufficient to give rise to an obligation.

Provisions

B3 A provision is recognised when an entity has no realistic alternative but to make a transfer of economic benefits as a result of an event that has created a legal or constructive obligation. The amount of the obligation is adjusted upward or downward, with a corresponding loss or gain recognised in ~~the income statement~~ profit or loss, if the entity's best estimate of the amount of the obligation changes.

B4 This Standard requires that an entity apply the same criteria for recognising and measuring a provision at an interim date as it would at the end of its financial year. The existence or non-existence of an obligation to transfer benefits is not a function of the length of the reporting period. It is a question of fact.

Year-end bonuses

B5 The nature of year-end bonuses varies widely. Some are earned simply by continued employment during a time period. Some bonuses are earned based on a monthly, quarterly, or annual measure of operating result. They may be purely discretionary, contractual, or based on years of historical precedent.

B6 A bonus is anticipated for interim reporting purposes if, and only if, (a) the bonus is a legal obligation or past practice would make the bonus a constructive obligation for which the entity has no realistic alternative but to make the payments, and (b) a reliable estimate of the obligation can be made. IAS 19 *Employee Benefits* provides guidance.

Contingent lease payments

B7 Contingent lease payments can be an example of a legal or constructive obligation that ~~are~~ is recognised as a liability. If a lease provides for contingent payments based on the lessee achieving a certain level of annual sales, an obligation can arise in the interim periods of the financial year before the required annual level of sales has been achieved, if that required level of sales is expected to be achieved and the entity, therefore, has no realistic alternative but to make the future lease payment.

Intangible assets

B8 An entity will apply the definition and recognition criteria for an intangible asset in the same way in an interim period as in an annual period. Costs incurred before the recognition criteria for an intangible asset are met are recognised as an expense. Costs incurred after the specific point in time at which the criteria are met are recognised as part of the cost of an intangible asset. 'Deferring' costs as assets in an interim ~~balance sheet~~statement of financial position in the hope that the recognition criteria will be met later in the financial year is not justified.

Pensions

B9 Pension cost for an interim period is calculated on a year-to-date basis by using the actuarially determined pension cost rate at the end of the prior financial year, adjusted for significant market fluctuations since that time and for significant curtailments, settlements, or other significant one-time events.

Vacations, holidays, and other short-term compensated absences

B10 Accumulating compensated absences are those that are carried forward and can be used in future periods if the current period's entitlement is not used in full. IAS 19 *Employee Benefits* requires that an entity measure the expected cost of and obligation for accumulating compensated absences at the amount the entity expects to pay as a result of the unused entitlement that has accumulated at the end of the reporting period. That principle is also applied ~~at interim financial reporting dates~~ at the end of interim financial reporting periods. Conversely, an entity recognises no expense or liability for non-accumulating compensated absences ~~at an interim reporting date~~ at the end of an interim reporting period, just as it recognises none ~~at an annual reporting date~~ at the end of an annual reporting period.

Other planned but irregularly occurring costs

B11 An entity's budget may include certain costs expected to be incurred irregularly during the financial year, such as charitable contributions and employee training costs. Those costs generally are discretionary even though they are planned and tend to recur from year to year. Recognising an obligation ~~at an interim financial reporting date~~ at the end of an interim financial reporting period for such costs that have not yet been incurred generally is not consistent with the definition of a liability.

Measuring interim income tax expense

B12 Interim period income tax expense is accrued using the tax rate that would be applicable to expected total annual earnings, that is, the estimated average annual effective income tax rate applied to the pre-tax income of the interim period.

B13 This is consistent with the basic concept set out in paragraph 28 that the same accounting recognition and measurement principles shall be applied in an interim financial report as are applied in annual financial statements. Income taxes are assessed on an annual basis. Interim period income tax expense is calculated by applying to an interim period's pre-tax income the tax rate that would be applicable to expected total annual earnings, that is, the estimated average annual effective income tax rate. That estimated average annual rate would reflect a blend of the progressive tax rate structure expected to be applicable to the full year's earnings including enacted or substantively enacted changes in the income tax rates scheduled to take effect later in the financial year. IAS 12 *Income Taxes* provides guidance on substantively enacted changes in tax rates. The estimated average annual income tax rate would be re-estimated on a year-to-date basis, consistent with paragraph 28 of this Standard. Paragraph 16(d) requires disclosure of a significant change in estimate.

B14 To the extent practicable, a separate estimated average annual effective income tax rate is determined for each taxing jurisdiction and applied individually to the interim period pre-tax income of each jurisdiction. Similarly, if different income tax rates apply to different categories of income (such as capital gains or income earned in particular industries), to the extent practicable a separate rate is applied to each individual category of interim period pre-tax income. While that degree of precision is desirable, it may not be achievable in all cases, and a weighted average of rates across jurisdictions or across categories of income is used if it is a reasonable approximation of the effect of using more specific rates.

B15 To illustrate the application of the foregoing principle, an entity reporting quarterly expects to earn 10,000 pre-tax each quarter and operates in a jurisdiction with a tax rate of 20 per cent on the first 20,000 of annual earnings and 30 per cent on all additional earnings. Actual earnings match expectations. The following table shows the amount of income tax expense that is reported in each quarter:

	1st Quarter	**2nd Quarter**	**3rd Quarter**	**4th Quarter**	**Annual**
Tax expense	2,500	2,500	2,500	2,500	10,000

10,000 of tax is expected to be payable for the full year on 40,000 of pre-tax income.

B16 As another illustration, an entity reports quarterly, earns 15,000 pre-tax profit in the first quarter but expects to incur losses of 5,000 in each of the three remaining quarters (thus having zero income for the year), and operates in a jurisdiction in which its estimated average annual income tax rate is expected to be 20 per cent. The following table shows the amount of income tax expense that is reported in each quarter:

	1st Quarter	**2nd Quarter**	**3rd Quarter**	**4th Quarter**	**Annual**
Tax expense	3,000	(1,000)	(1,000)	(1,000)	0

Difference in financial reporting year and tax year

B17 If the financial reporting year and the income tax year differ, income tax expense for the interim periods of that financial reporting year is measured using separate weighted average estimated effective tax rates for each of the income tax years applied to the portion of pre-tax income earned in each of those income tax years.

B18 To illustrate, an entity's financial reporting year ends 30 June and it reports quarterly. Its taxable year ends 31 December. For the financial year that begins 1 July, Year 1 and ends 30 June, Year 2, the entity earns $10,000 pre-tax each quarter. The estimated average annual income tax rate is 30 per cent in Year 1 and 40 per cent in Year 2.

	Quarter Ending 30 Sept Year 1	**Quarter Ending 31 Dec Year 1**	**Quarter Ending 31 Mar Year 2**	**Quarter Ending 30 June Year 2**	**Year Ending 30 June Year 2**
Tax expense	3,000	3,000	4,000	4,000	14,000

Tax credits

B19 Some tax jurisdictions give taxpayers credits against the tax payable based on amounts of capital expenditures, exports, research and development expenditures, or other bases. Anticipated tax benefits of this type for the full year are generally reflected in computing the estimated annual effective income tax rate, because those credits are granted and calculated on an annual basis under most tax laws and regulations. On the other hand, tax benefits that relate to a one-time event are recognised in computing income tax expense in that interim period, in the same way that special tax rates applicable to particular categories of income are not blended into a single effective annual tax rate. Moreover, in some jurisdictions tax benefits or credits, including those related to capital expenditures and levels of exports, while reported on the income tax return, are more similar to a government grant and are recognised in the interim period in which they arise.

Tax loss and tax credit carrybacks and carryforwards

B20 The benefits of a tax loss carryback are reflected in the interim period in which the related tax loss occurs. IAS 12 provides that 'the benefit relating to a tax loss that can be carried back to recover current tax of a previous period shall be recognised as an asset'. A corresponding reduction of tax expense or increase of tax income is also recognised.

B21 IAS 12 provides that 'a deferred asset shall be recognised for the carryforward of unused tax losses and unused tax credits to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised'. IAS 12 provides criteria for assessing the probability of taxable profit against which the unused tax losses and credits can be utilised. Those criteria are applied at the end of each interim period and, if they are met, the effect of the tax loss carryforward is reflected in the computation of the estimated average annual effective income tax rate.

B22 To illustrate, an entity that reports quarterly has an operating loss carryforward of 10,000 for income tax purposes at the start of the current financial year for which a deferred tax asset has not been recognised. The entity earns 10,000 in the first quarter of the current year and expects to earn 10,000 in each of the three remaining quarters. Excluding the carryforward, the estimated average annual income tax rate is expected to be 40 per cent. Tax expense is as follows:

	1st Quarter	**2nd Quarter**	**3rd Quarter**	**4th Quarter**	**Annual**
Tax expense	3,000	3,000	3,000	3,000	12,000

Contractual or anticipated purchase price changes

B23 Volume rebates or discounts and other contractual changes in the prices of raw materials, labour, or other purchased goods and services are anticipated in interim periods, by both the payer and the recipient, if it is probable that they have been earned or will take effect. Thus, contractual rebates and discounts are anticipated but discretionary rebates and discounts are not anticipated because the resulting asset or liability would not satisfy the conditions in the *Framework* that an asset must be a resource controlled by the entity as a result of a past event and that a liability must be a present obligation whose settlement is expected to result in an outflow of resources.

Depreciation and amortisation

B24 Depreciation and amortisation for an interim period is based only on assets owned during that interim period. It does not take into account asset acquisitions or dispositions planned for later in the financial year.

Inventories

B25 Inventories are measured for interim financial reporting by the same principles as at financial year-end. IAS 2 *Inventories* establishes standards for recognising and measuring inventories. Inventories pose particular problems at ~~any financial reporting date~~ the end of any financial reporting period because of the need to determine inventory quantities, costs, and net realisable values. Nonetheless, the same measurement principles are applied for interim inventories. To save cost and time, entities often use estimates to measure inventories at interim dates to a greater extent than at annual reporting periods. Following are examples of how to apply the net realisable value test at an interim date and how to treat manufacturing variances at interim dates.

Net realisable value of inventories

B26 The net realisable value of inventories is determined by reference to selling prices and related costs to complete and dispose at interim dates. An entity will reverse a write-down to net realisable value in a subsequent interim period only if it would be appropriate to do so at the end of the financial year.

B27 [Deleted]

Interim period manufacturing cost variances

B28 Price, efficiency, spending, and volume variances of a manufacturing entity are recognised in income at interim reporting dates to the same extent that those variances are recognised in income at financial year end. Deferral of variances that are expected to be absorbed by year-end is not appropriate because it could result in reporting inventory at the interim date at more or less than its portion of the actual cost of manufacture.

Foreign currency translation gains and losses

B29 Foreign currency translation gains and losses are measured for interim financial reporting by the same principles as at financial year end.

B30 IAS 21 *The Effects of Changes in Foreign Exchange Rates* specifies how to translate the financial statements for foreign operations into the presentation currency, including guidelines for using average or closing foreign exchange rates and guidelines for recognising the resulting adjustments in profit or loss ~~or in equity~~, or in other comprehensive income. Consistently with IAS 21, the actual average and closing rates for the interim period are used. Entities do not anticipate some future changes in foreign exchange rates in the remainder of the current financial year in translating foreign operations at an interim date.

B31 If IAS 21 requires translation adjustments to be recognised as income or expense in the period in which they arise, that principle is applied during each interim period. Entities do not defer some foreign currency translation adjustments at an interim date if the adjustment is expected to reverse before the end of the financial year.

Interim financial reporting in hyperinflationary economies

B32. Interim financial reports in hyperinflationary economies are prepared by the same principles as at financial year-end.

B33 IAS 29 *Financial Reporting in Hyperinflationary Economies* requires that the financial statements of an entity that reports in the currency of a hyperinflationary economy be stated in terms of the measuring unit current at ~~balance sheet date~~the end of the reporting period, and the gain or loss on the net monetary position is included in net income. Also, comparative financial data reported for prior periods are restated to the current measuring unit.

B34 Entities follow those same principles at interim dates, thereby presenting all interim data in the measuring unit as of the end of the interim period, with the resulting gain or loss on the net monetary position included in the interim period's net income. Entities do not annualise the recognition of the gain or loss. Nor do they use an estimated annual inflation rate in preparing an interim financial report in a hyperinflationary economy.

Impairment of assets

B35 IAS 36 *Impairment of Assets* requires that an impairment loss be recognised if the recoverable amount has declined below carrying amount.

B36 This Standard requires that an entity apply the same impairment testing, recognition, and reversal criteria at an interim date as it would at the end of its financial year. That does not mean, however, that an entity must necessarily make a detailed impairment calculation at the end of each interim period. Rather, an entity will review for indications of significant impairment since the end of the most recent financial year to determine whether such a calculation is needed.

Appendix C
Examples of the use of estimates

This Appendix, which accompanies, but is not part of, IAS 34, provides examples to illustrate application of the principle in paragraph 41.

C1 **Inventories**: Full stock-taking and valuation procedures may not be required for inventories at interim dates, although it may be done at financial year-end. It may be sufficient to make estimates at interim dates based on sales margins.

C2 **Classifications of current and non-current assets and liabilities:** Entities may do a more thorough investigation for classifying assets and liabilities as current or non-current at annual reporting dates than at interim dates.

C3 **Provisions:** Determination of the appropriate amount of a provision (such as a provision for warranties, environmental costs, and site restoration costs) may be complex and often costly and time-consuming. Entities sometimes engage outside experts to assist in the annual calculations. Making similar estimates at interim dates often entails updating of the prior annual provision rather than the engaging of outside experts to do a new calculation.

C4 **Pensions**: IAS 19 *Employee Benefits* requires that an entity determine the present value of defined benefit obligations and the market value of plan assets at the end of each reporting period and encourages an entity to involve a professionally qualified actuary in measurement of the obligations. For interim reporting purposes, reliable measurement is often obtainable by extrapolation of the latest actuarial valuation.

C5 **Income taxes:** Entities may calculate income tax expense and deferred income tax liability at annual dates by applying the tax rate for each individual jurisdiction to measures of income for each jurisdiction. Paragraph 14 of Appendix B acknowledges that while that degree of precision is desirable at interim reporting dates as well, it may not be achievable in all cases, and a weighted average of rates across jurisdictions or across categories of income is used if it is a reasonable approximation of the effect of using more specific rates.

C6 **Contingencies:** The measurement of contingencies may involve the opinions of legal experts or other advisers. Formal reports from independent experts are sometimes obtained with respect to contingencies. Such opinions about litigation, claims, assessments, and other contingencies and uncertainties may or may not also be needed at interim dates.

C7 **Revaluations and fair value accounting**: IAS 16 *Property, Plant and Equipment* allows an entity to choose as its accounting policy the revaluation model whereby items of property, plant and equipment are revalued to fair value. Similarly, IAS 40 *Investment Property* requires an entity to determine the fair value of investment property. For those measurements, an entity may rely on professionally qualified valuers at annual reporting dates though not at interim reporting dates.

C8 **Intercompany reconciliations:** Some intercompany balances that are reconciled on a detailed level in preparing consolidated financial statements at financial year-end might be reconciled at a less detailed level in preparing consolidated financial statements at an interim date.

C9 **Specialised industries:** Because of complexity, costliness, and time, interim period measurements in specialised industries might be less precise than at financial year-end. An example would be calculation of insurance reserves by insurance companies.

Appendix D
Comparison with International Accounting Standards

This comparison appendix, which was prepared as at October 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 34.

The International Accounting Standard comparable with HKAS 34 is IAS 34 *Interim Financial Reporting*.

There are no major textual differences between HKAS 34 and IAS 34.

HKAS 36
Revised ~~May 2009~~March 2010

Hong Kong Accounting Standard 36

Impairment of Assets

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

CONTENTS

Hong Kong Accounting Standard 36 *Impairment of Assets* (HKAS 36) is set out in paragraphs 1-141 and Appendices A - D. All the paragraphs have equal authority. HKAS 36 should be read in the context of its objective and the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Framework for the Preparation and Presentation of Financial Statements*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Introduction

IN1 Hong Kong Accounting Standard 36 *Impairment of Assets* (HKAS 36) replaces SSAP 31 *Impairment of Assets* (issued in 2001), and should be applied:

(a) on acquisition to goodwill and intangible assets acquired in business combinations for which the agreement date is on or after 1 January 2005.

(b) to all other assets, for annual periods beginning on or after 1 January 2005.

Earlier application is encouraged.

Reasons for issuing HKAS 36

IN2 Pursuant with its convergence policy, the Hong Kong Institute of Certified Public Accountants ("HKICPA") issues HKAS 36 as part of its project on business combinations to converge with the International Accounting Standard Board ("the Board")'s project on business combinations. The project's objective ~~is~~was to improve the quality of the accounting for business combinations and the subsequent accounting for goodwill and intangible assets acquired in business combinations.

IN3 The project ~~has~~had two phases. The first phase resulted in the HKICPA issuing simultaneously in 2004 HKFRS 3 *Business Combinations* and HKAS 36 and HKAS 38 *Intangible Assets* to converge with IFRS 3 and revised versions of IAS 36 and IAS 38 issued by the Board. The first phase of the project focused primarily on the following issues:

(a) the method of accounting for business combinations;

(b) the initial measurement of the identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination;

(c) the recognition of provisions for terminating or reducing the activities of an acquiree;

(d) the treatment of any excess of the acquirer's interest in the fair values of identifiable net assets acquired in a business combination over the cost of the combination; and

(e) the accounting for goodwill and intangible assets acquired in a business combination.

IN4 The second phase of the project resulted in the HKICPA issuing simultaneously in 2008 a revised HKFRS 3 and amendments to HKAS 27 *Consolidated and Separate Financial Statements* to converge with a revised IFRS 3 and amendments to IAS 27 issued by the Board. ~~Therefore, t~~The HKICPA's intention while issuing HKAS 36 was to reflect only those changes resulting from the Business Combinations project, and *not* to reconsider all of the previous requirements in SSAP 31. The changes are primarily concerned with the impairment test for goodwill.

Summary of main changes

Frequency of impairment testing

IN5 SSAP 31 required the recoverable amount of an asset to be measured whenever there is an indication that the asset may be impaired. This requirement is included in the Standard. However, the Standard also requires:

(a) the recoverable amount of an intangible asset with an indefinite useful life to be measured annually, irrespective of whether there is any indication that it may be impaired. The most recent detailed calculation of recoverable amount made in a preceding period may be used in the impairment test for that asset in the current period, provided specified criteria are met.

(b) the recoverable amount of an intangible asset not yet available for use to be measured annually, irrespective of whether there is any indication that it may be impaired.

(c) goodwill acquired in a business combination to be tested for impairment annually.

Measuring value in use

IN6 The Standard clarifies that the following elements should be reflected in the calculation of an asset's value in use:

(a) an estimate of the future cash flows the entity expects to derive from the asset;

(b) expectations about possible variations in the amount or timing of those future cash flows;

(c) the time value of money, represented by the current market risk-free rate of interest;

(d) the price for bearing the uncertainty inherent in the asset; and

(e) other factors, such as illiquidity, that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset.

The Standard also clarifies that the second, fourth and fifth of these elements can be reflected either as adjustments to the future cash flows or adjustments to the discount rate.

IN7 The Standard carries forward from SSAP 31 the requirement for the cash flow projections used to measure value in use to be based on reasonable and supportable assumptions that represent management's best estimate of the economic conditions that will exist over the remaining useful life of the asset. However, the Standard clarifies that management:

(a) should assess the reasonableness of the assumptions on which its current cash flow projections are based by examining the causes of differences between past cash flow projections and actual cash flows.

(b) should ensure that the assumptions on which its current cash flow projections are based are consistent with past actual outcomes, provided the effects of subsequent events or circumstances that did not exist when those actual cash flows were generated make this appropriate.

IN8 SSAP 31 required the cash flow projections used to measure value in use to be based on the most recent financial budgets/ forecasts approved by management. The Standard carries forward this requirement, but clarifies that the cash flow projections exclude any estimated cash inflows or outflows expected to arise from:

(a) future restructurings to which the entity is not yet committed; or

(b) improving or enhancing the asset's performance.

IN9 Additional guidance on using present value techniques in measuring an asset's value in use is included in Appendix A of the Standard. In addition, the guidance in SSAP 31 on estimating the discount rate when an asset-specific rate is not directly available from the market has been relocated to Appendix A.

Identifying the cash-generating unit to which an asset belongs

IN10 The Standard carries forward from SSAP 31 the requirement that if an active market exists for the output produced by an asset or a group of assets, that asset or group of assets should be identified as a cash-generating unit, even if some or all of the output is used internally. However, SSAP 31 required that, in such circumstances, management's best estimate of future market prices for the output should be used in estimating the future cash flows used to determine the unit's value in use. It also required that when an entity was estimating future cash flows to determine the value in use of cash-generating units using the output, management's best estimate of future market prices for the output should be used. The Standard requires that if the cash inflows generated by *any* asset or cash-generating unit are affected by internal transfer pricing, an entity should use management's best estimate of future price(s) that could be achieved in arm's length transactions in estimating:

(a) the future cash inflows used to determine the asset's or cash-generating unit's value in use; and

(b) the future cash outflows used to determine the value in use of other assets or cash-generating units affected by the internal transfer pricing.

Allocating goodwill to cash-generating units

IN11 SSAP 31 required goodwill acquired in a business combination to be tested for impairment as part of impairment testing the cash-generating unit(s) to which it related. It employed a 'bottom-up/top-down' approach under which the goodwill was, in effect, tested for impairment by allocating its carrying amount to each cash-generating unit or smallest group of cash-generating units to which a portion of that carrying amount could be allocated on a reasonable and consistent basis. The Standard similarly requires goodwill acquired in a business combination to be tested for impairment as part of impairment testing the cash-generating unit(s) to which it relates. However, the Standard clarifies that:

(a) the goodwill should, from the acquisition date, be allocated to each of the acquirer's cash-generating units, or groups of cash-generating units, that are expected to benefit from the synergies of the business combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units or groups of units.

(b) each unit or group of units to which the goodwill is allocated should:

(i) represent the lowest level within the entity at which the goodwill is monitored for internal management purposes; and

(ii) not be larger than ~~a~~an operating segment ~~based on either the entity's primary or the entity's secondary reporting format~~ determined in accordance with ~~HKAS 14 *Segment Reporting*~~HKFRS 8 *Operating Segments*.

IN12 The Standard also clarifies the following:

(a) if the initial allocation of goodwill acquired in a business combination cannot be completed before the end of the annual period in which the business combination occurs, that initial allocation should be completed before the end of the first annual period beginning after the acquisition date.

(b) when an entity disposes of an operation within a cash-generating unit (group of units) to which goodwill has been allocated, the goodwill associated with that operation should be:

(i) included in the carrying amount of the operation when determining the gain or loss on disposal; and

(ii) measured on the basis of the relative values of the operation disposed of and the portion of the cash-generating unit (group of units) retained, unless the entity can demonstrate that some other method better reflects the goodwill associated with the operation disposed of.

(c) when an entity reorganises its reporting structure in a manner that changes the composition of cash-generating units (groups of units) to which goodwill has been allocated, the goodwill should be reallocated to the units (groups of units) affected. This reallocation should be performed using a relative value approach similar to that used when an entity disposes of an operation within a cash-generating unit (group of units), unless the entity can demonstrate that some other method better reflects the goodwill associated with the reorganised units (groups of units).

Timing of impairment tests for goodwill

IN13 The Standard permits:

(a) the annual impairment test for a cash-generating unit (group of units) to which goodwill has been allocated to be performed at any time during an annual reporting period, provided the test is performed at the same time every year.

(b) different cash-generating units (groups of units) to be tested for impairment at different times.

However, if some of the goodwill allocated to a cash-generating unit (group of units) was acquired in a business combination during the current annual period, the Standard requires that unit (group of units) to be tested for impairment before the end of the current period.

IN14 The Standard permits the most recent detailed calculation made in a preceding period of the recoverable amount of a cash-generating unit (group of units) to which goodwill has been allocated to be used in the impairment test for that unit (group of units) in the current period, provided specified criteria are met.

Reversals of impairment losses for goodwill

IN15 SSAP 31 required an impairment loss recognised for goodwill in a previous period to be reversed when the impairment loss was caused by a specific external event of an exceptional nature that is not expected to recur and subsequent external events have occurred that reverse the effect of that event. The Standard prohibits the recognition of reversals of impairment losses for goodwill.

Disclosure

IN16 The Standard requires that if any portion of the goodwill acquired in a business combination during the period has not been allocated to a cash-generating unit at the ~~reporting date~~end of the reporting period, an entity should disclose the amount of the unallocated goodwill together with the reasons why that amount remains unallocated.

IN17 The Standard requires disclosure of information for each cash-generating unit (group of units) for which the carrying amount of goodwill or intangible assets with indefinite useful lives allocated to that unit (group of units) is significant in comparison with the entity's total carrying amount of goodwill or intangible assets with indefinite lives. That information is concerned primarily with the key assumptions used to measure the recoverable amounts of such units (groups of units).

IN18 The Standard also requires specified information to be disclosed if some or all of the carrying amount of goodwill or intangible assets with indefinite lives is allocated across multiple cash-generating units (groups of units), and the amount so allocated to each unit (group of units) is not significant in comparison with the total carrying amount of goodwill or intangible assets with indefinite lives. Further disclosures are required if, in such circumstances, the recoverable amounts of any of those units (groups of units) are based on the same key assumption(s) and the aggregate carrying amount of goodwill or intangible assets with indefinite lives allocated to them is significant in comparison with the entity's total carrying amount of goodwill or intangible assets with indefinite lives.

Hong Kong Accounting Standard 36
Impairment of Assets

Objective

1 The objective of this Standard is to prescribe the procedures that an entity applies to ensure that its assets are carried at no more than their recoverable amount. An asset is carried at more than its recoverable amount if its carrying amount exceeds the amount to be recovered through use or sale of the asset. If this is the case, the asset is described as impaired and the Standard requires the entity to recognise an impairment loss. The Standard also specifies when an entity should reverse an impairment loss and prescribes disclosures.

Scope

2 This Standard shall be applied in accounting for the impairment of all assets, other than:

(a) inventories (see HKAS 2 *Inventories*);

(b) assets arising from construction contracts (see HKAS 11 *Construction Contracts*);

(c) deferred tax assets (see HKAS 12 *Income Taxes*);

(d) assets arising from employee benefits (see HKAS 19 *Employee Benefits*);

(e) financial assets that are within the scope of HKAS 39 *Financial Instruments: Recognition and Measurement*;

(f) investment property that is measured at fair value (see HKAS 40 *Investment Property*);

(g) biological assets related to agricultural activity that are measured at fair value less ~~estimated point-of-sale~~ costs to sell (see HKAS 41 *Agriculture*);

(h) deferred acquisition costs, and intangible assets, arising from an insurer's contractual rights under insurance contracts within the scope of HKFRS 4 *Insurance Contracts*; and

(i) non-current assets (or disposal groups) classified as held for sale in accordance with HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*.

3 This Standard does not apply to inventories, assets arising from construction contracts, deferred tax assets, assets arising from employee benefits, or assets classified as held for sale (or included in a disposal group that is classified as held for sale) because existing ~~Standards~~HKFRSs applicable to these assets contain requirements for recognising and measuring these assets.

4 This Standard applies to financial assets classified as:

(a) subsidiaries, as defined in HKAS 27 *Consolidated and Separate Financial Statements*;

(b) associates, as defined in HKAS 28 *Investments in Associates*; and

(c) joint ventures, as defined in HKAS 31 *Interests in Joint Ventures*.

For impairment of other financial assets, refer to HKAS 39.

5 This Standard does not apply to financial assets within the scope of HKAS 39, investment property measured at fair value in accordance with HKAS 40, or biological assets related to agricultural activity measured at fair value less ~~estimated point-of-sale~~ costs to sell in accordance with HKAS 41. However, this Standard applies to assets that are carried at revalued amount (ie fair value) in accordance with other ~~Standards~~HKFRSs, such as the revaluation model in HKAS 16 *Property, Plant and Equipment*. Identifying whether a revalued asset may be impaired depends on the basis used to determine fair value:

(a) if the asset's fair value is its market value, the only difference between the asset's fair value and its fair value less costs to sell is the direct incremental costs to dispose of the asset:

(i) if the disposal costs are negligible, the recoverable amount of the revalued asset is necessarily close to, or greater than, its revalued amount (ie fair value). In this case, after the revaluation requirements have been applied, it is unlikely that the revalued asset is impaired and recoverable amount need not be estimated.

(ii) if the disposal costs are not negligible, the fair value less costs to sell of the revalued asset is necessarily less than its fair value. Therefore, the revalued asset will be impaired if its value in use is less than its revalued amount (ie fair value). In this case, after the revaluation requirements have been applied, an entity applies this Standard to determine whether the asset may be impaired.

(b) if the asset's fair value is determined on a basis other than its market value, its revalued amount (ie fair value) may be greater or lower than its recoverable amount. Hence, after the revaluation requirements have been applied, an entity applies this Standard to determine whether the asset may be impaired.

Definitions

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

An *active market* is a market in which all the following conditions exist:

(a) the items traded within the market are homogeneous;

(b) willing buyers and sellers can normally be found at any time; and

(c) prices are available to the public.

†~~**The** *agreement date* **for a business combination is the date that a substantive agreement between the combining parties is reached and, in the case of publicly listed entities, announced to the public. In the case of a hostile takeover, the earliest date that a substantive agreement between the combining parties is reached is the date that a sufficient number of the acquiree's owners have accepted the acquirer's offer for the acquirer to obtain control of the acquiree.**~~

Carrying amount **is the amount at which an asset is recognised after deducting any accumulated depreciation (amortisation) and accumulated impairment losses thereon.**

A *cash-generating unit* **is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.**

Corporate assets **are assets other than goodwill that contribute to the future cash flows of both the cash-generating unit under review and other cash-generating units.**

Costs of disposal **are incremental costs directly attributable to the disposal of an asset or cash-generating unit, excluding finance costs and income tax expense.**

Depreciable amount **is the cost of an asset, or other amount substituted for cost in the financial statements, less its residual value.**

Depreciation (Amortisation) **is the systematic allocation of the depreciable amount of an asset over its useful life.**[*]

Fair value less costs to sell **is the amount obtainable from the sale of an asset or cash-generating unit in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal.**

An *impairment loss* **is the amount by which the carrying amount of an asset or a cash-generating unit exceeds its recoverable amount.**

The *recoverable amount* **of an asset or a cash-generating unit is the higher of its fair value less costs to sell and its value in use.**

Useful life **is either:**

(a) **the period of time over which an asset is expected to be used by the entity; or**

(b) **the number of production or similar units expected to be obtained from the asset by the entity.**

Value in use **is the present value of the future cash flows expected to be derived from an asset or cash-generating unit.**

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

* In the case of an intangible asset, the term 'amortisation' is generally used instead of 'depreciation'. The two terms have the same meaning.

Identifying an asset that may be impaired

7 Paragraphs 8-17 specify when recoverable amount shall be determined. These requirements use the term 'an asset' but apply equally to an individual asset or a cash-generating unit. The remainder of this Standard is structured as follows:

(a) paragraphs 18-57 set out the requirements for measuring recoverable amount. These requirements also use the term 'an asset' but apply equally to an individual asset and a cash-generating unit.

(b) paragraphs 58-108 set out the requirements for recognising and measuring impairment losses. Recognition and measurement of impairment losses for individual assets other than goodwill are dealt with in paragraphs 58-64. Paragraphs 65-108 deal with the recognition and measurement of impairment losses for cash-generating units and goodwill.

(c) paragraphs 109-116 set out the requirements for reversing an impairment loss recognised in prior periods for an asset or a cash-generating unit. Again, these requirements use the term 'an asset' but apply equally to an individual asset or a cash-generating unit. Additional requirements for an individual asset are set out in paragraphs 117-121, for a cash-generating unit in paragraphs 122 and 123, and for goodwill in paragraphs 124 and 125.

(d) paragraphs 126-133 specify the information to be disclosed about impairment losses and reversals of impairment losses for assets and cash-generating units. Paragraphs 134-137 specify additional disclosure requirements for cash-generating units to which goodwill or intangible assets with indefinite useful lives have been allocated for impairment testing purposes.

8 An asset is impaired when its carrying amount exceeds its recoverable amount. Paragraphs 12-14 describe some indications that an impairment loss may have occurred. If any of those indications is present, an entity is required to make a formal estimate of recoverable amount. Except as described in paragraph 10, this Standard does not require an entity to make a formal estimate of recoverable amount if no indication of an impairment loss is present.

9 An entity shall assess at ~~each reporting date~~the end of each reporting period whether there is any indication that an asset may be impaired. If any such indication exists, the entity shall estimate the recoverable amount of the asset.

10 Irrespective of whether there is any indication of impairment, an entity shall also:

(a) test an intangible asset with an indefinite useful life or an intangible asset not yet available for use for impairment annually by comparing its carrying amount with its recoverable amount. This impairment test may be performed at any time during an annual period, provided it is performed at the same time every year. Different intangible assets may be tested for impairment at different times. However, if such an intangible asset was initially recognised during the current annual period, that intangible asset shall be tested for impairment before the end of the current annual period.

(b) test goodwill acquired in a business combination for impairment annually in accordance with paragraphs 80-99.

11 The ability of an intangible asset to generate sufficient future economic benefits to recover its carrying amount is usually subject to greater uncertainty before the asset is available for use than after it is available for use. Therefore, this Standard requires an entity to test for impairment, at least annually, the carrying amount of an intangible asset that is not yet available for use.

12 In assessing whether there is any indication that an asset may be impaired, an entity shall consider, as a minimum, the following indications:

External sources of information

(a) during the period, an asset's market value has declined significantly more than would be expected as a result of the passage of time or normal use.

(b) significant changes with an adverse effect on the entity have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the entity operates or in the market to which an asset is dedicated.

(c) market interest rates or other market rates of return on investments have increased during the period, and those increases are likely to affect the discount rate used in calculating an asset's value in use and decrease the asset's recoverable amount materially.

(d) the carrying amount of the net assets of the entity is more than its market capitalisation.

Internal sources of information

(e) evidence is available of obsolescence or physical damage of an asset.

(f) significant changes with an adverse effect on the entity have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, an asset is used or is expected to be used. These changes include the asset becoming idle, plans to discontinue or restructure the operation to which an asset belongs, plans to dispose of an asset before the previously expected date, and reassessing the useful life of an asset as finite rather than indefinite.[*]

(g) evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected.

Dividend from a subsidiary, jointly controlled entity or associate

(h) for an investment in a subsidiary, jointly controlled entity or associate, the investor recognises a dividend from the investment and evidence is available that:

(i) the carrying amount of the investment in the separate financial statements exceeds the carrying amounts in the consolidated

[*] 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 this Standard and is accounted for in accordance with HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*.

financial statements of the investee's net asset, including associated goodwill; or

(ii) the dividend exceeds the total comprehensive income of the subsidiary, jointly controlled entity or associate in the period the dividend is declared.

13 The list in paragraph 12 is not exhaustive. An entity may identify other indications that an asset may be impaired and these would also require the entity to determine the asset's recoverable amount or, in the case of goodwill, perform an impairment test in accordance with paragraphs 80-99.

14 Evidence from internal reporting that indicates that an asset may be impaired includes the existence of:

(a) cash flows for acquiring the asset, or subsequent cash needs for operating or maintaining it, that are significantly higher than those originally budgeted;

(b) actual net cash flows or operating profit or loss flowing from the asset that are significantly worse than those budgeted;

(c) a significant decline in budgeted net cash flows or operating profit, or a significant increase in budgeted loss, flowing from the asset; or

(d) operating losses or net cash outflows for the asset, when current period amounts are aggregated with budgeted amounts for the future.

15 As indicated in paragraph 10, this Standard requires an intangible asset with an indefinite useful life or not yet available for use and goodwill to be tested for impairment, at least annually. Apart from when the requirements in paragraph 10 apply, the concept of materiality applies in identifying whether the recoverable amount of an asset needs to be estimated. For example, if previous calculations show that an asset's recoverable amount is significantly greater than its carrying amount, the entity need not re-estimate the asset's recoverable amount if no events have occurred that would eliminate that difference. Similarly, previous analysis may show that an asset's recoverable amount is not sensitive to one (or more) of the indications listed in paragraph 12.

16 As an illustration of paragraph 15, if market interest rates or other market rates of return on investments have increased during the period, an entity is not required to make a formal estimate of an asset's recoverable amount in the following cases:

(a) if the discount rate used in calculating the asset's value in use is unlikely to be affected by the increase in these market rates. For example, increases in short-term interest rates may not have a material effect on the discount rate used for an asset that has a long remaining useful life.

(b) if the discount rate used in calculating the asset's value in use is likely to be affected by the increase in these market rates but previous sensitivity analysis of recoverable amount shows that:

(i) it is unlikely that there will be a material decrease in recoverable amount because future cash flows are also likely to increase (eg in some cases, an entity may be able to demonstrate that it adjusts its revenues to compensate for any increase in market rates); or

(ii) the decrease in recoverable amount is unlikely to result in a material impairment loss.

17 If there is an indication that an asset may be impaired, this may indicate that the remaining useful life, the depreciation (amortisation) method or the residual value for the asset needs to be reviewed and adjusted in accordance with the Standard applicable to the asset, even if no impairment loss is recognised for the asset.

Measuring recoverable amount

18 This Standard defines recoverable amount as the higher of an asset's or cash-generating unit's fair value less costs to sell and its value in use. Paragraphs 19-57 set out the requirements for measuring recoverable amount. These requirements use the term 'an asset' but apply equally to an individual asset or a cash-generating unit.

19 It is not always necessary to determine both an asset's fair value less costs to sell and its value in use. If either of these amounts exceeds the asset's carrying amount, the asset is not impaired and it is not necessary to estimate the other amount.

20 It may be possible to determine fair value less costs to sell, even if an asset is not traded in an active market. However, sometimes it will not be possible to determine fair value less costs to sell because there is no basis for making a reliable estimate of the amount obtainable from the sale of the asset in an arm's length transaction between knowledgeable and willing parties. In this case, the entity may use the asset's value in use as its recoverable amount.

21 If there is no reason to believe that an asset's value in use materially exceeds its fair value less costs to sell, the asset's fair value less costs to sell may be used as its recoverable amount. This will often be the case for an asset that is held for disposal. This is because the value in use of an asset held for disposal will consist mainly of the net disposal proceeds, as the future cash flows from continuing use of the asset until its disposal are likely to be negligible.

22 Recoverable amount is determined for an individual asset, unless the asset does not generate cash inflows that are largely independent of those from other assets or groups of assets. If this is the case, recoverable amount is determined for the cash-generating unit to which the asset belongs (see paragraphs 65-103), unless either:

(a) the asset's fair value less costs to sell is higher than its carrying amount; or

(b) the asset's value in use can be estimated to be close to its fair value less costs to sell and fair value less costs to sell can be determined.

23 In some cases, estimates, averages and computational short cuts may provide reasonable approximations of the detailed computations illustrated in this Standard for determining fair value less costs to sell or value in use.

Measuring the recoverable amount of an intangible asset with an indefinite useful life

24 Paragraph 10 requires an intangible asset with an indefinite useful life to be tested for impairment annually by comparing its carrying amount with its recoverable amount, irrespective of whether there is any indication that it may be impaired. However, the

most recent detailed calculation of such an asset's recoverable amount made in a preceding period may be used in the impairment test for that asset in the current period, provided all of the following criteria are met:

(a) if the intangible asset does not generate cash inflows from continuing use that are largely independent of those from other assets or groups of assets and is therefore tested for impairment as part of the cash-generating unit to which it belongs, the assets and liabilities making up that unit have not changed significantly since the most recent recoverable amount calculation;

(b) the most recent recoverable amount calculation resulted in an amount that exceeded the asset's carrying amount by a substantial margin; and

(c) based on an analysis of events that have occurred and circumstances that have changed since the most recent recoverable amount calculation, the likelihood that a current recoverable amount determination would be less than the asset's carrying amount is remote.

Fair value less costs to sell

25 The best evidence of an asset's fair value less costs to sell is a price in a binding sale agreement in an arm's length transaction, adjusted for incremental costs that would be directly attributable to the disposal of the asset.

26 If there is no binding sale agreement but an asset is traded in an active market, fair value less costs to sell is the asset's market price less the costs of disposal. The appropriate market price is usually the current bid price. When current bid prices are unavailable, the price of the most recent transaction may provide a basis from which to estimate fair value less costs to sell, provided that there has not been a significant change in economic circumstances between the transaction date and the date as at which the estimate is made.

27 If there is no binding sale agreement or active market for an asset, fair value less costs to sell is based on the best information available to reflect the amount that an entity could obtain, at the ~~balance sheet date~~end of the reporting period, from the disposal of the asset in an arm's length transaction between knowledgeable, willing parties, after deducting the costs of disposal. In determining this amount, an entity considers the outcome of recent transactions for similar assets within the same industry. Fair value less costs to sell does not reflect a forced sale, unless management is compelled to sell immediately.

28 Costs of disposal, other than those that have been recognised as liabilities, are deducted in determining fair value less costs to sell. Examples of such costs are legal costs, stamp duty and similar transaction taxes, costs of removing the asset, and direct incremental costs to bring an asset into condition for its sale. However, termination benefits (as defined in HKAS 19) and costs associated with reducing or reorganising a business following the disposal of an asset are not direct incremental costs to dispose of the asset.

29 Sometimes, the disposal of an asset would require the buyer to assume a liability and only a single fair value less costs to sell is available for both the asset and the liability. Paragraph 78 explains how to deal with such cases.

Value in use

30 The following elements shall be reflected in the calculation of an asset's value in use:

(a) an estimate of the future cash flows the entity expects to derive from the asset;

(b) expectations about possible variations in the amount or timing of those future cash flows;

(c) the time value of money, represented by the current market risk-free rate of interest;

(d) the price for bearing the uncertainty inherent in the asset; and

(e) other factors, such as illiquidity, that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset.

31 Estimating the value in use of an asset involves the following steps:

(a) estimating the future cash inflows and outflows to be derived from continuing use of the asset and from its ultimate disposal; and

(b) applying the appropriate discount rate to those future cash flows.

32 The elements identified in paragraph 30(b), (d) and (e) can be reflected either as adjustments to the future cash flows or as adjustments to the discount rate. Whichever approach an entity adopts to reflect expectations about possible variations in the amount or timing of future cash flows, the result shall be to reflect the expected present value of the future cash flows, ie the weighted average of all possible outcomes. Appendix A provides additional guidance on the use of present value techniques in measuring an asset's value in use.

Basis for estimates of future cash flows

33 In measuring value in use an entity shall:

(a) base cash flow projections on reasonable and supportable assumptions that represent management's best estimate of the range of economic conditions that will exist over the remaining useful life of the asset. Greater weight shall be given to external evidence.

(b) base cash flow projections on the most recent financial budgets/forecasts approved by management, but shall exclude any estimated future cash inflows or outflows expected to arise from future restructurings or from improving or enhancing the asset's performance. Projections based on these budgets/forecasts shall cover a maximum period of five years, unless a longer period can be justified.

(c) estimate cash flow projections beyond the period covered by the most recent budgets/forecasts by extrapolating the projections based on the budgets/forecasts using a steady or declining growth rate for subsequent years, unless an increasing rate can be justified. This growth rate shall not

exceed the long-term average growth rate for the products, industries, or country or countries in which the entity operates, or for the market in which the asset is used, unless a higher rate can be justified.

34 Management assesses the reasonableness of the assumptions on which its current cash flow projections are based by examining the causes of differences between past cash flow projections and actual cash flows. Management shall ensure that the assumptions on which its current cash flow projections are based are consistent with past actual outcomes, provided the effects of subsequent events or circumstances that did not exist when those actual cash flows were generated make this appropriate.

35 Detailed, explicit and reliable financial budgets/forecasts of future cash flows for periods longer than five years are generally not available. For this reason, management's estimates of future cash flows are based on the most recent budgets/forecasts for a maximum of five years. Management may use cash flow projections based on financial budgets/forecasts over a period longer than five years if it is confident that these projections are reliable and it can demonstrate its ability, based on past experience, to forecast cash flows accurately over that longer period.

36 Cash flow projections until the end of an asset's useful life are estimated by extrapolating the cash flow projections based on the financial budgets/forecasts using a growth rate for subsequent years. This rate is steady or declining, unless an increase in the rate matches objective information about patterns over a product or industry lifecycle. If appropriate, the growth rate is zero or negative.

37 When conditions are favourable, competitors are likely to enter the market and restrict growth. Therefore, entities will have difficulty in exceeding the average historical growth rate over the long term (say, twenty years) for the products, industries, or country or countries in which the entity operates, or for the market in which the asset is used.

38 In using information from financial budgets/forecasts, an entity considers whether the information reflects reasonable and supportable assumptions and represents management's best estimate of the set of economic conditions that will exist over the remaining useful life of the asset.

Composition of estimates of future cash flows

39 Estimates of future cash flows shall include:

(a) projections of cash inflows from the continuing use of the asset;

(b) projections of cash outflows that are necessarily incurred to generate the cash inflows from continuing use of the asset (including cash outflows to prepare the asset for use) and can be directly attributed, or allocated on a reasonable and consistent basis, to the asset; and

(c) net cash flows, if any, to be received (or paid) for the disposal of the asset at the end of its useful life.

40 Estimates of future cash flows and the discount rate reflect consistent assumptions about price increases attributable to general inflation. Therefore, if the discount rate includes the effect of price increases attributable to general inflation, future cash flows are estimated in nominal terms. If the discount rate excludes the effect of price increases attributable to general inflation, future cash flows are estimated in real terms

(but include future specific price increases or decreases).

41 Projections of cash outflows include those for the day-to-day servicing of the asset as well as future overheads that can be attributed directly, or allocated on a reasonable and consistent basis, to the use of the asset.

42 When the carrying amount of an asset does not yet include all the cash outflows to be incurred before it is ready for use or sale, the estimate of future cash outflows includes an estimate of any further cash outflow that is expected to be incurred before the asset is ready for use or sale. For example, this is the case for a building under construction or for a development project that is not yet completed.

43 To avoid double-counting, estimates of future cash flows do not include:

(a) cash inflows from assets that generate cash inflows that are largely independent of the cash inflows from the asset under review (for example, financial assets such as receivables); and

(b) cash outflows that relate to obligations that have been recognised as liabilities (for example, payables, pensions or provisions).

44 Future cash flows shall be estimated for the asset in its current condition. Estimates of future cash flows shall not include estimated future cash inflows or outflows that are expected to arise from:

(a) a future restructuring to which an entity is not yet committed; or

(b) improving or enhancing the asset's performance.

45 Because future cash flows are estimated for the asset in its current condition, value in use does not reflect:

(a) future cash outflows or related cost savings (for example reductions in staff costs) or benefits that are expected to arise from a future restructuring to which an entity is not yet committed; or

(b) future cash outflows that will improve or enhance the asset's performance or the related cash inflows that are expected to arise from such outflows.

46 A restructuring is a programme that is planned and controlled by management and materially changes either the scope of the business undertaken by an entity or the manner in which the business is conducted. HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets* contains guidance clarifying when an entity is committed to a restructuring.

47 When an entity becomes committed to a restructuring, some assets are likely to be affected by this restructuring. Once the entity is committed to the restructuring:

(a) its estimates of future cash inflows and cash outflows for the purpose of determining value in use reflect the cost savings and other benefits from the restructuring (based on the most recent financial budgets/forecasts approved by management); and

(b) its estimates of future cash outflows for the restructuring are included in a restructuring provision in accordance with HKAS 37.

Illustrative Example 5 illustrates the effect of a future restructuring on a value in use calculation.

48 Until an entity incurs cash outflows that improve or enhance the asset's performance, estimates of future cash flows do not include the estimated future cash inflows that are expected to arise from the increase in economic benefits associated with the cash outflow (see Illustrative Example 6).

49 Estimates of future cash flows include future cash outflows necessary to maintain the level of economic benefits expected to arise from the asset in its current condition. When a cash-generating unit consists of assets with different estimated useful lives, all of which are essential to the ongoing operation of the unit, the replacement of assets with shorter lives is considered to be part of the day-to-day servicing of the unit when estimating the future cash flows associated with the unit. Similarly, when a single asset consists of components with different estimated useful lives, the replacement of components with shorter lives is considered to be part of the day-to-day servicing of the asset when estimating the future cash flows generated by the asset.

50 Estimates of future cash flows shall not include:

(a) cash inflows or outflows from financing activities; or

(b) income tax receipts or payments.

51 Estimated future cash flows reflect assumptions that are consistent with the way the discount rate is determined. Otherwise, the effect of some assumptions will be counted twice or ignored. Because the time value of money is considered by discounting the estimated future cash flows, these cash flows exclude cash inflows or outflows from financing activities. Similarly, because the discount rate is determined on a pre-tax basis, future cash flows are also estimated on a pre-tax basis.

52 The estimate of net cash flows to be received (or paid) for the disposal of an asset at the end of its useful life shall be the amount that an entity expects to obtain from the disposal of the asset in an arm's length transaction between knowledgeable, willing parties, after deducting the estimated costs of disposal.

53 The estimate of net cash flows to be received (or paid) for the disposal of an asset at the end of its useful life is determined in a similar way to an asset's fair value less costs to sell, except that, in estimating those net cash flows:

(a) an entity uses prices prevailing at the date of the estimate for similar assets that have reached the end of their useful life and have operated under conditions similar to those in which the asset will be used.

(b) the entity adjusts those prices for the effect of both future price increases due to general inflation and specific future price increases or decreases. However, if estimates of future cash flows from the asset's continuing use and the discount rate exclude the effect of general inflation, the entity also excludes this effect from the estimate of net cash flows on disposal.

Foreign currency future cash flows

54 Future cash flows are estimated in the currency in which they will be generated and then discounted using a discount rate appropriate for that currency. An entity translates the present value using the spot exchange rate at the date of the value in use calculation.

Discount rate

55 The discount rate (rates) shall be a pre-tax rate (rates) that reflect(s) current market assessments of:

(a) the time value of money; and

(b) the risks specific to the asset for which the future cash flow estimates have not been adjusted.

56 A rate that reflects current market assessments of the time value of money and the risks specific to the asset is the return that investors would require if they were to choose an investment that would generate cash flows of amounts, timing and risk profile equivalent to those that the entity expects to derive from the asset. This rate is estimated from the rate implicit in current market transactions for similar assets or from the weighted average cost of capital of a listed entity that has a single asset (or a portfolio of assets) similar in terms of service potential and risks to the asset under review. However, the discount rate(s) used to measure an asset's value in use shall not reflect risks for which the future cash flow estimates have been adjusted. Otherwise, the effect of some assumptions will be double-counted.

57 When an asset-specific rate is not directly available from the market, an entity uses surrogates to estimate the discount rate. Appendix A provides additional guidance on estimating the discount rate in such circumstances.

Recognising and measuring an impairment loss

58 Paragraphs 59-64 set out the requirements for recognising and measuring impairment losses for an individual asset other than goodwill. Recognising and measuring impairment losses for cash-generating units and goodwill are dealt with in paragraphs 65-108.

59 If, and only if, the recoverable amount of an asset is less than its carrying amount, the carrying amount of the asset shall be reduced to its recoverable amount. That reduction is an impairment loss.

60 An impairment loss shall be recognised immediately in profit or loss, unless the asset is carried at revalued amount in accordance with another Standard (for example, in accordance with the revaluation model in HKAS 16). Any impairment loss of a revalued asset shall be treated as a revaluation decrease in accordance with that other Standard.

61 An impairment loss on a non-revalued asset is recognised in profit or loss. However, an impairment loss on a revalued asset is recognised ~~directly against any revaluation surplus for the asset~~in other comprehensive income to the extent that the impairment loss does not exceed the amount in the revaluation surplus for that same asset. Such an impairment loss on a revalued asset reduces the revaluation surplus for that asset.

62 **When the amount estimated for an impairment loss is greater than the carrying amount of the asset to which it relates, an entity shall recognise a liability if, and only if, that is required by another Standard.**

63 **After the recognition of an impairment loss, the depreciation (amortisation) charge for the asset shall be adjusted in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.**

64 If an impairment loss is recognised, any related deferred tax assets or liabilities are determined in accordance with HKAS 12 by comparing the revised carrying amount of the asset with its tax base (see Illustrative Example 3).

Cash-generating units and goodwill

65* Paragraphs 66-108 and Appendix C set out the requirements for identifying the cash-generating unit to which an asset belongs and determining the carrying amount of, and recognising impairment losses for, cash-generating units and goodwill.

Identifying the cash-generating unit to which an asset belongs

66 **If there is any indication that an asset may be impaired, recoverable amount shall be estimated for the individual asset. If it is not possible to estimate the recoverable amount of the individual asset, an entity shall determine the recoverable amount of the cash-generating unit to which the asset belongs (the asset's cash-generating unit).**

67 The recoverable amount of an individual asset cannot be determined if:

(a) the asset's value in use cannot be estimated to be close to its fair value less costs to sell (for example, when the future cash flows from continuing use of the asset cannot be estimated to be negligible); and

(b) the asset does not generate cash inflows that are largely independent of those from other assets.

In such cases, value in use and, therefore, recoverable amount, can be determined only for the asset's cash-generating unit.

Example
A mining entity owns a private railway to support its mining activities. The private railway could be sold only for scrap value and it does not generate cash inflows that are largely independent of the cash inflows from the other assets of the mine. *It is not possible to estimate the recoverable amount of the private railway because its value in use cannot be determined and is probably different from scrap value. Therefore, the entity estimates the recoverable amount of the cash-generating unit to which the private railway belongs, ie the mine as a whole.*

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

68 As defined in paragraph 6, an asset's cash-generating unit is the smallest group of assets that includes the asset and generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. Identification of an asset's cash-generating unit involves judgement. If recoverable amount cannot be determined for an individual asset, an entity identifies the lowest aggregation of assets that generate largely independent cash inflows.

Example
A bus company provides services under contract with a municipality that requires minimum service on each of five separate routes. Assets devoted to each route and the cash flows from each route can be identified separately. One of the routes operates at a significant loss. *Because the entity does not have the option to curtail any one bus route, the lowest level of identifiable cash inflows that are largely independent of the cash inflows from other assets or groups of assets is the cash inflows generated by the five routes together. The cash-generating unit for each route is the bus company as a whole.*

69 Cash inflows are inflows of cash and cash equivalents received from parties external to the entity. In identifying whether cash inflows from an asset (or group of assets) are largely independent of the cash inflows from other assets (or groups of assets), an entity considers various factors including how management monitors the entity's operations (such as by product lines, businesses, individual locations, districts or regional areas) or how management makes decisions about continuing or disposing of the entity's assets and operations. Illustrative Example 1 gives examples of identification of a cash-generating unit.

70 If an active market exists for the output produced by an asset or group of assets, that asset or group of assets shall be identified as a cash-generating unit, even if some or all of the output is used internally. If the cash inflows generated by any asset or cash-generating unit are affected by internal transfer pricing, an entity shall use management's best estimate of future price(s) that could be achieved in arm's length transactions in estimating:

(a) the future cash inflows used to determine the asset's or cash-generating unit's value in use; and

(b) the future cash outflows used to determine the value in use of any other assets or cash-generating units that are affected by the internal transfer pricing.

71 Even if part or all of the output produced by an asset or a group of assets is used by other units of the entity (for example, products at an intermediate stage of a production process), this asset or group of assets forms a separate cash-generating unit if the entity could sell the output on an active market. This is because the asset or group of assets could generate cash inflows that would be largely independent of the cash inflows from other assets or groups of assets. In using information based on financial budgets/forecasts that relates to such a cash-generating unit, or to any other asset or cash-generating unit affected by internal transfer pricing, an entity adjusts this information if internal transfer prices do not reflect management's best estimate of future prices that could be achieved in arm's length transactions.

72 Cash-generating units shall be identified consistently from period to period for the same asset or types of assets, unless a change is justified.

73 If an entity determines that an asset belongs to a cash-generating unit different from that in previous periods, or that the types of assets aggregated for the asset's cash-generating unit have changed, paragraph 130 requires disclosures about the cash-generating unit, if an impairment loss is recognised or reversed for the cash-generating unit.

Recoverable amount and carrying amount of a cash-generating unit

74 The recoverable amount of a cash-generating unit is the higher of the cash-generating unit's fair value less costs to sell and its value in use. For the purpose of determining the recoverable amount of a cash-generating unit, any reference in paragraphs 19-57 to 'an asset' is read as a reference to 'a cash-generating unit'.

75 The carrying amount of a cash-generating unit shall be determined on a basis consistent with the way the recoverable amount of the cash-generating unit is determined.

76 The carrying amount of a cash-generating unit:

(a) includes the carrying amount of only those assets that can be attributed directly, or allocated on a reasonable and consistent basis, to the cash-generating unit and will generate the future cash inflows used in determining the cash-generating unit's value in use; and

(b) does not include the carrying amount of any recognised liability, unless the recoverable amount of the cash-generating unit cannot be determined without consideration of this liability.

This is because fair value less costs to sell and value in use of a cash-generating unit are determined excluding cash flows that relate to assets that are not part of the cash-generating unit and liabilities that have been recognised (see paragraphs 28 and 43).

77 When assets are grouped for recoverability assessments, it is important to include in the cash-generating unit all assets that generate or are used to generate the relevant stream of cash inflows. Otherwise, the cash-generating unit may appear to be fully recoverable when in fact an impairment loss has occurred. In some cases, although some assets contribute to the estimated future cash flows of a cash-generating unit, they cannot be allocated to the cash-generating unit on a reasonable and consistent basis. This might be the case for goodwill or corporate assets such as head office assets. Paragraphs 80-103 explain how to deal with these assets in testing a cash-generating unit for impairment.

78 It may be necessary to consider some recognised liabilities to determine the recoverable amount of a cash-generating unit. This may occur if the disposal of a cash-generating unit would require the buyer to assume the liability. In this case, the fair value less costs to sell (or the estimated cash flow from ultimate disposal) of the cash-generating unit is the estimated selling price for the assets of the cash-generating unit and the liability together, less the costs of disposal. To perform a meaningful comparison between the carrying amount of the cash-generating unit and its recoverable amount, the carrying amount of the liability is deducted in determining both the cash-generating unit's value in use and its carrying amount.

Example
A company operates a mine in a country where legislation requires that the owner must restore the site on completion of its mining operations. The cost of restoration includes the replacement of the overburden, which must be removed before mining operations commence. A provision for the costs to replace the overburden was recognised as soon as the overburden was removed. The amount provided was recognised as part of the cost of the mine and is being depreciated over the mine's useful life. The carrying amount of the provision for restoration costs is CU500,[*] which is equal to the present value of the restoration costs. The entity is testing the mine for impairment. The cash-generating unit for the mine is the mine as a whole. The entity has received various offers to buy the mine at a price of around CU800. This price reflects the fact that the buyer will assume the obligation to restore the overburden. Disposal costs for the mine are negligible. The value in use of the mine is approximately CU1,200, excluding restoration costs. The carrying amount of the mine is CU1,000. *The cash-generating unit's fair value less costs to sell is CU800. This amount considers restoration costs that have already been provided for. As a consequence, the value in use for the cash-generating unit is determined after consideration of the restoration costs and is estimated to be CU700 (CU1,200 less CU500). The carrying amount of the cash-generating unit is CU500, which is the carrying amount of the mine (CU1,000) less the carrying amount of the provision for restoration costs (CU500). Therefore, the recoverable amount of the cash-generating unit exceeds its carrying amount.*

79 For practical reasons, the recoverable amount of a cash-generating unit is sometimes determined after consideration of assets that are not part of the cash-generating unit (for example, receivables or other financial assets) or liabilities that have been recognised (for example, payables, pensions and other provisions). In such cases, the carrying amount of the cash-generating unit is increased by the carrying amount of those assets and decreased by the carrying amount of those liabilities.

Goodwill

Allocating goodwill to cash-generating units

80 For the purpose of impairment testing, goodwill acquired in a business combination shall, from the acquisition date, be allocated to each of the acquirer's cash-generating units, or groups of cash-generating units, that is expected to benefit from the synergies of the combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units or groups of units. Each unit or group of units to which the goodwill is so allocated shall:

(a) represent the lowest level within the entity at which the goodwill is monitored for internal management purposes; and

(b)[†] not be larger than ~~a~~an operating segment as defined by paragraph 5 of ~~based on either the entity's primary or the entity's secondary reporting format determined in accordance with HKAS 14 Segment Reporting~~HKFRS 8 *Operating Segments* before aggregation.

[*] In this Standard, monetary amounts are denominated in 'currency units' (CU).
[†] Amendments effective for annual periods beginning on or after 1 January 2010.

81[*] Goodwill ~~acquired~~ recognised in a business combination is an asset representings ~~a payment made by an acquirer in anticipation of~~ the future economic benefits arising from other assets acquired in a business combination that are not ~~capable of being~~ individually identified and separately recognised. Goodwill does not generate cash flows independently of other assets or groups of assets, and often contributes to the cash flows of multiple cash-generating units. Goodwill sometimes cannot be allocated on a non-arbitrary basis to individual cash-generating units, but only to groups of cash-generating units. As a result, the lowest level within the entity at which the goodwill is monitored for internal management purposes sometimes comprises a number of cash-generating units to which the goodwill relates, but to which it cannot be allocated. References in paragraphs 83-99 and Appendix C to a cash-generating unit to which goodwill is allocated should be read as references also to a group of cash-generating units to which goodwill is allocated.

82 Applying the requirements in paragraph 80 results in goodwill being tested for impairment at a level that reflects the way an entity manages its operations and with which the goodwill would naturally be associated. Therefore, the development of additional reporting systems is typically not necessary.

83 A cash-generating unit to which goodwill is allocated for the purpose of impairment testing may not coincide with the level at which goodwill is allocated in accordance with HKAS 21 *The Effects of Changes in Foreign Exchange Rates* for the purpose of measuring foreign currency gains and losses. For example, if an entity is required by HKAS 21 to allocate goodwill to relatively low levels for the purpose of measuring foreign currency gains and losses, it is not required to test the goodwill for impairment at that same level unless it also monitors the goodwill at that level for internal management purposes.

84 If the initial allocation of goodwill acquired in a business combination cannot be completed before the end of the annual period in which the business combination is effected, that initial allocation shall be completed before the end of the first annual period beginning after the acquisition date.

85[*] In accordance with HKFRS 3 *Business Combinations*, if the initial accounting for a business combination can be determined only provisionally by the end of the period in which the combination is effected, the acquirer:

(a) accounts for the combination using those provisional values; and

(b) recognises any adjustments to those provisional values as a result of completing the initial accounting within the measurement period, which shall not exceed twelve months ~~of~~ from the acquisition date.

In such circumstances, it might also not be possible to complete the initial allocation of the goodwill ~~acquired~~ recognised in the combination before the end of the annual period in which the combination is effected. When this is the case, the entity discloses the information required by paragraph 133.

86 If goodwill has been allocated to a cash-generating unit and the entity disposes of an operation within that unit, the goodwill associated with the operation disposed of shall be:

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

(a) included in the carrying amount of the operation when determining the gain or loss on disposal; and

(b) measured on the basis of the relative values of the operation disposed of and the portion of the cash-generating unit retained, unless the entity can demonstrate that some other method better reflects the goodwill associated with the operation disposed of.

Example
An entity sells for CU100 an operation that was part of a cash-generating unit to which goodwill has been allocated. The goodwill allocated to the unit cannot be identified or associated with an asset group at a level lower than that unit, except arbitrarily. The recoverable amount of the portion of the cash-generating unit retained is CU300. *Because the goodwill allocated to the cash-generating unit cannot be non-arbitrarily identified or associated with an asset group at a level lower than that unit, the goodwill associated with the operation disposed of is measured on the basis of the relative values of the operation disposed of and the portion of the unit retained. Therefore, 25 per cent of the goodwill allocated to the cash-generating unit is included in the carrying amount of the operation that is sold.*

87 **If an entity reorganises its reporting structure in a way that changes the composition of one or more cash-generating units to which goodwill has been allocated, the goodwill shall be reallocated to the units affected. This reallocation shall be performed using a relative value approach similar to that used when an entity disposes of an operation within a cash-generating unit, unless the entity can demonstrate that some other method better reflects the goodwill associated with the reorganised units.**

Example
Goodwill had previously been allocated to cash-generating unit A. The goodwill allocated to A cannot be identified or associated with an asset group at a level lower than A, except arbitrarily. A is to be divided and integrated into three other cash-generating units, B, C and D. *Because the goodwill allocated to A cannot be non-arbitrarily identified or associated with an asset group at a level lower than A, it is reallocated to units B, C and D on the basis of the relative values of the three portions of A before those portions are integrated with B, C and D.*

Testing cash-generating units with goodwill for impairment

88 **When, as described in paragraph 81, goodwill relates to a cash-generating unit but has not been allocated to that unit, the unit shall be tested for impairment, whenever there is an indication that the unit may be impaired, by comparing the unit's carrying amount, excluding any goodwill, with its recoverable amount. Any impairment loss shall be recognised in accordance with paragraph 104.**

89 If a cash-generating unit described in paragraph 88 includes in its carrying amount an intangible asset that has an indefinite useful life or is not yet available for use and that asset can be tested for impairment only as part of the cash-generating unit, paragraph 10 requires the unit also to be tested for impairment annually.

90 **A cash-generating unit to which goodwill has been allocated shall be tested for impairment annually, and whenever there is an indication that the unit may be impaired, by comparing the carrying amount of the unit, including the goodwill, with the recoverable amount of the unit. If the recoverable amount of the unit exceeds the carrying amount of the unit, the unit and the goodwill allocated to that unit shall be regarded as not impaired. If the carrying amount of the unit exceeds the recoverable amount of the unit, the entity shall recognise the impairment loss in accordance with paragraph 104.**

~~*Minority Interest*~~

91-95[*] [Deleted]~~In accordance with HKFRS 3, goodwill recognised in a business combination represents the goodwill acquired by a parent based on the parent's ownership interest, rather than the amount of goodwill controlled by the parent as a result of the business combination. Therefore, goodwill attributable to a minority interest is not recognised in the parent's consolidated financial statements. Accordingly, if there is a minority interest in a cash-generating unit to which goodwill has been allocated, the carrying amount of that unit comprises:~~

~~(a) both the parent's interest and the minority interest in the identifiable net assets of the unit; and~~

~~(b) the parent's interest in goodwill. However, part of the recoverable amount of the cash-generating unit determined in accordance with this Standard is attributable to the minority interest in goodwill.~~

~~92 Consequently, for the purpose of impairment testing a non-wholly-owned cash-generating unit with goodwill, the carrying amount of that unit is notionally adjusted, before being compared with its recoverable amount. This is accomplished by grossing up the carrying amount of goodwill allocated to the unit to include the goodwill attributable to the minority interest. This notionally adjusted carrying amount is then compared with the recoverable amount of the unit to determine whether the cash-generating unit is impaired. If it is, the entity allocates the impairment loss in accordance with paragraph 104 first to reduce the carrying amount of goodwill allocated to the unit.~~

~~93 However, because goodwill is recognised only to the extent of the parent's ownership interest, any impairment loss relating to the goodwill is apportioned between that attributable to the parent and that attributable to the minority interest, with only the former being recognised as a goodwill impairment loss.~~

~~94 If the total impairment loss relating to goodwill is less than the amount by which the notionally adjusted carrying amount of the cash-generating unit exceeds its recoverable amount, paragraph 104 requires the remaining excess to be allocated to the other assets of the unit pro rata on the basis of the carrying amount of each asset in the unit.~~

~~95 Illustrative Example 7 illustrates the impairment testing of a non-wholly-owned cash-generating unit with goodwill.~~

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

Timing of impairment tests

96 **The annual impairment test for a cash-generating unit to which goodwill has been allocated may be performed at any time during an annual period, provided the test is performed at the same time every year. Different cash-generating units may be tested for impairment at different times. However, if some or all of the goodwill allocated to a cash-generating unit was acquired in a business combination during the current annual period, that unit shall be tested for impairment before the end of the current annual period.**

97 **If the assets constituting the cash-generating unit to which goodwill has been allocated are tested for impairment at the same time as the unit containing the goodwill, they shall be tested for impairment before the unit containing the goodwill. Similarly, if the cash-generating units constituting a group of cash-generating units to which goodwill has been allocated are tested for impairment at the same time as the group of units containing the goodwill, the individual units shall be tested for impairment before the group of units containing the goodwill.**

98 At the time of impairment testing a cash-generating unit to which goodwill has been allocated, there may be an indication of an impairment of an asset within the unit containing the goodwill. In such circumstances, the entity tests the asset for impairment first, and recognises any impairment loss for that asset before testing for impairment the cash-generating unit containing the goodwill. Similarly, there may be an indication of an impairment of a cash-generating unit within a group of units containing the goodwill. In such circumstances, the entity tests the cash-generating unit for impairment first, and recognises any impairment loss for that unit, before testing for impairment the group of units to which the goodwill is allocated.

99 **The most recent detailed calculation made in a preceding period of the recoverable amount of a cash-generating unit to which goodwill has been allocated may be used in the impairment test of that unit in the current period provided all of the following criteria are met:**

(a) the assets and liabilities making up the unit have not changed significantly since the most recent recoverable amount calculation;

(b) the most recent recoverable amount calculation resulted in an amount that exceeded the carrying amount of the unit by a substantial margin; and

(c) based on an analysis of events that have occurred and circumstances that have changed since the most recent recoverable amount calculation, the likelihood that a current recoverable amount determination would be less than the current carrying amount of the unit is remote.

Corporate assets

100 Corporate assets include group or divisional assets such as the building of a headquarters or a division of the entity, EDP equipment or a research centre. The structure of an entity determines whether an asset meets this Standard's definition of corporate assets for a particular cash-generating unit. The distinctive characteristics of corporate assets are that they do not generate cash inflows independently of other assets or groups of assets and their carrying amount cannot be fully attributed to the cash-generating unit under review.

101 Because corporate assets do not generate separate cash inflows, the recoverable amount of an individual corporate asset cannot be determined unless management has decided to dispose of the asset. As a consequence, if there is an indication that a corporate asset may be impaired, recoverable amount is determined for the cash-generating unit or group of cash-generating units to which the corporate asset belongs, and is compared with the carrying amount of this cash-generating unit or group of cash-generating units. Any impairment loss is recognised in accordance with paragraph 104.

102 In testing a cash-generating unit for impairment, an entity shall identify all the corporate assets that relate to the cash-generating unit under review. If a portion of the carrying amount of a corporate asset:

(a) can be allocated on a reasonable and consistent basis to that unit, the entity shall compare the carrying amount of the unit, including the portion of the carrying amount of the corporate asset allocated to the unit, with its recoverable amount. Any impairment loss shall be recognised in accordance with paragraph 104.

(b) cannot be allocated on a reasonable and consistent basis to that unit, the entity shall:

(i) compare the carrying amount of the unit, excluding the corporate asset, with its recoverable amount and recognise any impairment loss in accordance with paragraph 104;

(ii) identify the smallest group of cash-generating units that includes the cash-generating unit under review and to which a portion of the carrying amount of the corporate asset can be allocated on a reasonable and consistent basis; and

(iii) compare the carrying amount of that group of cash-generating units, including the portion of the carrying amount of the corporate asset allocated to that group of units, with the recoverable amount of the group of units. Any impairment loss shall be recognised in accordance with paragraph 104.

103 Illustrative Example 8 illustrates the application of these requirements to corporate assets.

Impairment loss for a cash-generating unit

104 An impairment loss shall be recognised for a cash-generating unit (the smallest group of cash-generating units to which goodwill or a corporate asset has been allocated) if, and only if, the recoverable amount of the unit (group of units) is less than the carrying amount of the unit (group of units). The impairment loss shall be allocated to reduce the carrying amount of the assets of the unit (group of units) in the following order:

(a) first, to reduce the carrying amount of any goodwill allocated to the cash-generating unit (group of units); and

(b) then, to the other assets of the unit (group of units) pro rata on the basis of the carrying amount of each asset in the unit (group of units).

These reductions in carrying amounts shall be treated as impairment losses on individual assets and recognised in accordance with paragraph 60.

105 In allocating an impairment loss in accordance with paragraph 104, an entity shall not reduce the carrying amount of an asset below the highest of:

(a) its fair value less costs to sell (if determinable);

(b) its value in use (if determinable); and

(c) zero.

The amount of the impairment loss that would otherwise have been allocated to the asset shall be allocated pro rata to the other assets of the unit (group of units).

106 If it is not practicable to estimate the recoverable amount of each individual asset of a cash-generating unit, this Standard requires an arbitrary allocation of an impairment loss between the assets of that unit, other than goodwill, because all assets of a cash-generating unit work together.

107 If the recoverable amount of an individual asset cannot be determined (see paragraph 67):

(a) an impairment loss is recognised for the asset if its carrying amount is greater than the higher of its fair value less costs to sell and the results of the allocation procedures described in paragraphs 104 and 105; and

(b) no impairment loss is recognised for the asset if the related cash-generating unit is not impaired. This applies even if the asset's fair value less costs to sell is less than its carrying amount.

Example

A machine has suffered physical damage but is still working, although not as well as before it was damaged. The machine's fair value less costs to sell is less than its carrying amount. The machine does not generate independent cash inflows. The smallest identifiable group of assets that includes the machine and generates cash inflows that are largely independent of the cash inflows from other assets is the production line to which the machine belongs. The recoverable amount of the production line shows that the production line taken as a whole is not impaired.

Assumption 1: budgets/forecasts approved by management reflect no commitment of management to replace the machine.

The recoverable amount of the machine alone cannot be estimated because the machine's value in use:

(a) may differ from its fair value less costs to sell; and

(b) can be determined only for the cash-generating unit to which the machine belongs (the production line).

The production line is not impaired. Therefore, no impairment loss is recognised for the machine. Nevertheless, the entity may need to reassess the depreciation period or the depreciation method for the machine. Perhaps a shorter depreciation period or a faster *depreciation method is required to reflect the expected remaining useful life of the machine or the pattern in which economic benefits are expected to be consumed by the entity.*

Assumption 2: budgets/forecasts approved by management reflect a commitment of management to replace the machine and sell it in the near future. Cash flows from continuing use of the machine until its disposal are estimated to be negligible.

The machine's value in use can be estimated to be close to its fair value less costs to sell. Therefore, the recoverable amount of the machine can be determined and no consideration is given to the cash-generating unit to which the machine belongs (ie the production line). Because the machine's fair value less costs to sell is less than its carrying amount, an impairment loss is recognised for the machine.

108 After the requirements in paragraphs 104 and 105 have been applied, a liability shall be recognised for any remaining amount of an impairment loss for a cash-generating unit if, and only if, that is required by another ~~Standard~~HKFRS.

Reversing an impairment loss

109 Paragraphs 110-116 set out the requirements for reversing an impairment loss recognised for an asset or a cash-generating unit in prior periods. These requirements use the term 'an asset' but apply equally to an individual asset or a cash-generating unit. Additional requirements for an individual asset are set out in paragraphs 117-121, for a cash-generating unit in paragraphs 122 and 123 and for goodwill in paragraphs 124 and 125.

110 An entity shall assess at the end of each ~~reporting date~~reporting period whether there is any indication that an impairment loss recognised in prior periods for an asset other than goodwill may no longer exist or may have decreased. If any such indication exists, the entity shall estimate the recoverable amount of that asset.

111 In assessing whether there is any indication that an impairment loss recognised in prior periods for an asset other than goodwill may no longer exist or may have decreased, an entity shall consider, as a minimum, the following indications:

External sources of information

(a) the asset's market value has increased significantly during the period.

(b) significant changes with a favourable effect on the entity have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the entity operates or in the market to which the asset is dedicated.

(c) market interest rates or other market rates of return on investments have decreased during the period, and those decreases are likely to affect the discount rate used in calculating the asset's value in use and increase the asset's recoverable amount materially.

Internal sources of information

(d) significant changes with a favourable effect on the entity have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, the asset is used or is expected to be used. These changes include costs incurred during the period to improve or enhance the asset's performance or restructure the operation to which the asset belongs.

(e) evidence is available from internal reporting that indicates that the economic performance of the asset is, or will be, better than expected.

112 Indications of a potential decrease in an impairment loss in paragraph 111 mainly mirror the indications of a potential impairment loss in paragraph 12.

113 If there is an indication that an impairment loss recognised for an asset other than goodwill may no longer exist or may have decreased, this may indicate that the remaining useful life, the depreciation (amortisation) method or the residual value may need to be reviewed and adjusted in accordance with the ~~Standard~~ HKFRS applicable to the asset, even if no impairment loss is reversed for the asset.

114 An impairment loss recognised in prior periods for an asset other than goodwill shall be reversed if, and only if, there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognised. If this is the case, the carrying amount of the asset shall, except as described in paragraph 117, be increased to its recoverable amount. That increase is a reversal of an impairment loss.

115 A reversal of an impairment loss reflects an increase in the estimated service potential of an asset, either from use or from sale, since the date when an entity last recognised an impairment loss for that asset. Paragraph 130 requires an entity to identify the change in estimates that causes the increase in estimated service potential. Examples of changes in estimates include:

(a) a change in the basis for recoverable amount (ie whether recoverable amount is based on fair value less costs to sell or value in use);

(b) if recoverable amount was based on value in use, a change in the amount or timing of estimated future cash flows or in the discount rate; or

(c) if recoverable amount was based on fair value less costs to sell, a change in estimate of the components of fair value less costs to sell.

116 An asset's value in use may become greater than the asset's carrying amount simply because the present value of future cash inflows increases as they become closer. However, the service potential of the asset has not increased. Therefore, an impairment loss is not reversed just because of the passage of time (sometimes called the 'unwinding' of the discount), even if the recoverable amount of the asset becomes higher than its carrying amount.

Reversing an impairment loss for an individual asset

117 The increased carrying amount of an asset other than goodwill attributable to a reversal of an impairment loss shall not exceed the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior years.

118 Any increase in the carrying amount of an asset other than goodwill above the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior years is a revaluation. In accounting for such a revaluation, an entity applies the ~~Standard~~ HKFRS applicable to the asset.

119 **A reversal of an impairment loss for an asset other than goodwill shall be recognised immediately in profit or loss, unless the asset is carried at revalued amount in accordance with another ~~Standard~~ HKFRS (for example, the revaluation model in HKAS 16). Any reversal of an impairment loss of a revalued asset shall be treated as a revaluation increase in accordance with that other ~~Standard~~HKFRS.**

120 A reversal of an impairment loss on a revalued asset is ~~credited directly to equity under the heading~~recognised in other comprehensive income and increases the revaluation surplus for that asset. However, to the extent that an impairment loss on the same revalued asset was previously recognised in profit or loss, a reversal of that impairment loss is also recognised in profit or loss.

121 **After a reversal of an impairment loss is recognised, the depreciation (amortisation) charge for the asset shall be adjusted in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.**

Reversing an impairment loss for a cash-generating unit

122 **A reversal of an impairment loss for a cash-generating unit shall be allocated to the assets of the unit, except for goodwill, pro rata with the carrying amounts of those assets. These increases in carrying amounts shall be treated as reversals of impairment losses for individual assets and recognised in accordance with paragraph 119.**

123 **In allocating a reversal of an impairment loss for a cash-generating unit in accordance with paragraph 122, the carrying amount of an asset shall not be increased above the lower of:**

(a) its recoverable amount (if determinable); and

(b) the carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior periods.

The amount of the reversal of the impairment loss that would otherwise have been allocated to the asset shall be allocated pro rata to the other assets of the unit, except for goodwill.

Reversing an impairment loss for goodwill

124 **An impairment loss recognised for goodwill shall not be reversed in a subsequent period.**

125 HKAS 38 *Intangible Assets* prohibits the recognition of internally generated goodwill. Any increase in the recoverable amount of goodwill in the periods following the recognition of an impairment loss for that goodwill is likely to be an increase in internally generated goodwill, rather than a reversal of the impairment loss recognised for the acquired goodwill.

Disclosure

126 **An entity shall disclose the following for each class of assets:**

(a) the amount of impairment losses recognised in profit or loss during the period and the line item(s) of the ~~income~~ statement of comprehensive income in which those impairment losses are included.

(b) the amount of reversals of impairment losses recognised in profit or loss during the period and the line item(s) of the ~~income~~ statement of comprehensive income in which those impairment losses are reversed.

(c) the amount of impairment losses on revalued assets recognised ~~directly in equity~~in other comprehensive income during the period.

(d) the amount of reversals of impairment losses on revalued assets recognised ~~directly in equity~~in other comprehensive income during the period.

127 A class of assets is a grouping of assets of similar nature and use in an entity's operations.

128 The information required in paragraph 126 may be presented with other information disclosed for the class of assets. For example, this information may be included in a reconciliation of the carrying amount of property, plant and equipment, at the beginning and end of the period, as required by HKAS 16.

129 **An entity that reports segment information in accordance with ~~HKAS 14 *Segment Reporting*~~HKFRS 8 shall disclose the following for each reportable segment ~~based on an entity's primary reporting format~~:**

(a) the amount of impairment losses recognised in profit or loss and ~~directly in equity~~in other comprehensive income during the period.

(b) the amount of reversals of impairment losses recognised in profit or loss and ~~directly in equity~~in other comprehensive income during the period.

130 **An entity shall disclose the following for each material impairment loss recognised or reversed during the period for an individual asset, including goodwill, or a cash-generating unit:**

(a) the events and circumstances that led to the recognition or reversal of the impairment loss.

(b) the amount of the impairment loss recognised or reversed.

(c) for an individual asset:

(i) the nature of the asset; and

(ii) if the entity reports segment information in accordance with ~~HKAS 14~~HKFRS 8, the reportable segment to which the asset belongs~~, based on the entity's primary reporting format~~.

(d) for a cash-generating unit:

(i) a description of the cash-generating unit (such as whether it is a product line, a plant, a business operation, a geographical area, or a reportable segment as defined in ~~HKAS 14~~HKFRS 8);

(ii) the amount of the impairment loss recognised or reversed by class of assets and, if the entity reports segment information in accordance with ~~HKAS 14~~HKFRS 8, by reportable segment ~~based on the entity's primary reporting format~~; and

(iii) if the aggregation of assets for identifying the cash-generating unit has changed since the previous estimate of the cash-generating unit's recoverable amount (if any), a description of the current and former way of aggregating assets and the reasons for changing the way the cash-generating unit is identified.

(e) whether the recoverable amount of the asset (cash-generating unit) is its fair value less costs to sell or its value in use.

(f) if recoverable amount is fair value less costs to sell, the basis used to determine fair value less costs to sell (such as whether fair value was determined by reference to an active market).

(g) if recoverable amount is value in use, the discount rate(s) used in the current estimate and previous estimate (if any) of value in use.

131 An entity shall disclose the following information for the aggregate impairment losses and the aggregate reversals of impairment losses recognised during the period for which no information is disclosed in accordance with paragraph 130:

(a) the main classes of assets affected by impairment losses and the main classes of assets affected by reversals of impairment losses.

(b) the main events and circumstances that led to the recognition of these impairment losses and reversals of impairment losses.

132 An entity is encouraged to disclose assumptions used to determine the recoverable amount of assets (cash-generating units) during the period. However, paragraph 134 requires an entity to disclose information about the estimates used to measure the recoverable amount of a cash-generating unit when goodwill or an intangible asset with an indefinite useful life is included in the carrying amount of that unit.

133 If, in accordance with paragraph 84, any portion of the goodwill acquired in a business combination during the period has not been allocated to a cash-generating unit (group of units) at the ~~reporting date~~end of the reporting period, the amount of the unallocated goodwill shall be disclosed together with the reasons why that amount remains unallocated.

Estimates used to measure recoverable amounts of cash-generating units containing goodwill or intangible assets with indefinite useful lives

134 **An entity shall disclose the information required by (a)-(f) for each cash-generating unit (group of units) for which the carrying amount of goodwill or intangible assets with indefinite useful lives allocated to that unit (group of units) is significant in comparison with the entity's total carrying amount of goodwill or intangible assets with indefinite useful lives:**

(a) the carrying amount of goodwill allocated to the unit (group of units).

(b) the carrying amount of intangible assets with indefinite useful lives allocated to the unit (group of units).

(c) the basis on which the unit's (group of units') recoverable amount has been determined (ie value in use or fair value less costs to sell).

(d) if the unit's (group of units') recoverable amount is based on value in use:

(i) a description of each key assumption on which management has based its cash flow projections for the period covered by the most recent budgets/forecasts. Key assumptions are those to which the unit's (group of units') recoverable amount is most sensitive.

(ii) a description of management's approach to determining the value(s) assigned to each key assumption, whether those value(s) reflect past experience or, if appropriate, are consistent with external sources of information, and, if not, how and why they differ from past experience or external sources of information.

(iii) the period over which management has projected cash flows based on financial budgets/forecasts approved by management and, when a period greater than five years is used for a cash-generating unit (group of units), an explanation of why that longer period is justified.

(iv) the growth rate used to extrapolate cash flow projections beyond the period covered by the most recent budgets/forecasts, and the justification for using any growth rate that exceeds the long-term average growth rate for the products, industries, or country or countries in which the entity operates, or for the market to which the unit (group of units) is dedicated.

(v) the discount rate(s) applied to the cash flow projections.

(e) if the unit's (group of units') recoverable amount is based on fair value less costs to sell, the methodology used to determine fair value less costs to sell. If fair value less costs to sell is not determined using an observable market price for the unit (group of units), the following information shall also be disclosed:

(i) **a description of each key assumption on which management has based its determination of fair value less costs to sell. Key assumptions are those to which the unit's (group of units') recoverable amount is most sensitive.**

(ii) **a description of management's approach to determining the value~~(s)~~(or values) assigned to each key assumption, whether those value~~(s)~~ reflect past experience or, if appropriate, are consistent with external sources of information, and, if not, how and why they differ from past experience or external sources of information.**

If fair value less costs to sell is determined using discounted cash flow projections, the following information shall also be disclosed:

(iii) **the period over which management has projected cash flows.**

(iv) **the growth rate used to extrapolate cash flow projections.**

(v) **the discount rate(s) applied to the cash flow projections.**

(f) **if a reasonably possible change in a key assumption on which management has based its determination of the unit's (group of units') recoverable amount would cause the unit's (group of units') carrying amount to exceed its recoverable amount:**

(i) **the amount by which the unit's (group of units') recoverable amount exceeds its carrying amount.**

(ii) **the value assigned to the key assumption.**

(iii) **the amount by which the value assigned to the key assumption must change, after incorporating any consequential effects of that change on the other variables used to measure recoverable amount, in order for the unit's (group of units') recoverable amount to be equal to its carrying amount.**

135 If some or all of the carrying amount of goodwill or intangible assets with indefinite useful lives is allocated across multiple cash-generating units (groups of units), and the amount so allocated to each unit (group of units) is not significant in comparison with the entity's total carrying amount of goodwill or intangible assets with indefinite useful lives, that fact shall be disclosed, together with the aggregate carrying amount of goodwill or intangible assets with indefinite useful lives allocated to those units (groups of units). In addition, if the recoverable amounts of any of those units (groups of units) are based on the same key assumption(s) and the aggregate carrying amount of goodwill or intangible assets with indefinite useful lives allocated to them is significant in comparison with the entity's total carrying amount of goodwill or intangible assets with indefinite useful lives, an entity shall disclose that fact, together with:

(a) **the aggregate carrying amount of goodwill allocated to those units (groups of units).**

(b) **the aggregate carrying amount of intangible assets with indefinite useful lives allocated to those units (groups of units).**

(c) **a description of the key assumption(s).**

(d) **a description of management's approach to determining the value(s) assigned to the key assumption(s), whether those value(s) reflect past experience or, if appropriate, are consistent with external sources of information, and, if not, how and why they differ from past experience or external sources of information.**

(e) **if a reasonably possible change in the key assumption(s) would cause the aggregate of the units' (groups of units') carrying amounts to exceed the aggregate of their recoverable amounts:**

(i) **the amount by which the aggregate of the units' (groups of units') recoverable amounts exceeds the aggregate of their carrying amounts.**

(ii) **the value(s) assigned to the key assumption(s).**

(iii) **the amount by which the value(s) assigned to the key assumption(s) must change, after incorporating any consequential effects of the change on the other variables used to measure recoverable amount, in order for the aggregate of the units' (groups of units') recoverable amounts to be equal to the aggregate of their carrying amounts.**

136 The most recent detailed calculation made in a preceding period of the recoverable amount of a cash-generating unit (group of units) may, in accordance with paragraph 24 or 99, be carried forward and used in the impairment test for that unit (group of units) in the current period provided specified criteria are met. When this is the case, the information for that unit (group of units) that is incorporated into the disclosures required by paragraphs 134 and 135 relate to the carried forward calculation of recoverable amount.

137 Illustrative Example 9 illustrates the disclosures required by paragraphs 134 and 135.

Transitional provisions and effective date

138[*] **~~If an entity elects in accordance with paragraph 85 of HKFRS 3 *Business Combinations* to apply HKFRS 3 from any date before the effective dates set out in paragraphs 78-84 of HKFRS 3, it also shall apply this Standard prospectively from that same date.~~ [Deleted]**

139[*] **~~Otherwise, a~~An entity shall apply this Standard:**

(a) **to goodwill and intangible assets acquired in business combinations for which the agreement date is on or after 1 January 2005; and**

(b) **to all other assets prospectively from the beginning of the first annual period beginning on or after 1 January 2005.**

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

140 Entities to which paragraph 139 applies are encouraged to apply the requirements of this Standard before the effective dates specified in paragraph 139. However, if an entity applies this Standard before those effective dates, it also shall apply HKFRS 3 and HKAS 38 at the same time.

140A HKAS 1 *Presentation of Financial Statements* (as revised in 2007) amended the terminology used throughout HKFRSs. In addition it amended paragraphs 61, 120, 126 and 129. An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. If an entity applies HKAS 1 (revised 2007) for an earlier period, the amendments shall be applied for that earlier period.

140B[*] HKFRS 3 (as revised in 2008) amended paragraphs 65, 81, 85 and 139, deleted paragraphs 91-95 and 138 and added Appendix C. An entity shall apply those amendments for annual periods beginning on or after 1 July 2009. If an entity applies HKFRS 3 (revised 2008) for an earlier period, the amendments shall also be applied for that earlier period.

140C Paragraph 134(e) was amended by *Improvements to HKFRSs* issued in October 2008. An entity shall apply that amendment for annual periods beginning on or after 1 January 2009. Earlier application is permitted. If an entity applies the amendment for an earlier period it shall disclose that fact.

140D *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate* (Amendments to HKFRS 1 *First-time Adoption of Hong Kong Financial Reporting Standards* and HKAS 27), issued in October 2008, added paragraph 12(h). An entity shall apply that amendment prospectively for annual periods beginning on or after 1 January 2009. Earlier application is permitted. If an entity applies the related amendments in paragraphs 4 and 38A of HKAS 27 for an earlier period, it shall apply the amendment in paragraph 12(h) at the same time.

140E[†] *Improvements to HKFRSs* issued in May 2009 amended paragraph 80(b). An entity shall apply that amendment prospectively for annual periods beginning on or after 1 January 2010. Earlier application is permitted. If an entity applies the amendment for an earlier period it shall disclose that fact.

Withdrawal of SSAP 31

141 This Standard supersedes SSAP 31 *Impairment of Assets* (issued in 2001).

[*] Amendments effective for annual periods beginning on or after 1 July 2009.
[†] Amendments effective for annual periods beginning on or after 1 January 2010.

Appendix A

Using present value techniques to measure value in use

This appendix is an integral part of the Standard. It provides guidance on the use of present value techniques in measuring value in use. Although the guidance uses the term 'asset', it equally applies to a group of assets forming a cash-generating unit.

The components of a present value measurement

A1 The following elements together capture the economic differences between assets:

(a) an estimate of the future cash flow, or in more complex cases, series of future cash flows the entity expects to derive from the asset;

(b) expectations about possible variations in the amount or timing of those cash flows;

(c) the time value of money, represented by the current market risk-free rate of interest;

(d) the price for bearing the uncertainty inherent in the asset; and

(e) other, sometimes unidentifiable, factors (such as illiquidity) that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset.

A2 This appendix contrasts two approaches to computing present value, either of which may be used to estimate the value in use of an asset, depending on the circumstances. Under the 'traditional' approach, adjustments for factors (b)-(e) described in paragraph A1 are embedded in the discount rate. Under the 'expected cash flow' approach, factors (b), (d) and (e) cause adjustments in arriving at risk-adjusted expected cash flows. Whichever approach an entity adopts to reflect expectations about possible variations in the amount or timing of future cash flows, the result should be to reflect the expected present value of the future cash flows, ie the weighted average of all possible outcomes.

General principles

A3 The techniques used to estimate future cash flows and interest rates will vary from one situation to another depending on the circumstances surrounding the asset in question. However, the following general principles govern any application of present value techniques in measuring assets:

(a) interest rates used to discount cash flows should reflect assumptions that are consistent with those inherent in the estimated cash flows. Otherwise, the effect of some assumptions will be double-counted or ignored. For example, a discount rate of 12 per cent might be applied to contractual cash flows of a loan receivable. That rate reflects expectations about future defaults from loans with particular characteristics. That same 12 per cent rate should not be used to discount expected cash flows because those cash flows already reflect assumptions about future defaults.

(b) estimated cash flows and discount rates should be free from both bias and factors unrelated to the asset in question. For example, deliberately understating estimated net cash flows to enhance the apparent future profitability of an asset introduces a bias into the measurement.

(c) estimated cash flows or discount rates should reflect the range of possible outcomes rather than a single most likely, minimum or maximum possible amount.

Traditional and expected cash flow approaches to present value

Traditional approach

A4 Accounting applications of present value have traditionally used a single set of estimated cash flows and a single discount rate, often described as 'the rate commensurate with the risk'. In effect, the traditional approach assumes that a single discount rate convention can incorporate all the expectations about the future cash flows and the appropriate risk premium. Therefore, the traditional approach places most of the emphasis on selection of the discount rate.

A5 In some circumstances, such as those in which comparable assets can be observed in the marketplace, a traditional approach is relatively easy to apply. For assets with contractual cash flows, it is consistent with the manner in which marketplace participants describe assets, as in 'a 12 per cent bond'.

A6 However, the traditional approach may not appropriately address some complex measurement problems, such as the measurement of non-financial assets for which no market for the item or a comparable item exists. A proper search for 'the rate commensurate with the risk' requires analysis of at least two items—an asset that exists in the marketplace and has an observed interest rate and the asset being measured. The appropriate discount rate for the cash flows being measured must be inferred from the observable rate of interest in that other asset. To draw that inference, the characteristics of the other asset's cash flows must be similar to those of the asset being measured. Therefore, the measurer must do the following:

(a) identify the set of cash flows that will be discounted;

(b) identify another asset in the marketplace that appears to have similar cash flow characteristics;

(c) compare the cash flow sets from the two items to ensure that they are similar (for example, are both sets contractual cash flows, or is one contractual and the other an estimated cash flow?);

(d) evaluate whether there is an element in one item that is not present in the other (for example, is one less liquid than the other?); and

(e) evaluate whether both sets of cash flows are likely to behave (ie vary) in a similar fashion in changing economic conditions.

Expected cash flow approach

A7 The expected cash flow approach is, in some situations, a more effective measurement tool than the traditional approach. In developing a measurement, the expected cash flow approach uses all expectations about possible cash flows instead of the single most likely cash flow. For example, a cash flow might be CU100, CU200 or CU300 with probabilities of 10 per cent, 60 per cent and 30 per cent, respectively. The expected cash flow is CU220. The expected cash flow approach thus differs from the traditional approach by focusing on direct analysis of the cash flows in question and on more explicit statements of the assumptions used in the measurement.

A8 The expected cash flow approach also allows use of present value techniques when the timing of cash flows is uncertain. For example, a cash flow of CU1,000 may be received in one year, two years or three years with probabilities of 10 per cent, 60 per cent and 30 per cent, respectively. The example below shows the computation of expected present value in that situation.

Present value of CU1,000 in 1 year at 5%	CU952.38	
Probability	10.00%	CU95.24
Present value of CU1,000 in 2 years at 5.25%	CU902.73	
Probability	60.00%	CU541.64
Present value of CU1,000 in 3 years at 5.50%	CU851.61	
Probability	30.00%	CU255.48
Expected present value		CU892.36

A9 The expected present value of CU892.36 differs from the traditional notion of a best estimate of CU902.73 (the 60 per cent probability). A traditional present value computation applied to this example requires a decision about which of the possible timings of cash flows to use and, accordingly, would not reflect the probabilities of other timings. This is because the discount rate in a traditional present value computation cannot reflect uncertainties in timing.

A10 The use of probabilities is an essential element of the expected cash flow approach. Some question whether assigning probabilities to highly subjective estimates suggests greater precision than, in fact, exists. However, the proper application of the traditional approach (as described in paragraph A6) requires the same estimates and subjectivity without providing the computational transparency of the expected cash flow approach.

A11 Many estimates developed in current practice already incorporate the elements of expected cash flows informally. In addition, accountants often face the need to measure an asset using limited information about the probabilities of possible cash flows. For example, an accountant might be confronted with the following situations:

(a) the estimated amount falls somewhere between CU50 and CU250, but no amount in the range is more likely than any other amount. Based on that limited information, the estimated expected cash flow is CU150 [(50 + 250)/2].

(b) the estimated amount falls somewhere between CU50 and CU250, and the most likely amount is CU100. However, the probabilities attached to each amount are unknown. Based on that limited information, the estimated expected cash flow is CU133.33 [(50 + 100 + 250)/3].

(c) the estimated amount will be CU50 (10 per cent probability), CU250 (30 per cent probability), or CU100 (60 per cent probability). Based on that limited information, the estimated expected cash flow is CU140 [(50 × 0.10) + (250 × 0.30) + (100 × 0.60)].

In each case, the estimated expected cash flow is likely to provide a better estimate of value in use than the minimum, most likely or maximum amount taken alone.

A12 The application of an expected cash flow approach is subject to a cost-benefit constraint. In some cases, an entity may have access to extensive data and may be able to develop many cash flow scenarios. In other cases, an entity may not be able to develop more than general statements about the variability of cash flows without incurring substantial cost. The entity needs to balance the cost of obtaining additional information against the additional reliability that information will bring to the measurement.

A13 Some maintain that expected cash flow techniques are inappropriate for measuring a single item or an item with a limited number of possible outcomes. They offer an example of an asset with two possible outcomes: a 90 per cent probability that the cash flow will be CU10 and a 10 per cent probability that the cash flow will be CU1,000. They observe that the expected cash flow in that example is CU109 and criticise that result as not representing either of the amounts that may ultimately be paid.

A14 Assertions like the one just outlined reflect underlying disagreement with the measurement objective. If the objective is accumulation of costs to be incurred, expected cash flows may not produce a representationally faithful estimate of the expected cost. However, this Standard is concerned with measuring the recoverable amount of an asset. The recoverable amount of the asset in this example is not likely to be CU10, even though that is the most likely cash flow. This is because a measurement of CU10 does not incorporate the uncertainty of the cash flow in the measurement of the asset. Instead, the uncertain cash flow is presented as if it were a certain cash flow. No rational entity would sell an asset with these characteristics for CU10.

Discount rate

A15 Whichever approach an entity adopts for measuring the value in use of an asset, interest rates used to discount cash flows should not reflect risks for which the estimated cash flows have been adjusted. Otherwise, the effect of some assumptions will be double-counted.

A16 When an asset-specific rate is not directly available from the market, an entity uses surrogates to estimate the discount rate. The purpose is to estimate, as far as possible, a market assessment of:

(a) the time value of money for the periods until the end of the asset's useful life; and

(b) factors (b), (d) and (e) described in paragraph A1, to the extent those factors have not caused adjustments in arriving at estimated cash flows.

A17 As a starting point in making such an estimate, the entity might take into account the following rates:

(a) the entity's weighted average cost of capital determined using techniques such as the Capital Asset Pricing Model;

(b) the entity's incremental borrowing rate; and

(c) other market borrowing rates.

A18 However, these rates must be adjusted:

(a) to reflect the way that the market would assess the specific risks associated with the asset's estimated cash flows; and

(b) to exclude risks that are not relevant to the asset's estimated cash flows or for which the estimated cash flows have been adjusted.

Consideration should be given to risks such as country risk, currency risk and price risk.

A19 The discount rate is independent of the entity's capital structure and the way the entity financed the purchase of the asset, because the future cash flows expected to arise from an asset do not depend on the way in which the entity financed the purchase of the asset.

A20 Paragraph 55 requires the discount rate used to be a pre-tax rate. Therefore, when the basis used to estimate the discount rate is post-tax, that basis is adjusted to reflect a pre-tax rate.

A21 An entity normally uses a single discount rate for the estimate of an asset's value in use. However, an entity uses separate discount rates for different future periods where value in use is sensitive to a difference in risks for different periods or to the term structure of interest rates.

Appendix B

Amendment to HKAS 16

The amendment in this appendix shall be applied when an entity applies HKAS 16 Property, Plant and Equipment . *This appendix is superseded when HKAS 36* Impairment of Assets *becomes effective. This appendix replaces the consequential amendments made by HKAS 16 to SSAP 31(which is referred to in HKAS 16 Appendix paragraph A4 as "HKAS 36"). HKAS 36 incorporates the requirements of the paragraphs in this appendix. Consequently, the amendments from HKAS 16 are not necessary once an entity is subject to HKAS 36 . Accordingly, this appendix is applicable only to entities that elect to apply HKAS 16 before its effective date.*

* * *

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

Appendix C

Impairment testing cash-generating units with goodwill and non-controlling interests (Effective for annual periods beginning on or after 1 July 2009)

This appendix is an integral part of the Standard.

C1 In accordance with HKFRS 3 (as revised in 2008), the acquirer measures and recognises goodwill as of the acquisition date as the excess of (a) over (b) below:

(a) the aggregate of:

(i) the consideration transferred measured in accordance with HKFRS 3, which generally requires acquisition-date fair value;

(ii) the amount of any non-controlling interest in the acquiree measured in accordance with HKFRS 3; and

(iii) in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree.

(b) the net of the acquisition-date amounts of the identifiable assets acquired and liabilities assumed measured in accordance with HKFRS 3.

Allocation of goodwill

C2 Paragraph 80 of this Standard requires goodwill acquired in a business combination to be allocated to each of the acquirer's cash-generating units, or groups of cash-generating units, expected to benefit from the synergies of the combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units, or groups of units. It is possible that some of the synergies resulting from a business combination will be allocated to a cash-generating unit in which the non-controlling interest does not have an interest.

Testing for impairment

C3 Testing for impairment involves comparing the recoverable amount of a cash-generating unit with the carrying amount of the cash-generating unit.

C4 If an entity measures non-controlling interests as its proportionate interest in the net identifiable assets of a subsidiary at the acquisition date, rather than at fair value, goodwill attributable to non-controlling interests is included in the recoverable amount of the related cash-generating unit but is not recognised in the parent's consolidated financial statements. As a consequence, an entity shall gross up the carrying amount of goodwill allocated to the unit to include the goodwill attributable to the non-controlling interest. This adjusted carrying amount is then compared with the recoverable amount of the unit to determine whether the cash-generating unit is impaired.

Allocating an impairment loss

C5 Paragraph 104 requires any identified impairment loss to be allocated first to reduce the carrying amount of goodwill allocated to the unit and then to the other assets of the unit pro rata on the basis of the carrying amount of each asset in the unit.

C6 If a subsidiary, or part of a subsidiary, with a non-controlling interest is itself a cash-generating unit, the impairment loss is allocated between the parent and the non-controlling interest on the same basis as that on which profit or loss is allocated.

C7 If a subsidiary, or part of a subsidiary, with a non-controlling interest is part of a larger cash-generating unit, goodwill impairment losses are allocated to the parts of the cash-generating unit that have a non-controlling interest and the parts that do not. The impairment losses should be allocated to the parts of the cash-generating unit on the basis of:

(a) to the extent that the impairment relates to goodwill in the cash-generating unit, the relative carrying values of the goodwill of the parts before the impairment; and

(b) to the extent that the impairment relates to identifiable assets in the cash-generating unit, the relative carrying values of the net identifiable assets of the parts before the impairment. Any such impairment is allocated to the assets of the parts of each unit pro rata on the basis of the carrying amount of each asset in the part.

In those parts that have a non-controlling interest, the impairment loss is allocated between the parent and the non-controlling interest on the same basis as that on which profit or loss is allocated.

C8 If an impairment loss attributable to a non-controlling interest relates to goodwill that is not recognised in the parent's consolidated financial statements (see paragraph C4), that impairment is not recognised as a goodwill impairment loss. In such cases, only the impairment loss relating to the goodwill that is allocated to the parent is recognised as a goodwill impairment loss.

C9 Illustrative Example 7 illustrates the impairment testing of a non-wholly-owned cash-generating unit with goodwill.

Appendix D

Amendments resulting from other HKFRSs

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

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

Paragraphs 2(e) and 5 are amended and paragraph 140F is added as follows:

2 ...

(e) financial assets that are within the scope ~~of HKAS 39~~ ~~*Financial Instruments: Recognition and Measurement*~~ HKFRS 9 *Financial Instruments*;

5 This Standard does not apply to financial assets within the scope of ~~HKAS 39~~ HKFRS 9, investment property measured at fair value in accordance with HKAS 40, or biological assets related to agricultural activity measured at fair value less costs to sell in accordance with HKAS 41. However, ...

140F HKFRS 9, issued in November 2009, amended paragraphs 2(e) and 5. An entity shall apply those amendments when it applies HKFRS 9.

Appendix E

Comparison with International Accounting Standards

This comparison appendix, which was prepared as at August 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 36.

The International Accounting Standard comparable with HKAS 36 is IAS 36 *Impairment of Assets.*

There are no major textual differences between HKAS 36 and IAS 36.

Basis for Conclusions on
Hong Kong Accounting Standard 36

Impairment of Assets

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

BASIS FOR CONCLUSIONS ON IAS 36 *IMPAIRMENT OF ASSETS*

HKAS 36 is based on IAS 36 *Impairment of Assets*. In approving HKAS 36, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IASB's Basis for Conclusions on IAS 36. Accordingly, there are no significant differences between HKAS 36 and IAS 36. The IASB's Basis for Conclusions is reproduced below for reference. The paragraph numbers of IAS 36 referred to below generally correspond with those in HKAS 36.

CONTENTS

* In IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, issued by the IASB in 2004, the term, 'net selling price' was replaced in IAS 36 by 'fair value less costs to sell'.

Basis for Conclusions on
on IAS 36 Impairment of Assets

The International Accounting Standards Board revised IAS 36 as part of its project on business combinations. It was not the Board's intention to reconsider as part of that project all of the requirements in IAS 36.

The previous version of IAS 36 was accompanied by a Basis for Conclusions summarising the former International Accounting Standards Committee's considerations in reaching some of its conclusions in that Standard. For convenience the Board has incorporated into its own Basis for Conclusions material from the previous Basis for Conclusions that discusses (a) matters the Board did not reconsider and (b) the history of the development of a standard on impairment of assets. That material is contained in paragraphs denoted by numbers with the prefix BCZ. Paragraphs describing the Board's considerations in reaching its own conclusions are numbered with the prefix BC.

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 International Accounting Standards Board's considerations in reaching the conclusions in IAS 36 *Impairment of Assets*. Individual Board members gave greater weight to some factors than to others.

BC2 The International Accounting Standards Committee (IASC) issued the previous version of IAS 36 in 1998. It has been revised by the Board as part of its project on business combinations. That project had~~s~~ two phases. The first ~~has~~ resulted in the Board issuing simultaneously in 2004 IFRS 3 *Business Combinations* and revised versions of IAS 36 and IAS 38 *Intangible Assets*. ~~Therefore, t~~The Board's intention in revising IAS 36 as part of the first phase of the project was not to reconsider all of the requirements in IAS 36. The changes to IAS 36 we~~a~~re primarily concerned with the impairment tests for intangible assets with indefinite useful lives (hereafter referred to as 'indefinite-lived intangibles') and goodwill. The second phase of the project on business combinations resulted in the Board issuing simultaneously in 2008 a revised IFRS 3 and an amended version of IAS 27 *Consolidated and Separate Financial Statements*. The Board amended IAS 36 to reflect its decisions on the measurement of a non-controlling interest in an acquiree (see paragraph BC170A). The Board has not deliberated the other requirements in IAS 36. Those other requirements will be considered by the Board as part of a future project on impairment of assets.

BC3 The previous version of IAS 36 was accompanied by a Basis for Conclusions summarising IASC's considerations in reaching some of its conclusions in that Standard. For convenience, the Board has incorporated into this Basis for Conclusions material from the previous Basis for Conclusions that discusses matters the Board did not consider. That material is contained in paragraphs denoted by numbers with the prefix BCZ. The views expressed in paragraphs denoted by numbers with the prefix BCZ are those of IASC.

Scope (paragraph 2)

BCZ4 IAS 2 *Inventories* requires an enterprise to measure the recoverable amount of inventory at its net realisable value. IASC believed that there was no need to revise this requirement because it was well accepted as an appropriate test for recoverability of inventories. No major difference exists between IAS 2 and the requirements included in IAS 36 (see paragraphs BCZ37-BCZ39).

BCZ5 IAS 11 *Construction Contracts* and IAS 12 *Income Taxes* already deal with the impairment of assets arising from construction contracts and deferred tax assets respectively. Under both IAS 11 and IAS 12, recoverable amount is, in effect, determined on an undiscounted basis. IASC acknowledged that this was inconsistent with the requirements of IAS 36. However, IASC believed that it was not possible to eliminate that inconsistency without fundamental changes to IAS 11 and IAS 12. IASC had no plans to revise IAS 11 or IAS 12.

BCZ6 IAS 19 *Employee Benefits* contains an upper limit on the amount at which an enterprise should recognise an asset arising from employee benefits. Therefore, IAS 36 does not deal with such assets. The limit in IAS 19 is determined on a discounted basis that is broadly compatible with the requirements of IAS 36. The limit does not override the deferred recognition of certain actuarial losses and certain past service costs.

BCZ7 IAS 39 *Financial Instruments: Recognition and Measurement* sets out the requirements for impairment of financial assets.

BCZ8 IAS 36 is applicable to all assets, unless specifically excluded, regardless of their classification as current or non-current. Before IAS 36 was issued, there was no International Accounting Standard on accounting for the impairment of current assets other than inventories.

Measuring recoverable amount (paragraphs 18-57)

BCZ9 In determining the principles that should govern the measurement of recoverable amount, IASC considered, as a first step, what an enterprise will do if it discovers that an asset is impaired. IASC concluded that, in such cases, an enterprise will either keep the asset or dispose of it. For example, if an enterprise discovers that the service potential of an asset has decreased:

(a) the enterprise may decide to sell the asset if the net proceeds from the sale would provide a higher return on investment than continuing use in operations; or

(b) the enterprise may decide to keep the asset and use it, even if its service potential is lower than originally expected. Some reasons may be that:

   (i) the asset cannot be sold or disposed of immediately;

   (ii) the asset can be sold only at a low price;

(iii) the asset's service potential can still be recovered but only with additional efforts or expenditure; or

(iv) the asset could still be profitable although not to the same extent as expected originally.

IASC concluded that the resulting decision from a rational enterprise is, in substance, an investment decision based on estimated net future cash flows expected from the asset.

BCZ10 IASC then considered which of the following four alternatives for determining the recoverable amount of an asset would best reflect this conclusion:

(a) recoverable amount should be the sum of undiscounted future cash flows.

(b) recoverable amount should be the asset's fair value: more specifically, recoverable amount should be derived primarily from the asset's market value. If market value cannot be determined, then recoverable amount should be based on the asset's value in use as a proxy for market value.

(c) recoverable amount should be the asset's value in use.

(d) recoverable amount should be the higher of the asset's net selling price and value in use.*

Each of these alternatives is discussed below.

BCZ11 It should be noted that fair value, net selling price and value in use all reflect a present value calculation (implicit or explicit) of estimated net future cash flows expected from an asset:

(a) fair value reflects the market's expectation of the present value of the future cash flows to be derived from the asset;

(b) net selling price reflects the market's expectation of the present value of the future cash flows to be derived from the asset, less the direct incremental costs to dispose of the asset; and

(c) value in use is the enterprise's estimate of the present value of the future cash flows to be derived from continuing use and disposal of the asset.

These bases all consider the time value of money and the risks that the amount and timing of the actual cash flows to be received from an asset might differ from estimates. Fair value and net selling price may differ from value in use because the market may not use the same assumptions as an individual enterprise.

* In IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, issued by the IASB in 2004, the term, 'net selling price' was replaced in IAS 36 by 'fair value less costs to sell'.

Recoverable amount based on the sum of undiscounted cash flows

BCZ12 Some argue that recoverable amount should be measured as the sum of undiscounted future cash flows from an asset. They argue that:

(a) historical cost accounting is not concerned with measuring the economic value of assets. Therefore, the time value of money should not be considered in estimating the amount that will be recovered from an asset.

(b) it is premature to use discounting techniques without further research and debates on:

(i) the role of discounting in the financial statements; and

(ii) how assets should be measured generally.

If financial statements include assets that are carried on a variety of different bases (historical cost, discounted amounts or other bases), this will be confusing for users.

(c) identifying an appropriate discount rate will often be difficult and subjective.

(d) discounting will increase the number of impairment losses recognised. This, coupled with the requirement for reversals of impairment losses, introduces a volatile element into the income statement. It will make it harder for users to understand the performance of an enterprise. A minority of commentators on E55 *Impairment of Assets* supported this view.

BCZ13 IASC rejected measurement of recoverable amount based on the sum of undiscounted cash flows because:

(a) the objective of the measurement of recoverable amount is to reflect an investment decision. Money has a time value, even when prices are stable. If future cash flows were not discounted, two assets giving rise to cash flows of the same amount but with different timings would show the same recoverable amount. However, their current market values would be different because all rational economic transactions take account of the time value of money.

(b) measurements that take into consideration the time value of money are more relevant to investors, other external users of financial statements and management for resource allocation decisions, regardless of the general measurement basis adopted in the financial statements.

(c) many enterprises were already familiar with the use of discounting techniques, particularly for supporting investment decisions.

(d) discounting was already required for other areas of financial statements that are based on expectations of future cash flows, such as long-term provisions and employee benefit obligations.

(e) users are better served if they are aware on a timely basis of assets that will not generate sufficient returns to cover, at least, the time value of money.

Recoverable amount based on fair value

BCZ14 IAS 32 *Financial Instruments: Disclosure and Presentation*[†] and a number of other International Accounting Standards define fair value as:

> "... the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction..."

BCZ15 International Accounting Standards include the following requirements or guidance for measuring fair value:

(a) for the purpose of revaluation of an item of property, plant or equipment to its fair value, IAS 16 *Property, Plant and Equipment* indicates that fair value is usually an asset's market value, normally determined by appraisal undertaken by professionally qualified valuers and, if no market exists, fair value is based on the asset's depreciated replacement cost.

(b) for the purpose of revaluation of an intangible asset to its fair value, IASC proposed in E60 *Intangible Assets* that fair value be determined by reference to market values obtained from an active market. E60 proposed a definition of an active market.[*]

(c) IASC proposed revisions to IAS 22 (see E61 *Business Combinations*) so that fair value would be determined without consideration of the acquirer's intentions for the future use of an asset.[Φ]

(d) IAS 39[δ] indicates that if an active market exists, the fair value of a financial instrument is based on a quoted market price. If there is no active market, fair value is determined by using estimation techniques such as market values of similar types of financial instruments, discounted cash flow analysis and option pricing models.

BCZ16 Some argue that the only appropriate measurement for the recoverable amount of an asset is fair value (based on observable market prices or, if no observable market prices exist, estimated considering prices for similar assets and the results of discounted future cash flow calculations). Proponents of fair value argue that:

(a) the purpose of measuring recoverable amount is to estimate a market value, not an enterprise-specific value. An enterprise's estimate of the present value of future cash flows is subjective and in some cases may be abused. Observable market prices that reflect the judgement of the marketplace are a more reliable measurement of the amounts that will be recovered from an asset. They reduce the use of management's judgement.

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† In 2005 the IASB amended IAS 32 as *Financial Instruments: Presentation.*

* IASC approved an International Accounting Standard on intangible assets in 1998

Φ IASC approved revisions to IAS 22 *Business Combinations* in 1998.

δ The IASB's project to revise IAS 32 and IAS 39 in 2003 resulted in the relocation of the requirements on fair value measurement from IAS 32 to IAS 39.

(b) if an asset is expected to generate greater net cash inflows for the enterprise than for other participants, the superior returns are almost always generated by internally generated goodwill stemming from the synergy of the business and its management team. For consistency with IASC's proposals in E60 that internally generated goodwill should not be recognised as an asset, these above-market cash flows should be excluded from assessments of an asset's recoverable amount.

(c) determining recoverable amount as the higher of net selling price and value in use is tantamount to determining two diverging measures whilst there should be only one measure to estimate recoverable amount.

A minority of commentators on E55 supported measuring recoverable amount at fair value (based on observable market prices or, if no observable market prices exist, estimated considering prices for similar assets and the results of discounted future cash flow calculations).

BCZ17 IASC rejected the proposal that an asset's recoverable amount should be determined by reference to its fair value (based on observable market prices or, if no observable market prices exist, estimated considering prices for similar assets and the results of discounted future cash flow calculations). The reasons are the following:

(a) IASC believed that no preference should be given to the market's expectation of the recoverable amount of an asset (basis for fair value when market values are available and for net selling price) over a reasonable estimate performed by the individual enterprise that owns the asset (basis for fair value when market values are not available and for value in use). For example, an enterprise may have information about future cash flows that is superior to the information available in the marketplace. Also, an enterprise may plan to use an asset in a manner different from the market's view of the best use.

(b) market values are a way to estimate fair value but only if they reflect the fact that both parties, the acquirer and the seller, are willing to enter a transaction. If an enterprise can generate greater cash flows by using an asset than by selling it, it would be misleading to base recoverable amount on the market price of the asset because a rational enterprise would not be willing to sell the asset. Therefore, recoverable amount should not refer only to a transaction between two parties (which is unlikely to happen) but should also consider an asset's service potential from its use by the enterprise.

(c) IASC believed that in assessing the recoverable amount of an asset, it is the amount that an enterprise can expect to recover from that asset, including the effect of synergy with other assets, that is relevant.

The following two examples illustrate the proposal (rejected by IASC) that an enterprise should measure an asset's recoverable amount at its fair value (primarily based on observable market values if these values are available).

Example 1
10 years ago, an enterprise bought its headquarters building for 2,000. Since then, the real estate market has collapsed and the building's market value at balance sheet date is estimated to be 1,000. Disposal costs of the building would be negligible. The building's carrying amount at the balance sheet date is 1,500 and its remaining useful life is 30 years. The building meets all the enterprise's expectations and it is likely that these expectations will be met for the foreseeable future. As a consequence, the enterprise has no plans to move from its current headquarters. The value in use of the building cannot be determined because the building does not generate independent cash inflows. Therefore, the enterprise assesses the recoverable amount of the building's cash-generating unit, that is, the enterprise as a whole. That calculation shows that the building's cash-generating unit is not impaired. *Proponents of fair value (primarily based on observable market values if these values are available) would measure the recoverable amount of the building at its market value (1,000) and, hence, would recognise an impairment loss of 500 (1,500 less 1,000), even though calculations show that the building's cash-generating unit is not impaired.* *IASC did not support this approach and believed that the building was not impaired. IASC believed that, in the situation described, the enterprise would not be willing to sell the building for 1,000 and that the assumption of a sale was not relevant.*

Example 2
At the end of 20X0, an enterprise purchased a computer for 100 for general use in its operations. The computer is depreciated over 4 years on a straight-line basis. Residual value is estimated to be nil. At the end of 20X2, the carrying amount of the computer is 50. There is an active market for second-hand computers of this type. The market value of the computer is 30. The enterprise does not intend to replace the computer before the end of its useful life. The computer's cash-generating unit is not impaired. *Proponents of fair value (primarily based on observable market values if these values are available) would measure the recoverable amount of the computer at its market value (30) and, therefore, would recognise an impairment loss of 20 (50 less 30) even though the computer's cash-generating unit is not impaired.* *IASC did not support this approach and believed that the computer was not impaired as long as:* *(a) the enterprise was not committed to dispose of the computer before the end of its expected useful life; and* *(b) the computer's cash-generating unit was not impaired.*

BCZ18 If no deep and liquid market exists for an asset, IASC considered that value in use would be a reasonable estimate of fair value. This is likely to happen for many assets within the scope of IAS 36: observable market prices are unlikely to exist for goodwill, most intangible assets and many items of property, plant and equipment. Therefore, it is likely that the recoverable amount of these assets, determined in accordance with IAS 36, will be similar to the recoverable amount based on the fair value of these assets.

BCZ19 For some assets within the scope of IAS 36, observable market prices exist or consideration of prices for similar assets is possible. In such cases, the asset's net selling price will differ from the asset's fair value only by the direct incremental costs of disposal. IASC acknowledged that recoverable amount as the higher of net selling price and value in use would sometimes differ from fair value primarily based on market prices (even if the disposal costs are negligible). This is because, as explained in paragraph BCZ17(a), the market may not use the same assumptions about future cash flows as an individual enterprise.

BCZ20 IASC believed that IAS 36 included sufficient requirements to prevent an enterprise from using assumptions different from the marketplace that are unjustified. For example, an enterprise is required to determine value in use using:

(a) cash flow projections based on reasonable and supportable assumptions and giving greater weight to external evidence; and

(b) a discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

Recoverable amount based on value in use

BCZ21 Some argue that value in use is the only appropriate measurement for the recoverable amount of an asset because:

(a) financial statements are prepared under a going concern assumption. Therefore, no consideration should be given to an alternative measurement that reflects a disposal, unless this reflects the enterprise's intentions.

(b) assets should not be carried at amounts higher than their service potential from use by the enterprise. Unlike value in use, a market value does not necessarily reflect the service potential of an asset.

Few commentators on E55 supported this view.

BCZ22 IASC rejected this proposal because:

(a) if an asset's net selling price is higher than its value in use, a rational enterprise will dispose of the asset. In this situation, it is logical to base recoverable amount on the asset's net selling price to avoid recognising an impairment loss that is unrelated to economic reality.

(b) if an asset's net selling price is greater than its value in use, but management decides to keep the asset, the extra loss (the difference between net selling price and value in use) properly falls in later periods because it results from management's decision in these later periods to keep the asset.

Recoverable amount based on the higher of net selling price and value in use*

BCZ23 The requirement that recoverable amount should be the higher of net selling price and value in use stems from the decision that measurement of the recoverable amount of an asset should reflect the likely behaviour of a rational management. Furthermore, no preference should be given to the market's expectation of the recoverable amount of an asset (basis for net selling price) over a reasonable estimate performed by the individual enterprise which owns the asset (basis for value in use) or vice versa (see paragraphs BCZ17-BCZ20 and BCZ22). It is uncertain whether the assumptions of the market or the enterprise are more likely to be true. Currently, perfect markets do not exist for many of the assets within the scope of IAS 36 and it is unlikely that predictions of the future will be entirely accurate, regardless of who makes them.

BCZ24 IASC acknowledged that an enterprise would use judgement in determining whether an impairment loss needed to be recognised. For this reason, IAS 36 included some safeguards to limit the risk that an enterprise may make an over-optimistic (pessimistic) estimate of recoverable amount:

(a) IAS 36 requires a formal estimate of recoverable amount whenever there is an indication that:

  (i) an asset may be impaired; or

  (ii) an impairment loss may no longer exist or may have decreased. For this purpose, IAS 36 includes a relatively detailed (although not exhaustive) list of indicators that an asset may be impaired (see paragraphs 12 and 111 of IAS 36).

(b) IAS 36 provides guidelines for the basis of management's projections of future cash flows to be used to estimate value in use (see paragraph 33 of IAS 36).

BCZ25 IASC considered the cost of requiring an enterprise to determine both net selling price and value in use, if the amount determined first is below an asset's carrying amount. IASC concluded that the benefits of such a requirement outweigh the costs.

BCZ26 The majority of the commentators on E55 supported IASC's view that recoverable amount should be measured at the higher of net selling price and value in use.

Assets held for disposal

BCZ27 IASC considered whether the recoverable amount of an asset held for disposal should be measured only at the asset's net selling price. When an enterprise expects to dispose of an asset within the near future, the net selling price of the asset is normally close to its value in use. Indeed, the value in use usually consists mostly of the net proceeds to be received for the asset, since future cash flows from continuing use are usually close to nil. Therefore, IASC believed that the definition of recoverable amount as included in IAS 36 is appropriate for assets held for disposal without a need for further requirements or guidance.

* In IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, issued by the IASB in 2004, the term, 'net selling price' was replaced in IAS 36 by 'fair value less costs to sell'.

Other refinements to the measurement of recoverable amount

Replacement cost as a ceiling

BCZ28 Some argue that the replacement cost of an asset should be adopted as a ceiling for its recoverable amount. They argue that the value of an asset to the business would not exceed the amount that the enterprise would be willing to pay for the asset at the balance sheet date.

BCZ29 IASC believed that replacement cost techniques are not appropriate to measuring the recoverable amount of an asset. This is because replacement cost measures the cost of an asset and not the future economic benefits recoverable from its use and/or disposal.

Appraisal values

BCZ30 In some cases, an enterprise might seek external appraisal of recoverable amount. External appraisal is not a separate technique in its own right. IASC believed that if appraisal values are used, an enterprise should verify that the external appraisal follows the requirements of IAS 36.

Net selling price (paragraphs 25-29)*

BCZ31 IAS 36 defines net selling price as the amount obtainable from the sale of an asset in an arm's length transaction between knowledgeable, willing parties, less the incremental costs directly attributable to the disposal of the asset.

BCZ32 In other words, net selling price reflects the market's expectations of the future cash flows for an asset after the market's consideration of the time value of money and the risks inherent in receiving those cash flows, less the disposal costs.

BCZ33 Some argue that direct incremental costs of disposal should not be deducted from the amount obtainable from the sale of an asset because, unless management has decided to dispose of the asset, the going concern assumption should apply.

BCZ34 IASC believed that it is appropriate to deduct direct incremental costs of disposal in determining net selling price because the purpose of the exercise is to determine the net amount that an enterprise could recover from the sale of an asset at the date of the measurement and to compare it with the alternative of keeping the asset and using it.

BCZ35 IAS 36 indicates that termination benefits (as defined in IAS 19 *Employee Benefits*) and costs associated with reducing or reorganising a business following the disposal of an asset are not direct incremental costs to dispose of the asset. IASC considered these costs as incidental to (rather than a direct consequence of) the disposal of an asset. In addition, this guidance is consistent with the direction of the project on provisions.[+] .

BCZ36 Although the definition of 'net selling price' would be similar to a definition of 'net fair value', IASC decided to use the term 'net selling price' instead of 'net fair value'. IASC believed that the term 'net selling price' better describes the amount that an enterprise should determine and that will be compared with an asset's value in use.

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* In IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, issued by the IASB in 2004, the term, 'net selling price' was replaced in IAS 36 by 'fair value less costs to sell'.

\+ IASC approved an International Accounting Standard on provisions, contingent liabilities and contingent assets in 1998.

Net realisable value

BCZ37 IAS 2 *Inventories* defines net realisable value as:

"... the estimated selling price in the ordinary course of business … less the estimated costs necessary to make the sale..."

BCZ38 For the purpose of determining recoverable amount, IASC decided not to use the term 'net realisable value' as defined in IAS 2 because:

(a) IAS 2's definition of net realisable value does not refer explicitly to transactions carried out on an arm's length basis.

(b) net realisable value refers to an estimated selling price in the ordinary course of business. In certain cases, net selling price will reflect a forced sale, if management is compelled to sell immediately.

(c) it is important that net selling price uses, as a starting point, a selling price agreed between knowledgeable, willing buyers and sellers. This is not explicitly mentioned in the definition of net realisable value.

BCZ39 In most cases, net selling price and net realisable value will be similar. However, IASC did not believe that it was necessary to change the definition of net realisable value used in IAS 2 because, for inventories, the definition of net realisable value is well understood and seems to work satisfactorily.

Value in use (paragraphs 30-57 and the Appendix)

BCZ40 IAS 36 defines value in use as the present value of the future cash flows expected to be derived from an asset.

Expected value approach

BCZ41 Some argue that, to better reflect uncertainties in timing and amounts inherent in estimated future cash flows, expected future cash flows should be used in determining value in use. An expected value approach considers all expectations about possible future cash flows instead of the single, most likely, future cash flows.

Example
An enterprise estimates that there are two scenarios for future cash flows: a first possibility of future cash flows amounts to 120 with a 40 per cent probability and a second possibility amounts to 80 with a 60 per cent probability. *The most likely future cash flows would be 80 and the expected future cash flows would be 96 (80 × 60% + 120 × 40%).*

BCZ42 In most cases, it is likely that budgets/forecasts that are the basis for cash flow projections will reflect a single estimate of future cash flows only. For this reason, IASC decided that an expected value approach should be permitted but not required.

Future cash flows from internally generated goodwill and synergy with other assets

BCZ43 IASC rejected a proposal that estimates of future cash inflows should reflect only future cash inflows relating to the asset that was initially recognised (or the remaining portion of that asset if part of it has already been consumed or sold). The purpose of such a requirement would be to avoid including in an asset's value in use future cash inflows from internally generated goodwill or from synergy with other assets. This would be consistent with IASC's proposal in E60 *Intangible Assets* to prohibit the recognition of internally generated goodwill as an asset.*

BCZ44 In many cases, it will not be possible in practice to distinguish future cash inflows from the asset initially recognised from the future cash inflows from internally generated goodwill or a modification of the asset. This is particularly true when businesses are merged or once an asset has been enhanced by subsequent expenditure. IASC concluded that it is more important to focus on whether the carrying amount of an asset will be recovered rather than on whether the recovery stems partly from internally generated goodwill.

BCZ45 The proposal—that future cash inflows should reflect only future cash inflows relating to the asset that was initially recognised— would also conflict with the requirement under IAS 36 that cash flow projections should reflect reasonable and supportable assumptions that represent management's best estimate of the set of economic conditions that will exist over the remaining useful life of the asset (see paragraph 33 of IAS 36). Therefore, the Standard requires that future cash inflows should be estimated for an asset in its current condition, whether or not these future cash inflows are from the asset that was initially recognised or from its subsequent enhancement or modification.

Example
Several years ago, an enterprise purchased a customer list with 10,000 addresses that it recognised as an intangible asset. The enterprise uses this list for direct marketing of its products. Since initial recognition, about 2,000 customer addresses have been deleted from the list and 3,000 new customer addresses added to it. The enterprise is determining the value in use of the customer list. *Under the proposal (rejected by IASC) that an enterprise should reflect only future cash inflows relating to the asset that was initially recognised, the enterprise would consider only those future cash inflows generated by the remaining 8,000 (10,000 less 2,000) customers from the list acquired.* *Under IAS 36, an enterprise considers the future cash inflows generated by the customer list in its current condition, ie by all 11,000 customers (8,000 plus 3,000).*

* IASC approved an International Accounting Standard on intangible assets in 1998.

Value in use estimated in a foreign currency (paragraph 54)

BCZ46 In response to comments from field test participants, paragraph 54 of IAS 36 includes guidance on calculating the value in use of an asset that generates future cash flows in a foreign currency. IAS 36 indicates that value in use in a foreign currency is translated into the reporting currency* using the spot exchange rate at the balance sheet date.

BCZ47 If a currency is freely convertible and traded in an active market, the spot rate reflects the market's best estimate of future events that will affect that currency. Therefore, the only available unbiased estimate of a future exchange rate is the current spot rate, adjusted by the difference in expected future rates of general inflation in the two countries to which the currencies belong.

BCZ48 A value in use calculation already deals with the effect of general inflation since it is calculated either by:

(a) estimating future cash flows in nominal terms (ie including the effect of general inflation and specific price changes) and discounting them at a rate that includes the effects of general inflation; or

(b) estimating future cash flows in real terms (ie excluding the effect of general inflation but including the effect of specific price changes) and discounting them at a rate that excludes the effect of general inflation.

BCZ49 To use a forward rate to translate value in use expressed in a foreign currency would be inappropriate. This is because a forward rate reflects the market's adjustment for the differential in interest rates. Using such a rate would result in double-counting the time value of money (first in the discount rate and then in the forward rate).

BCZ50 Even if a currency is not freely convertible or is not traded in an active market—with the consequence that it can no longer be assumed that the spot exchange rate reflects the market's best estimate of future events that will affect that currency—IAS 36 indicates that an enterprise uses the spot exchange rate at the balance sheet date to translate value in use estimated in a foreign currency. This is because IASC believed that it is unlikely that an enterprise can make a more reliable estimate of future exchange rates than the current spot exchange rate.

BCZ51 An alternative to estimating the future cash flows in the currency in which they are generated would be to estimate them in another currency as a proxy and discount them at a rate appropriate for this other currency. This solution may be simpler, particularly where cash flows are generated in the currency of a hyperinflationary economy (in such cases, some would prefer using a hard currency as a proxy) or in a currency other than the reporting currency. However, this solution may be misleading if the exchange rate varies for reasons other than changes in the differential between the general inflation rates in the two countries to which the currencies belong. In addition, this solution is inconsistent with the approach under IAS 29 *Financial Reporting in Hyperinflationary Economies*, which does not allow, if the reporting currency* is the currency of a hyperinflationary economy, translation into a hard currency as a proxy for restatement in terms of the measuring unit current at the balance sheet date.

* In IAS 21 *The Effects of Changes in Foreign Exchange Rates*, as revised by the IASB in 2003, the term 'reporting currency' was replaced by 'functional currency'.

Discount rate (paragraphs 55-57 and A15-A21)

BCZ52 The purpose of discounting future cash flows is to reflect the time value of money and the uncertainties attached to those cash flows:

(a) assets that generate cash flows soon are worth more than those generating the same cash flows later. All rational economic transactions will take account of the time value of money. The cost of not receiving a cash inflow until some date in the future is an opportunity cost that can be measured by considering what income has been lost by not investing that money for the period. The time value of money, before consideration of risk, is given by the rate of return on a risk-free investment, such as government bonds of the same duration.

(b) the value of the future cash flows is affected by the variability (ie the risks) associated with the cash flows. Therefore, all rational economic transactions will take risk into account.

BCZ53 As a consequence IASC decided:

(a) to reject a discount rate based on a historical rate—ie the effective rate implicit when an asset was acquired. A subsequent estimate of recoverable amount has to be based on prevailing interest rates because management's decisions about whether to keep the asset are based on prevailing economic conditions. Historical rates do not reflect prevailing economic conditions.

(b) to reject a discount rate based on a risk-free rate, unless the future cash flows have been adjusted for all the risks specific to the asset.

(c) to require that the discount rate should be a rate that reflects current market assessments of the time value of money and the risks specific to the asset. This rate is the return that investors would require if they were to choose an investment that would generate cash flows of amounts, timing and risk profile equivalent to those that the enterprise expects to derive from the asset.

BCZ54 In principle, value in use should be an enterprise-specific measure determined in accordance with the enterprise's own view of the best use of that asset. Logically, the discount rate should be based on the enterprise's own assessment both of the time value of money and of the risks specific to the future cash flows from the asset. However, IASC believed that such a rate could not be verified objectively. Therefore, IAS 36 requires that the enterprise should make its own estimate of future cash flows but that the discount rate should reflect, as far as possible, the market's assessment of the time value of money. Similarly, the discount rate should reflect the premium that the market would require from uncertain future cash flows based on the distribution estimated by the enterprise.

BCZ55 IASC acknowledged that a current asset-specific market-determined rate would rarely exist for the assets covered by IAS 36. Therefore, an enterprise uses current market-determined rates for other assets (as similar as possible to the asset under review) as a starting point and adjusts these rates to reflect the risks specific to the asset for which the cash flow projections have not been adjusted.

Additional guidance included in the Standard in 2004

Elements reflected in value in use (paragraphs 30-32)

BC56 The Exposure Draft of Proposed Amendments to IAS 36 proposed, and the revised Standard includes, additional guidance to clarify:

(a) the elements that are reflected in an asset's value in use; and

(b) that some of those elements (ie expectations about possible variations in the amount or timing of future cash flows, the price for bearing the uncertainty inherent in the asset, and other factors that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset) can be reflected either as adjustments to the future cash flows or as adjustments to the discount rate.

The Board decided to include this additional guidance in the Exposure Draft in response to a number of requests from its constituents for clarification of the requirements in the previous version of IAS 36 on measuring value in use.

BC57 Respondents to the Exposure Draft generally agreed with the proposals. Those that disagreed varied widely in their views, arguing that:

(a) IAS 36 should be amended to permit entities to measure value in use using methods other than discounting of future cash flows.

(b) when measuring the value in use of an intangible asset, entities should be required to reflect the price for bearing the uncertainty inherent in the asset as adjustments to the future cash flows.

(c) it is inconsistent with the definition of value in use to reflect in that measure the other factors that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset—this element refers to market pricing of an asset rather than to the value to the entity of the asset. Other factors should be reflected in value in use only to the extent that they affect the cash flows the entity can achieve from the asset.

BC58 In considering (a) above, the Board observed that the measure of recoverable amount in IAS 36 (ie higher of value in use and fair value less costs to sell) stems from IASC's decision that an asset's recoverable amount should reflect the likely behaviour of a rational management, with no preference given to the market's expectation of the recoverable amount of an asset (ie fair value less costs to sell) over a reasonable estimate performed by the entity that controls the asset (ie value in use) or vice versa (see paragraph BCZ23). In developing the Exposure Draft and revising IAS 36, the Board concluded that it would be inappropriate to modify the measurement basis adopted in the previous version of IAS 36 for determining recoverable amount until the Board considers and resolves the broader question of the appropriate measurement objective(s) in accounting. Moreover, IAS 36 does not preclude the use of other valuation techniques in estimating fair value less costs to sell. For example, paragraph 27 of the Standard states that 'If there is no binding sale agreement or active market for an asset, fair value less costs to sell is based on the best information available to reflect the amount that an entity could obtain, at the balance sheet date, from the disposal of the asset in an arm's length transaction between knowledgeable, willing parties, after deducting the costs of disposal.'

BC59 In considering (b) above, the Board observed that the previous version of IAS 36 permitted risk adjustments to be reflected either in the cash flows or in the discount rate, without indicating a preference. The Board could see no justification for amending this approach to require risk adjustments for uncertainty to be factored into the cash flows, particularly given the Board's inclination to avoid modifying the requirements in the previous version of IAS 36 for determining recoverable amount until it considers and resolves the broader question of measurement in accounting. Additionally, the Board as part of its consultative process conducted field visits and round-table discussions during the comment period for the Exposure Draft.* Many field visit participants indicated a preference for reflecting such risk adjustments in the discount rate.

BC60 In considering (c) above, the Board observed that the measure of value in use adopted in IAS 36 is not a pure 'entity-specific' measure. Although the cash flows used as the starting point in the calculation represent entity-specific cash flows (ie they are derived from the most recent financial budgets/forecasts approved by management and represent management's best estimate of the set of economic conditions that will exist over the remaining useful life of the asset), their present value is required to be determined using a discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. Paragraph 56 of the Standard (paragraph 49 of the previous version of IAS 36) clarifies that "A rate that reflects current market assessments of the time value of money and the risks specific to the asset is the return that investors would require if they were to choose an investment that would generate cash flows of amounts, timing and risk profile equivalent to those that the entity expects to derive from the asset." In other words, an asset's value in use reflects how the market would price the cash flows that management expects to derive from that asset.

BC61 Therefore, the Board concluded that:

(a) it is consistent with the measure of value in use adopted in IAS 36 to include in the list of elements the other factors that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset.

(b) all of the elements proposed in the Exposure Draft (and listed in paragraph 30 of the revised Standard) should be reflected in the calculation of an asset's value in use.

Estimates of future cash flows (paragraphs 33, 34 and 44)

BC62 The Exposure Draft proposed requiring cash flow projections used in measuring value in use to be based on reasonable and supportable assumptions that take into account both past actual cash flows and management's past ability to forecast cash flows accurately.

* The field visits were conducted from early December 2002 to early April 2003, and involved IASB members and staff in meetings with 41 companies in Australia, France, Germany, Japan, South Africa, Switzerland and the United Kingdom. IASB members and staff also took part in a series of round-table discussions with auditors, preparers, accounting standard-setters and regulators in Canada and the United States on implementation issues encountered by North American companies during first-time application of US Statements of Financial Accounting Standards 141 *Business Combinations* and 142 *Goodwill and Other Intangible Assets*, and the equivalent Canadian Handbook Sections, which were issued in June 2001.

BC63 Many respondents to the Exposure Draft disagreed with this proposal, arguing that:

(a) the reasons for past cash flow forecasts differing from actual cash flows may be irrelevant to the current projections. For example, if there has been a major change in management, management's past ability to forecast cash flows might not be relevant to the current projections. Additionally, a poor record of forecasting cash flows accurately might be the result of factors outside of management's control (such as the events of September 11, 2001), rather than indicative of management bias.

(b) it is unclear how, in practice, the assumptions on which the cash flow projections are based could take into account past differences between management's forecasts and actual cash flows.

(c) the proposal is inconsistent with the requirement to base cash flow projections on the most recent financial budgets/forecasts approved by management.

BC64 The Board observed that, as worded, the proposal would have *required* the assumptions on which the cash flow forecasts are based to be adjusted for past actual cash flows and management's past ability to forecast cash flows accurately. The Board agreed with respondents that it is not clear how, in practice, this might be achieved, and that in some circumstances past actual cash flows and management's past ability to forecast cash flows accurately might not be relevant to the development of current forecasts. However, the Board remained of the view that in developing the assumptions on which the cash flow forecasts are based, management should remain mindful of, and when appropriate make the necessary adjustments for, an entity's actual past performance or previous history of management consistently overstating or understating cash flow forecasts.

BC65 Therefore, the Board decided not to proceed with the proposal, but instead to include in paragraph 34 of the Standard guidance clarifying that management:

(a) should assess the reasonableness of the assumptions on which its current cash flow projections are based by examining the causes of differences between past cash flow projections and actual cash flows; and

(b) should ensure that the assumptions on which its current cash flow projections are based are consistent with past actual outcomes, provided the effects of subsequent events or circumstances that did not exist when those actual cash flows were generated make this appropriate.

BC66 In finalising the Standard the Board also considered two issues identified by respondents to the Exposure Draft and referred to the Board by the International Financial Reporting Interpretations Committee. Both issues related to the application of paragraphs 27(b) and 37 of the previous version of IAS 36 (now paragraphs 33(b) and 44). The Board did not reconsider those paragraphs when developing the Exposure Draft.

BC67 Paragraph 27(b) required the cash flow projections used to measure value in use to be based on the most recent financial budgets/forecasts that have been approved by management. Paragraph 37, however, required the future cash flows to be estimated for the asset [or cash-generating unit] in its current condition and excluded estimated future cash inflows or outflows that are expected to arise from: (a) a future restructuring to which an enterprise is not yet committed; or (b) future capital expenditure that will improve or enhance the asset [or cash-generating unit] in excess of its originally assessed standard of performance.*

BC68 The first issue the Board considered related to the acquisition of a cash-generating unit when:

(a) the price paid for the unit was based on projections that included a major restructuring expected to result in a substantial increase in the net cash inflows derived from the unit; and

(b) there is no observable market from which to estimate the unit's fair value less costs to sell.

Respondents expressed concern that if the net cash inflows arising from the restructuring were not reflected in the unit's value in use, comparison of the unit's recoverable amount and carrying amount immediately after the acquisition would result in the recognition of an impairment loss.

BC69 The Board agreed with respondents that, all else being equal, the value in use of a newly acquired unit would, in accordance with IAS 36, be less than the price paid for the unit to the extent that the price includes the net benefits of a future restructuring to which the entity is not yet committed. However, this does not mean that a comparison of the unit's recoverable amount with its carrying amount immediately after the acquisition will result in the recognition of an impairment loss. The Board observed that:

(a) recoverable amount is measured in accordance with IAS 36 as the higher of value in use and fair value less costs to sell. Fair value less costs to sell is defined in the Standard as 'the amount obtainable from the sale of an asset or cash-generating unit in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal.'

(b) paragraphs 25-27 of the Standard provide guidance on estimating fair value less costs to sell. In accordance with that guidance, the best evidence of a recently acquired unit's fair value less costs to sell is likely to be the arm's length price the entity paid to acquire the unit, adjusted for disposal costs and for any changes in economic circumstances between the transaction date and the date at which the estimate is made.

(c) if the unit's fair value less costs to sell were to be otherwise estimated, it would also reflect the market's assessment of the expected net benefits any acquirer would be able to derive from restructuring the unit or from future capital expenditure on the unit.

* The requirement to exclude future capital expenditure that will improve or enhance the asset in excess of its originally assessed standard of performance was amended in 2003 as a consequential amendment arising from the revision of IAS 16 *Property, Plant and Equipment*. Paragraph 44 of IAS 36 now requires estimates of future cash flows to exclude future cash inflows or outflows that are expected to arise from improving or enhancing the asset's performance.

BC70 Therefore, all else being equal, the unit's recoverable amount would be its fair value less costs to sell, rather than its value in use. As such, the net benefits of the restructuring would be reflected in the unit's recoverable amount, meaning that an impairment loss would arise only to the extent of any material disposal costs.

BC71 The Board acknowledged that treating the newly acquired unit's fair value less costs to sell as its recoverable amount seems inconsistent with the reason underpinning a "higher of fair value less costs to sell and value in use" recoverable amount measurement objective. Measuring recoverable amount as the higher of fair value less costs to sell and value in use is intended to reflect the economic decisions that are made when an asset becomes impaired: is it better to sell or keep using the asset?

BC72 Nevertheless, the Board concluded that:

(a) amending IAS 36 to include in value in use calculations the costs and benefits of future restructurings to which the entity is not yet committed would be a significant change to the concept of value in use adopted in the previous version of IAS 36. That concept is 'value in use for the asset in its current condition'.

(b) the concept of value in use in IAS 36 should not be modified as part of the Business Combinations project, but should be reconsidered only once the Board considers and resolves the broader question of the appropriate measurement objectives in accounting.

BC73 The second issue the Board considered related to what some respondents suggested was a conflict between the requirements in paragraphs 27(b) and 37 of the previous version of IAS 36 (now paragraphs 33(b) and 44). Paragraph 27(b) required value in use to be based on the most recent forecasts approved by management— which would be likely to reflect management's intentions in relation to future restructurings and future capital expenditure—whereas paragraph 37 required value in use to exclude the effects of a future restructuring to which the enterprise is not yet committed and future capital expenditure that will improve or enhance the asset in excess of its originally assessed standard of performance.[*]

BC74 The Board concluded that it is clear from the Basis for Conclusions on the previous version of IAS 36 that IASC's intention was that value in use should be calculated using estimates of future cash inflows for an asset in its current condition. The Board nevertheless agreed with respondents that the requirement for value in use to be based on the most recent forecasts approved by management could be viewed as inconsistent with paragraph 37 of the previous version of IAS 36 when those forecasts include either future restructurings to which the entity is not yet committed or future cash flows associated with improving or enhancing the asset's performance.

[*] The requirement to exclude future capital expenditure that will improve or enhance the asset in excess of its originally assessed standard of performance was amended in 2003 as a consequential amendment arising from the revision of IAS 16 *Property, Plant and Equipment*. Paragraph 44 of IAS 36 now requires estimates of future cash flows to exclude future cash inflows or outflows that are expected to arise from improving or enhancing the asset's performance.

BC75 Therefore, the Board decided to clarify, in what is now paragraph 33(b) of the revised Standard, that cash flow projections should be based on the most recent financial budgets/forecasts that have been approved by management, but should exclude any estimated future cash inflows or outflows expected to arise from future restructurings or from improving or enhancing the asset's performance. The Board also decided to clarify that when a cash-generating unit contains assets with different estimated useful lives (or, similarly, when an asset comprises components with different estimated useful lives), the replacement of assets (components) with shorter lives is considered to be part of the day-to-day servicing of the unit (asset) when estimating the future cash flows associated with the unit (asset).

Using present value techniques to measure value in use (paragraphs A1-A14)

BC76 The Exposure Draft proposed additional application guidance on using present value techniques in measuring value in use. The Board decided to include this additional guidance in the Exposure Draft in response to requests for clarification of the requirements in the previous version of IAS 36 on measuring value in use.

BC77 Respondents to the Exposure Draft were generally supportive of the additional guidance. Those that were not varied in their views, suggesting that:

(a) limiting the guidance to a brief appendix to IAS 36 is insufficient.

(b) although the guidance is useful, it detracts from the main purpose of IAS 36, which is to establish accounting principles for impairment testing assets. Therefore, the guidance should be omitted from the Standard.

(c) entities should be required to use an expected cash flow approach to measure value in use.

(d) an expected cash flow approach is not consistent with how transactions are priced by management and should be prohibited.

BC78 In considering (a) and (b) above, the Board noted that the respondents that commented on the additional guidance generally agreed that it is useful and sufficient.

BC79 In considering (c) and (d) above, the Board observed that the previous version of IAS 36 did not require value in use to be calculated using an expected cash flow approach, nor did it prohibit such an approach. The Board could see no justification for requiring or prohibiting the use of an expected cash flow approach, particularly given the Board's inclination to avoid modifying the requirements in the previous version of IAS 36 for determining recoverable amount until it considers and resolves the broader measurement issues in accounting. Additionally, in relation to (d), some field visit participants said that they routinely undertake sensitivity and statistical analysis as the basis for using an expected value approach to budgeting/forecasting and strategic decision-making.

BC80 Therefore, the Board decided to include in the revised Standard the application guidance on using present value techniques that was proposed in the Exposure Draft.

Income taxes

Consideration of future tax cash flows

BCZ81 Future income tax cash flows may affect recoverable amount. It is convenient to analyse future tax cash flows into two components:

(a) the future tax cash flows that would result from any difference between the tax base of an asset (the amount attributed to it for tax purposes) and its carrying amount, after recognition of any impairment loss. Such differences are described in IAS 12 *Income Taxes* as 'temporary differences'.

(b) the future tax cash flows that would result if the tax base of the asset were equal to its recoverable amount.

BCZ82 For most assets, an enterprise recognises the tax consequences of temporary differences as a deferred tax liability or deferred tax asset in accordance with IAS 12. Therefore, to avoid double-counting, the future tax consequences of those temporary differences—the first component referred to in paragraph BCZ81—are not considered in determining recoverable amount (see further discussion in paragraphs BCZ86-BCZ89).

BCZ83 The tax base of an asset on initial recognition is normally equal to its cost. Therefore, net selling price* implicitly reflects market participants' assessment of the future tax cash flows that would result if the tax base of the asset were equal to its recoverable amount. Therefore, no adjustment is required to net selling price to reflect the second component referred to in paragraph BCZ81.

BCZ84 In principle, value in use should include the present value of the future tax cash flows that would result if the tax base of the asset were equal to its value in use—the second component referred to in paragraph BCZ81. Nevertheless it may be burdensome to estimate the effect of that component. This is because:

(a) to avoid double-counting, it is necessary to exclude the effect of temporary differences; and

(b) value in use would need to be determined by an iterative and possibly complex computation so that value in use itself reflects a tax base equal to that value in use.

For these reasons, IASC decided to require an enterprise to determine value in use by using pre-tax future cash flows and, hence, a pre-tax discount rate.

Determining a pre-tax discount rate

BCZ85 In theory, discounting post-tax cash flows at a post-tax discount rate and discounting pre-tax cash flows at a pre-tax discount rate should give the same result, as long as the pre-tax discount rate is the post-tax discount rate adjusted to reflect the specific amount and timing of the future tax cash flows. The pre-tax discount rate is not always the post-tax discount rate grossed up by a standard rate of tax.

* In IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, issued by the IASB in 2004, the term, 'net selling price' was replaced in IAS 36 by 'fair value less costs to sell'.

Example

This example illustrates that a post-tax discount rate grossed-up by a standard rate of tax is not always an appropriate pre-tax discount rate.

At the end of 20X0, the carrying amount of an asset is 1,757 and its remaining useful life is 5 years. The tax base in 20X0 is the cost of the asset. The cost is fully deductible at the end of 20X1. The tax rate is 20%. The discount rate for the asset can be determined only on a post-tax basis and is estimated to be 10%. At the end of 20X0, cash flow projections determined on a pre-tax basis are as follows:

	20X1	20X2	20X3	20X4	20X5
(1) Pre-tax cash flows (CF)	800	600	500	200	100

Value in use determined using post-tax cash flows and a post-tax discount rate

End of 20X0	*20X1*	*20X2*	*20X3*	*20X4*	*20X5*
(2) Deduction of the cost of the asset	*(1,757)*	-	-	-	-
*(3) Tax CF [((1)-(2))*20%]*	*(191)*	*120*	*100*	*40*	*20*
(4) Post-tax CF [(1)-(3)]	*991*	*480*	*400*	*160*	*80*
(5) Post-tax CF discounted at 10%	*901*	*396*	*301*	*109*	*50*
Value in use [∑(5)] =					*1,757*

Value in use determined using pre-tax cash flows and a pre-tax discount rate (determined by grossing-up the post-tax discount rate)

Pre-tax discount rate (grossed-up) [10%/(100%-20%)] 12.5%

End of 20X0	*20X1*	*20X2*	*20X3*	*20X4*	*20X5*
(6) Pre-tax CF discounted at 12.5%	*711*	*475*	*351*	*125*	*55*
Value in use [∑(6)] =					*1,717*

Determination of the 'real' pre-tax discount rate

A pre-tax discount rate can be determined by an iterative computation so that value in use determined using pre-tax cash flows and a pre-tax discount rate equals value in use determined using post-tax cash flows and a post-tax discount rate. In the example, the pre-tax discount rate would be 11.2%.

continued…

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End of 20X0	*20X1*	*20X2*	*20X3*	*20X4*	*20X5*
(7) Pre-tax CF discounted at 11.2%	*718*	*485*	*364*	*131*	*59*
Value in use [∑(7)] =					*1,757*

The 'real' pre-tax discount rate differs from the post-tax discount rate grossed-up by the standard rate of tax depending on the tax rate, the post-tax discount rate, the timing of the future tax cash flows and the useful life of the asset. Note that the tax base of the asset in this example has been set equal to its cost at the end of 20X0. Therefore, there is no deferred tax to consider in the balance sheet.

Interaction with IAS 12

BCZ86 IAS 36 requires that recoverable amount should be based on present value calculations, whereas under IAS 12 an enterprise determines deferred tax assets and liabilities by comparing the carrying amount of an asset (a present value if the carrying amount is based on recoverable amount) with its tax base (an undiscounted amount).

BCZ87 One way to eliminate this inconsistency would be to measure deferred tax assets and liabilities on a discounted basis. In developing the revised version of IAS 12 (approved in 1996), there was not enough support to require that deferred tax assets and liabilities should be measured on a discounted basis. IASC believed there was still not consensus to support such a change in existing practice. Therefore, IAS 36 requires an enterprise to measure the tax effects of temporary differences using the principles set out in IAS 12.

BCZ88 IAS 12 does not permit an enterprise to recognise certain deferred tax liabilities and assets. In such cases, some believe that the value in use of an asset, or a cash-generating unit, should be adjusted to reflect the tax consequences of recovering its pre-tax value in use. For example, if the tax rate is 25 per cent, an enterprise must receive pre-tax cash flows with a present value of 400 in order to recover a carrying amount of 300.

BCZ89 IASC acknowledged the conceptual merit of such adjustments but concluded that they would add unnecessary complexity. Therefore, IAS 36 neither requires nor permits such adjustments.

Comments by field visit participants and respondents to the December 2002 Exposure Draft

BC90 In revising IAS 36, the Board considered the requirement in the previous version of IAS 36 for:

(a) income tax receipts and payments to be excluded from the estimates of future cash flows used to measure value in use; and

(b) the discount rate used to measure value in use to be a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the asset for which the future cash flow estimates have not been adjusted.

BC91 The Board had not considered these requirements when developing the Exposure Draft. However, some field visit participants and respondents to the Exposure Draft stated that using pre-tax cash flows and pre-tax discount rates would be a significant implementation issue for entities. This is because typically an entity's accounting and strategic decision-making systems are fully integrated and use post-tax cash flows and post-tax discount rates to arrive at present value measures.

BC92 In considering this issue, the Board observed that the definition of value in use in the previous version of IAS 36 and the associated requirements on measuring value in use were not sufficiently precise to give a definitive answer to the question of what tax attribute an entity should reflect in value in use. For example, although IAS 36 specified discounting pre-tax cash flows at a pre-tax discount rate— with the pre-tax discount rate being the post-tax discount rate adjusted to reflect the specific amount and timing of the future tax cash flows—it did not specify *which* tax effects the pre-tax rate should include. Arguments could be mounted for various approaches.

BC93 The Board decided that any decision to amend the requirement in the previous version of IAS 36 for pre-tax cash flows to be discounted at a pre-tax discount rate should be made only after the Board has resolved the issue of what tax attribute should be reflected in value in use. The Board decided that it should not try to resolve this latter issue as part of the Business Combinations project—decisions on the treatment of tax in value in use calculations should be made only as part of its conceptual project on measurement. Therefore, the Board concluded it should not amend as part of the current revision of IAS 36 the requirement to use pre-tax cash flows and pre-tax discount rates when measuring value in use.

BC94 However, the Board observed that, conceptually, discounting post-tax cash flows at a post-tax discount rate and discounting pre-tax cash flows at a pre-tax discount rate should give the same result, as long as the pre-tax discount rate is the post-tax discount rate adjusted to reflect the specific amount and timing of the future tax cash flows. The pre-tax discount rate is generally not the post-tax discount rate grossed up by a standard rate of tax.

Recognition of an impairment loss (paragraphs 58-64)

BCZ95 IAS 36 requires that an impairment loss should be recognised whenever the recoverable amount of an asset is below its carrying amount. IASC considered various criteria for recognising an impairment loss in the financial statements:

(a) recognition if it is considered that the impairment loss is permanent ('permanent criterion');

(b) recognition if it is considered probable that an asset is impaired, ie if it is probable that an enterprise will not recover the carrying amount of the asset ('probability criterion'); and

(c) immediate recognition whenever recoverable amount is below the carrying amount ('economic criterion').

Recognition based on a 'permanent' criterion

BCZ96 Supporters of the 'permanent' criterion argue that:

(a) this criterion avoids the recognition of temporary decreases in the recoverable amount of an asset.

(b) the recognition of an impairment loss refers to future operations; it is contrary to the historical cost system to account for future events. Also, depreciation (amortisation) will reflect these future losses over the expected remaining useful life of the asset.

This view was supported by only a few commentators on E55 *Impairment of Assets*.

BCZ97 IASC decided to reject the 'permanent' criterion because:

(a) it is difficult to identify whether an impairment loss is permanent. There is a risk that, by using this criterion, recognition of an impairment loss may be delayed.

(b) this criterion is at odds with the basic concept that an asset is a resource that will generate future economic benefits. Cost-based accrual accounting cannot reflect events without reference to future expectations. If the events that led to a decrease in recoverable amount have already taken place, the carrying amount should be reduced accordingly.

Recognition based on a 'probability' criterion

BCZ98 Some argue that an impairment loss should be recognised only if it is considered probable that the carrying amount of an asset cannot be fully recovered. Proponents of a 'probability' criterion are divided between:

(a) those who support the use of a recognition trigger based on the sum of the future cash flows (undiscounted and without allocation of interest costs) as a practical approach to implementing the 'probability' criterion; and

(b) those who support reflecting the requirements in IAS 10 (reformatted 1994) *Contingencies and Events Occurring After the Balance Sheet Date*.*

Sum of undiscounted future cash flows (without interest costs)

BCZ99 Some national standard-setters use the 'probability' criterion as a basis for recognition of an impairment loss and require, as a practical approach to implementing that criterion, that an impairment loss should be recognised only if the sum of the future cash flows from an asset (undiscounted and without allocation of interest costs) is less than the carrying amount of the asset. An impairment loss, when recognised, is measured as the difference between the carrying amount of the asset and its recoverable amount measured at fair value (based on quoted market prices or, if no quoted market prices exist, estimated considering prices for similar assets and the results of valuation techniques, such as the sum of cash flows discounted to their present value, option-pricing models, matrix pricing, option adjusted spread models and fundamental analysis).

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* The requirements relating to contingencies in the 1994 version of IAS 10 were replaced in 1998 with the requirements in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

BCZ100 One of the characteristics of this approach is that the bases for recognition and measurement of an impairment loss are different. For example, even if the fair value of an asset is lower than its carrying amount, no impairment loss will be recognised if the sum of undiscounted cash flows (without allocation of interest costs) is greater than the asset's carrying amount. This might occur, especially if an asset has a long useful life.

BCZ101 Those who support using the sum of undiscounted future cash flows (without allocation of interest costs) as a recognition trigger argue that:

(a) using a recognition trigger based on undiscounted amounts is consistent with the historical cost framework.

(b) it avoids recognising temporary impairment losses and creating potentially volatile earnings that may mislead users of financial statements.

(c) net selling price* and value in use are difficult to substantiate— a price for the disposal of an asset or an appropriate discount rate is difficult to estimate.

(d) it is a higher threshold for recognising impairment losses. It should be relatively easy to conclude that the sum of undiscounted future cash flows will equal or exceed the carrying amount of an asset without incurring the cost of allocating projected cash flows to specific future periods.

This view was supported by a minority of commentators on E55 *Impairment of Assets*.

BCZ102 IASC considered the arguments listed above but rejected this approach because:

(a) when it identifies that an asset may be impaired, a rational enterprise will make an investment decision. Therefore, it is relevant to consider the time value of money and the risks specific to an asset in determining whether an asset is impaired. This is particularly true if an asset has a long useful life.

(b) IAS 36 does not require an enterprise to estimate the recoverable amount of each [depreciable] asset every year but only if there is an indication that an asset may be materially impaired. An asset that is depreciated (amortised) in an appropriate manner is unlikely to become materially impaired unless events or changes in circumstances cause a sudden reduction in the estimate of recoverable amount.

(c) probability factors are already encompassed in the determination of value in use, in projecting future cash flows and in requiring that recoverable amount should be the higher of net selling price and value in use.

(d) if there is an unfavourable change in the assumptions used to determine recoverable amount, users are better served if they are informed about this change in assumptions on a timely basis.

* In IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, issued by the IASB in 2004, the term, 'net selling price' was replaced in IAS 36 by 'fair value less costs to sell'.

Probability criterion based on IAS 10 (reformatted 1994)

BCZ103 IAS 10 required the amount of a contingent loss to be recognised as an expense and a liability if:

(a) it was probable that future events will confirm that, after taking into account any related probable recovery, an asset had been impaired or a liability incurred at the balance sheet date; and

(b) a reasonable estimate of the amount of the resulting loss could be made.

BCZ104 IASC rejected the view that an impairment loss should be recognised based on the requirements in IAS 10 because:

(a) the requirements in IAS 10 were not sufficiently detailed and would have made a 'probability' criterion difficult to apply.

(b) those requirements would have introduced another unnecessary layer of probability. Indeed, as mentioned above, probability factors are already encompassed in estimates of value in use and in requiring that recoverable amount should be the higher of net selling price and value in use.

Recognition based on an 'economic' criterion

BCZ105 IAS 36 relies on an 'economic' criterion for the recognition of an impairment loss—an impairment loss is recognised whenever the recoverable amount of an asset is below its carrying amount. This criterion was already used in many International Accounting Standards before IAS 36, such as IAS 9 *Research and Development Costs*, IAS 22 *Business Combinations*, and IAS 16 *Property, Plant and Equipment*.

BCZ106 IASC considered that an 'economic' criterion is the best criterion to give information which is useful to users in assessing future cash flows to be generated by the enterprise as a whole. In estimating the time value of money and the risks specific to an asset in determining whether the asset is impaired, factors, such as the probability or permanence of the impairment loss, are subsumed in the measurement.

BCZ107 The majority of commentators on E55 supported IASC's view that an impairment loss should be recognised based on an 'economic' criterion.

Revalued assets: recognition in the income statement versus directly in equity

BCZ108 IAS 36 requires that an impairment loss on a revalued asset should be recognised as an expense in the income statement[*] immediately, except that it should be recognised directly in equity[†] to the extent that it reverses a previous revaluation on the same asset.

[*] IAS 1 *Presentation of Financial Statements* (as revised in 2007) requires an entity to present all income and expense items in one statement of comprehensive income or in two statements (a separate income statement and a statement of comprehensive income).

[†] As a consequence of the revision of IAS 1 (revised 2007) an impairment loss is recognised in other comprehensive income.

BCZ109 Some argue that, when there is a clear reduction in the service potential (for example, physical damage) of a revalued asset, the impairment loss should be recognised in the income statement.

BCZ110 Others argue that an impairment loss should always be recognised as an expense in the income statement. The logic of this argument is that an impairment loss arises only where there is a reduction in the estimated future cash flows that form part of the business's operating activities. Indeed, according to IAS 16, whether or not an asset is revalued, the depreciation charge is always recognised in the income statement. Supporters of this view question why the treatment of an impairment loss on a revalued asset should be different to depreciation.

BCZ111 IASC believed that it would be difficult to identify whether an impairment loss is a downward revaluation or a reduction in service potential. Therefore, IASC decided to retain the treatment used in IAS 16 and to treat an impairment loss of a revalued asset as a revaluation decrease (and similarly, a reversal of an impairment loss as a subsequent revaluation increase).

BCZ112 For a revalued asset, the distinction between an 'impairment loss' ('reversal of an impairment loss') and another 'revaluation decrease' ('revaluation increase') is important for disclosure purposes. If an impairment loss that is material to the enterprise as a whole has been recognised or reversed, more information on how this impairment loss is measured is required by IAS 36 than for the recognition of a revaluation in accordance with IAS 16.

Cash-generating units (paragraphs 66-73)

BCZ113 Some support the principle of determining recoverable amount on an individual asset basis only. This view was expressed by a few commentators on E55. They argued that:

(a) it would be difficult to identify cash-generating units at a level other than the business as a whole and, therefore, impairment losses would never be recognised for individual assets; and

(b) it should be possible to recognise an impairment loss, regardless of whether an asset generates cash inflows that are independent from those of other assets or groups of assets. Commentators quoted examples of assets that have become under-utilised or obsolete but that are still in use.

BCZ114 IASC acknowledged that identifying the lowest level of independent cash inflows for a group of assets would involve judgement. However, IASC believed that the concept of cash-generating units is a matter of fact: assets work together to generate cash flows.

BCZ115 In response to requests from commentators on E55, IAS 36 includes additional guidance and examples for identifying cash-generating units and for determining the carrying amount of cash-generating units. IAS 36 emphasises that cash-generating units should be identified for the lowest level of aggregation of assets possible.

Internal transfer pricing (paragraph 70)

BC116 The previous version of IAS 36 required that if an active market exists for the output produced by an asset or a group of assets:

(a) that asset or group of assets should be identified as a cash-generating unit, even if some or all of the output is used internally; and

(b) management's best estimate of the future market prices for the output should be used in estimating:

(i) the future cash inflows that relate to the internal use of the output when determining the value in use of this cash-generating unit; and

(ii) the future cash outflows that relate to the internal use of the output when determining the value in use of the entity's other cash-generating units.

BC117 The requirement in (a) above has been carried forward in the revised Standard. However, some respondents to the Exposure Draft asked for additional guidance to clarify the role of internal transfer pricing versus prices in an arm's length transaction when developing cash flow forecasts. The Board decided to address this issue by amending the requirement in (b) above to deal more broadly with cash-generating units whose cash flows are affected by internal transfer pricing, rather than just cash-generating units whose internally consumed output could be sold on an active market.

BC118 Therefore, the Standard clarifies that if the cash inflows generated by *any* asset or cash-generating unit are affected by internal transfer pricing, an entity should use management's best estimate of future prices that could be achieved in arm's length transactions in estimating:

(a) the future cash inflows used to determine the asset's or cash-generating unit's value in use; and

(b) the future cash outflows used to determine the value in use of other assets or cash-generating units affected by the internal transfer pricing.

Testing indefinite-lived intangibles for impairment

BC119 As part of the first phase of its Business Combinations project, the Board concluded that:

(a) an intangible asset should be regarded as having an indefinite useful life when, based on an analysis of all relevant factors (eg legal, regulatory, contractual, competitive and economic), there is no foreseeable limit on the period over which the asset is expected to generate net cash inflows for the entity; and

(b) an indefinite-lived intangible should not be amortised, but should be tested regularly for impairment.

An outline of the Board's deliberations on each of these issues is provided in the Basis for Conclusions on IAS 38 *Intangible Assets*.

BC120 Having reached these conclusions, the Board then considered the form that the impairment test for indefinite-lived intangibles should take. The Board concluded that:

(a) an indefinite-lived intangible should be tested for impairment annually, or more frequently if there is any indication that it may be impaired; and

(b) the recoverable amounts of such assets should be measured, and impairment losses (and reversals of impairment losses) in respect of those assets should be accounted for, in accordance with the requirements in IAS 36 for assets other than goodwill.

Paragraphs BC121-BC126 outline the Board's deliberations in reaching its conclusion about the frequency and timing of impairment testing indefinite-lived intangibles. Paragraphs BC129 and BC130 outline the Board's deliberations in reaching its conclusions about measuring the recoverable amount of such assets and accounting for impairment losses and reversals of impairment losses.

Frequency and timing of impairment testing (paragraphs 9 and 10(a))

BC121 In developing the Exposure Draft, the Board observed that requiring assets to be remeasured when they are impaired is a valuation concept rather than one of cost allocation. This concept, which some have termed 'the recoverable cost concept', focuses on the benefits to be derived from the asset in the future, rather than on the process by which the cost or other carrying amount of the asset should be allocated to particular accounting periods. Therefore, the purpose of an impairment test is to assess whether the carrying amount of an asset will be recovered through use or sale of the asset. Nevertheless, allocating the depreciable amount of an asset with a limited useful life on a systematic basis over that life provides some assurance against the asset's carrying amount exceeding its recoverable amount. The Board acknowledged that non-amortisation of an intangible asset increases the reliance that must be placed on impairment reviews of that asset to ensure that its carrying amount does not exceed its recoverable amount.

BC122 Accordingly, the Exposure Draft proposed that indefinite-lived intangibles should be tested for impairment at the end of each annual reporting period. The Board concluded, however, that testing such assets annually for impairment is not a substitute for management being aware of events occurring or circumstances changing between annual tests that indicate a possible impairment. Therefore, the Exposure Draft also proposed that an entity should be required to test such assets for impairment whenever there is an indication of possible impairment, and not wait until the next annual test.

BC123 The respondents to the Exposure Draft generally supported the proposal to test indefinite-lived intangibles for impairment annually and whenever there is an indication of possible impairment. Those that disagreed argued that requiring an annual impairment test would be excessively burdensome, and recommended requiring an impairment test only when there is an indication that an indefinite-lived intangible might be impaired. After considering these comments the Board:

(a) reaffirmed its view that non-amortisation of an intangible asset increases the reliance that must be placed on impairment reviews of that asset to ensure that its carrying amount does not exceed its recoverable amount.

(b) concluded that IAS 36 should require indefinite-lived intangibles to be tested for impairment annually and whenever there is an indication of possible impairment.

BC124 However, as noted in paragraph BC122, the Exposure Draft proposed that the annual impairment tests for indefinite-lived intangibles should be performed at the end of each annual period. Many respondents to the Exposure Draft disagreed that IAS 36 should mandate the timing of the annual impairment tests. They argued that:

(a) it would be inconsistent with the proposal (now a requirement) that the annual impairment test for a cash-generating unit to which goodwill has been allocated may be performed at any time during an annual period, provided the test is performed at the same time every year. There is no justification for providing less flexibility in the timing of the annual impairment test for indefinite-lived intangibles.

(b) if the impairment test for an indefinite-lived intangible is linked to the impairment test for goodwill (ie if the indefinite lived intangible is assessed for impairment at the same cash-generating unit level as goodwill, rather than individually or as part of a smaller cash-generating unit), the requirement to measure its recoverable amount at the end of the annual period could result in the cash-generating unit to which it (and the goodwill) belongs being tested for impairment at least twice each annual period, which is too burdensome. For example, assume a cash-generating unit contains goodwill and an indefinite-lived intangible, and that the indefinite-lived intangible is assessed for impairment at the same cash-generating unit level as goodwill. Assume also that the entity reports quarterly, has a December year-end, and decides to test goodwill for impairment at the end of the third quarter to coincide with the completion of its annual strategic planning/budgeting process. The proposal that the annual impairment test for an indefinite-lived intangible should be performed at the end of each annual period would mean that the entity would be required:

(i) to calculate at the end of each September the recoverable amount of the cash-generating unit, compare it with its carrying amount, and, if the carrying amount exceeds the recoverable amount, recognise an impairment loss for the unit by reducing the carrying amount of goodwill and allocating any remaining impairment loss to the other assets in the unit, including the indefinite-lived intangible.

(ii) to perform the same steps again each December to test the indefinite-lived intangible for impairment.

(iii) to perform the same steps again at any other time throughout the annual period if there is an indication that the cash-generating unit, the goodwill or the indefinite-lived intangible may be impaired.

BC125 In considering these comments, the Board indicated a preference for requiring entities to perform the recoverable amount calculations for both goodwill and indefinite-lived intangibles at the end of the annual period. However, the Board acknowledged that, as outlined in paragraph BC124(b), impairment tests for indefinite-lived intangibles will sometimes be linked to impairment tests for goodwill, and that many entities would find it difficult to perform all those tests at the end of the annual period.

BC126 Therefore, consistently with the annual impairment test for goodwill, the Standard permits the annual impairment test for an indefinite-lived intangible to be performed at any time during an annual period, provided it is performed at the same time every year.

Carrying forward a recoverable amount calculation (paragraph 24)

BC127 The Standard permits the most recent detailed calculation of the recoverable amount of an indefinite-lived intangible to be carried forward from a preceding period for use in the current period's impairment test, provided all of the criteria in paragraph 24 of the Standard are met.

BC128 Integral to the Board's decision that indefinite-lived intangibles should be tested for impairment annually was the view that many entities should be able to conclude that the recoverable amount of such an asset is greater than its carrying amount without actually recomputing recoverable amount. However, the Board concluded that this would be the case only if the last recoverable amount determination exceeded the carrying amount by a substantial margin, and nothing had happened since then to make the likelihood of an impairment loss other than remote. The Board concluded that, in such circumstances, permitting a detailed calculation of the recoverable amount of an indefinite-lived intangible to be carried forward from the preceding period for use in the current period's impairment test would significantly reduce the costs of applying the impairment test, without compromising its integrity.

Measuring recoverable amount and accounting for impairment losses and reversals of impairment losses

BC129 The Board could see no compelling reason why the measurement basis adopted for determining recoverable amount and the treatment of impairment losses and reversals of impairment losses for one group of identifiable assets should differ from those applying to other identifiable assets. Adopting different methods would impair the usefulness of the information provided to users about an entity's identifiable assets, because both comparability and reliability, which rest on the notion that similar transactions are accounted for in the same way, would be diminished. Therefore, the Board concluded that the recoverable amounts of indefinite-lived intangibles should be measured, and impairment losses and reversals of impairment losses in respect of those assets should be accounted for, consistently with other identifiable assets covered by the Standard.

BC130 The Board expressed some concern over the measurement basis adopted in the previous version of IAS 36 for determining recoverable amount (ie higher of value in use and net selling price) and its treatment of impairment losses and reversals of impairment losses for assets other than goodwill. However, the Board's intention in revising IAS 36 was *not* to reconsider the general approach to impairment testing. Accordingly, the Board decided that it should address concerns over that general approach as part of its future re-examination of IAS 36 in its entirety, rather than as part of its Business Combinations project.

Testing goodwill for impairment (paragraphs 80-99)

BC131 ~~The Board concluded that if a rigorous and operational impairment test could be devised, more useful information would be provided to users of an entity's financial statements under an approach in which goodwill is not amortised, but is instead tested for impairment annually or more frequently if events or changes in circumstances indicate that the goodwill might be impaired. An outline of the Board's deliberations in reaching this conclusion is provided in the Basis for Conclusions on IFRS 3 *Business Combinations*.~~[Deleted]

BC131A The Board concluded that goodwill should not be amortised and instead should be tested for impairment annually, or more frequently if events or changes in circumstances indicate that it might be impaired. IAS 22 *Business Combinations* required acquired goodwill to be amortised on a systematic basis over the best estimate of its useful life. There was a rebuttable presumption that its useful life did not exceed twenty years from initial recognition. If that presumption was rebutted, acquired goodwill was required to be tested for impairment in accordance with the previous version of IAS 36 at least at each financial year-end, even if there was no indication that it was impaired.

BC131B In considering the appropriate accounting for acquired goodwill after its initial recognition, the Board examined the following three approaches:

(a) straight-line amortisation but with an impairment test whenever there is an indication that the goodwill might be impaired;

(b) non-amortisation but with an impairment test annually or more frequently if events or changes in circumstances indicate that the goodwill might be impaired; and

(c) permitting entities a choice between approaches (a) and (b).

BC131C The Board concluded, and the respondents to ED 3 *Business Combinations* that expressed a clear view on this issue generally agreed, that entities should not be allowed a choice between approaches (a) and (b). Permitting such choices impairs the usefulness of the information provided to users of financial statements because both comparability and reliability are diminished.

BC131D The respondents to ED 3 who expressed a clear view on this issue generally supported approach (a). They put forward the following arguments in support of that approach:

(a) acquired goodwill is an asset that is consumed and replaced by internally generated goodwill. Therefore, amortisation ensures that the acquired goodwill is recognised in profit or loss and no internally generated goodwill is recognised as an asset in its place, consistently with the general prohibition in IAS 38 on the recognition of internally generated goodwill.

(b) conceptually, amortisation is a method of allocating the cost of acquired goodwill over the periods it is consumed, and is consistent with the approach taken to other intangible and tangible fixed assets that do not have indefinite useful lives. Indeed, entities are required to determine the useful lives of items of property, plant and equipment, and allocate their depreciable amounts on a systematic basis over those useful lives. There is no conceptual reason for treating acquired goodwill differently.

(c) the useful life of acquired goodwill cannot be predicted with a satisfactory level of reliability, nor can the pattern in which that goodwill diminishes be known. However, systematic amortisation over an albeit arbitrary period provides an appropriate balance between conceptual soundness and operationality at an acceptable cost: it is the only practical solution to an intractable problem.

BC131E In considering these comments, the Board agreed that achieving an acceptable level of reliability in the form of representational faithfulness while striking some balance with what is practicable was the primary challenge it faced in deliberating the subsequent accounting for goodwill. The Board observed that the useful life of acquired goodwill and the pattern in which it diminishes generally are not possible to predict, yet its amortisation depends on such predictions. As a result, the amount amortised in any given period can be described as at best an arbitrary estimate of the consumption of acquired goodwill during that period. The Board acknowledged that if goodwill is an asset, in some sense it must be true that goodwill acquired in a business combination is being consumed and replaced by internally generated goodwill, provided that an entity is able to maintain the overall value of goodwill (by, for example, expending resources on advertising and customer service). However, consistently with the view it reached in developing ED 3, the Board remained doubtful about the usefulness of an amortisation charge that reflects the consumption of acquired goodwill, when the internally generated goodwill replacing it is not recognised. Therefore, the Board reaffirmed the conclusion it reached in developing ED 3 that straight-line amortisation of goodwill over an arbitrary period fails to provide useful information. The Board noted that both anecdotal and research evidence supports this view.

BC131F In considering respondents' comments summarised in paragraph BC131D(b), the Board noted that although the useful lives of both goodwill and tangible fixed assets are directly related to the period over which they are expected to generate net cash inflows for the entity, the expected physical utility to the entity of a tangible fixed asset places an upper limit on the asset's useful life. In other words, unlike goodwill, the useful life of a tangible fixed asset could never extend beyond the asset's expected physical utility to the entity.

BC131G The Board reaffirmed the view it reached in developing ED 3 that if a rigorous and operational impairment test could be devised, more useful information would be provided to users of an entity's financial statements under an approach in which goodwill is not amortised, but instead tested for impairment annually or more frequently if events or changes in circumstances indicate that the goodwill might be impaired. After considering respondents' comments to the exposure draft of proposed amendments to IAS 36 on the form that such an impairment test should take, the Board concluded that a sufficiently rigorous and operational impairment test could be devised.

BC132 Paragraphs BC133-BC177 outline the Board's deliberations on the form that the impairment test for goodwill should take:

(a) paragraphs BC137-BC159 discuss the requirements relating to the allocation of goodwill to cash-generating units and the level at which goodwill is tested for impairment.

(b) paragraphs BC160-BC170 discuss the requirements relating to the recognition and measurement of impairment losses for goodwill, including the frequency of impairment testing.

(c) paragraphs BC171-BC177 discuss the requirements relating to the timing of goodwill impairment tests.

BC133 As a first step in its deliberations, the Board considered the objective of the goodwill impairment test and the measure of recoverable amount that should be adopted for such a test. The Board observed that recent North American standards use fair value as the basis for impairment testing goodwill, whereas the previous version of IAS 36 and the United Kingdom standard are based on an approach under which recoverable amount is measured as the higher of value in use and net selling price.

BC134 The Board also observed that goodwill acquired in a business combination represents a payment made by an acquirer in anticipation of future economic benefits from assets that are not capable of being individually identified and separately recognised. Goodwill does not generate cash flows independently of other assets or groups of assets and therefore cannot be measured directly. Instead, it is measured as a residual amount, being the excess of the cost of a business combination over the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities. Moreover, goodwill acquired in a business combination and goodwill generated after that business combination cannot be separately identified, because they contribute jointly to the same cash flows.*

BC135 The Board concluded that because it is not possible to measure separately goodwill generated internally after a business combination and to factor that measure into the impairment test for acquired goodwill, the carrying amount of goodwill will always be shielded from impairment by that internally generated goodwill. Therefore, the Board took the view that the objective of the goodwill impairment test could at best be to ensure that the carrying amount of goodwill is recoverable from future cash flows expected to be generated by both acquired goodwill and goodwill generated internally after the business combination.

BC136 The Board noted that because goodwill is measured as a residual amount, the starting point in any goodwill impairment test would have to be the recoverable amount of the operation or unit to which the goodwill relates, regardless of the measurement basis adopted for determining recoverable amount. The Board decided that until it considers and resolves the broader question of the appropriate measurement objective(s) in accounting, identifying the appropriate measure of recoverable amount for that unit would be problematic. Therefore, although the Board expressed concern over the measurement basis adopted in IAS 36 for determining recoverable amount, it decided that it should not depart from that basis when measuring the recoverable amount of a unit whose carrying amount includes acquired goodwill. The Board noted that this would have the added advantage of allowing the impairment test for goodwill to be integrated with the impairment test in IAS 36 for other assets and cash-generating units that include goodwill.

Allocating goodwill to cash-generating units (paragraphs 80-87)

BC137 The previous version of IAS 36 required goodwill to be tested for impairment as part of impairment testing the cash-generating units to which it relates. It employed a 'bottom-up/top-down' approach under which the goodwill was in effect tested for impairment by allocating its carrying amount to each of the smallest cash-generating units to which a portion of that carrying amount could be allocated on a reasonable and

* In the second phase of its business combinations project, the Board revised the definition and measurement of goodwill in IFRS 3. See paragraph 32 and Appendix A of IFRS 3 (as revised in 2008).

consistent basis.

BC138 Consistently with the previous version of IAS 36, the Exposure Draft proposed that:

(a) goodwill should be tested for impairment as part of impairment testing the cash-generating units to which it relates; and

(b) the carrying amount of goodwill should be allocated to each of the smallest cash-generating units to which a portion of that carrying amount can be allocated on a reasonable and consistent basis.

However, the Exposure Draft proposed additional guidance clarifying that a portion of the carrying amount of goodwill should be regarded as capable of being allocated to a cash-generating unit on a reasonable and consistent basis only when that unit represents the lowest level at which management monitors the return on investment in assets that include the goodwill. That cash-generating unit could not, however, be larger than a segment based on the entity's primary reporting format determined in accordance with IAS 14 *Segment Reporting*.

BC139 In developing this proposal, the Board noted that because acquired goodwill does not generate cash flows independently of other assets or groups of assets, it can be tested for impairment only as part of impairment testing the cash-generating units to which it relates. However, the Board was concerned that in the absence of any guidance on the precise meaning of 'allocated on a reasonable and consistent basis', some might conclude that when a business combination enhances the value of all of the acquirer's pre-existing cash-generating units, any goodwill acquired in that business combination should be tested for impairment only at the level of the entity itself. The Board concluded that this should not be the case. Rather, there should be a link between the level at which goodwill is tested for impairment and the level of internal reporting that reflects the way an entity manages its operations and with which the goodwill naturally would be associated. Therefore, it was important to the Board that goodwill should be tested for impairment at a level at which information about the operations of an entity and the assets that support them is provided for internal reporting purposes.

BC140 In redeliberating this issue, the Board noted that respondents' and field visit participants' comments indicated that the Board's intention relating to the allocation of goodwill had been widely misunderstood, with many concluding that goodwill would need to be allocated to a much lower level than that intended by the Board. For example, some respondents and field visit participants were concerned that the proposal to allocate goodwill to such a low level would force entities to allocate goodwill arbitrarily to cash-generating units, and therefore to develop new or additional reporting systems to perform the test. The Board confirmed that its intention was that there should be a link between the level at which goodwill is tested for impairment and the level of internal reporting that reflects the way an entity manages its operations. Therefore, except for entities that do not monitor goodwill at or below the segment level, the proposals relating to the level of the goodwill impairment test should *not* cause entities to allocate goodwill arbitrarily to cash-generating units. Nor should they create the need for entities to develop new or additional reporting systems.

BC141 The Board observed from its discussions with field visit participants that much of the confusion stemmed from the definition of a 'cash-generating unit', when coupled with the proposal in paragraph 73 of the Exposure Draft for goodwill to be allocated to each "smallest cash-generating unit to which a portion of the carrying amount of the goodwill can be allocated on a reasonable and consistent basis". Additionally, field visit participants and respondents were unclear about the reference in paragraph 74 of the

Exposure Draft to 'the lowest level at which management monitors the return on investments in assets that include goodwill', the most frequent question being 'what level of management?' (eg board of directors, chief executive officer, or segment management).

BC142 The Board noted that once its intention on this issue was clarified for field visit participants, they all, with the exception of one company that believes goodwill should be tested for impairment at the entity level, supported the level at which the Board believes goodwill should be tested for impairment.

BC143 The Board also noted the comment from a number of respondents and field visit participants that for some organisations, particularly those managed on a matrix basis, the proposal for cash-generating units to which the goodwill is allocated to be no larger than a segment based on the entity's *primary* reporting format could result in an outcome that is inconsistent with the Board's intention, ie that there should be a link between the level at which goodwill is tested for impairment and the level of internal reporting that reflects the way an entity manages its operations. The following example illustrates this point:

> A company managed on a matrix basis is organised primarily on a geographical basis, with product groups providing the secondary basis of segmentation. Goodwill is acquired as part of an acquisition of a product group that is present in several geographical regions, and is then monitored on an ongoing basis for internal reporting purposes as part of the product group/secondary segment. It is feasible that the secondary segment might, depending on the definition of 'larger', be 'larger' than a primary segment.

BC144 Therefore, the Board decided:

(a) that the Standard should require each unit or group of units to which goodwill is allocated to represent the lowest level within the entity at which the goodwill is monitored for internal management purposes.

(b) to clarify in the Standard that acquired goodwill should, from the acquisition date, be allocated to each of the acquirer's cash-generating units, or groups of cash-generating units, that are expected to benefit from the combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units or groups of units.

(c) to replace the proposal for cash-generating units or groups of units to which goodwill is allocated to be no larger than a segment based on the entity's *primary* reporting format, with the requirement that they be no larger than a segment based on either the entity's primary or the entity's secondary reporting format. The Board concluded that this amendment is necessary to ensure that entities managed on a matrix basis are able to test goodwill for impairment at the level of internal reporting that reflects the way they manage their operations.*

BC145 Some respondents to the Exposure Draft raised the following additional concerns on the allocation of goodwill for impairment testing purposes:

(a) mandating that goodwill should be allocated to at least the segment level is inappropriate—it will often result in arbitrary allocations, and entities would need to develop new or additional reporting systems.

* In 2006 IAS 14 was replaced by IFRS 8 *Operating Segments*. IFRS 8 does not require disclosure of primary and secondary segment information. See paragraph BC150A.

(b) for convergence reasons, the level of the goodwill impairment test should be the same as the level in US Financial Accounting Standards Board Statement of Financial Accounting Standards No. 142 *Goodwill and Other Intangible Assets* (SFAS 142) (ie the reporting unit level).

(c) cash-generating units that constitute businesses with similar characteristics should, as is required by SFAS 142, be aggregated and treated as single units, notwithstanding that they may be monitored independently for internal purposes.

BC146 In relation to (a), the Board reaffirmed the conclusion it reached when developing the Exposure Draft that requiring goodwill to be allocated to at least the segment level is necessary to avoid entities erroneously concluding that, when a business combination enhances the value of all of the acquirer's pre-existing cash-generating units, any goodwill acquired in that combination could be tested for impairment only at the level of the entity itself.

BC147 In relation to (b), the Board noted that SFAS 142 requires goodwill to be tested for impairment at a level of reporting referred to as a 'reporting unit'. A reporting unit is an operating segment (as defined in SFAS 131 *Disclosures about Segments of an Enterprise and Related Information*[†]) or one level below an operating segment (referred to as a component). A component of an operating segment is a reporting unit if the component constitutes a business for which discrete financial information is available and segment management regularly reviews the operating results of that component. However, two or more components of an operating segment must be aggregated and deemed a single reporting unit if the components have similar economic characteristics. An operating segment is deemed to be a reporting unit if all of its components are similar, if none of its components is a reporting unit, or if it comprises only a single component.

BC148 Therefore, unlike IAS 36, SFAS 142 places a limit on how far goodwill can be 'pushed down' for impairment testing (ie one level below an operating segment).

BC149 In deciding not to converge with SFAS 142 on the level of the goodwill impairment test, the Board noted the following findings from the field visits and North American round-table discussions:

(a) most of the US registrant field visit participants stated that the Board's proposals on the level of the goodwill impairment test would result, in practice, in goodwill being tested for impairment at the same level at which it is tested in accordance with SFAS 142. However, several stated that under the Board's proposals, goodwill would be tested for impairment at a lower level than under SFAS 142. Nevertheless, they believe that the Board's approach provides users and management with more useful information.

[†] The basis for identifying 'operating segments' under SFAS 131 differs from the basis for identifying segments based on the entity's primary reporting format under IFRS 8. SFAS 131 defines an operating segment as a component of an enterprise (a) that engages in business activities from which it may earn revenues and incur expenses, including revenues and expenses relating to transactions with other components of the enterprise; (b) whose operating results are regularly reviewed by the enterprise's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance; and (c) for which discrete financial information is available. <u>IAS 14 was replaced by IFRS 8 in 2006. See paragraph BC150A.</u>

(b) several round-table participants stated that they (or, in the case of audit firm participants, their clients) manage and have available information about their investments in goodwill at a lower level than the level of the SFAS 142 impairment test. They expressed a high level of dissatisfaction at being prevented by SFAS 142 from recognising goodwill impairments that they knew existed at these lower levels, but which 'disappeared' once the lower level units were aggregated with other units containing sufficient 'cushions' to offset the impairment loss.

BC150 In considering suggestion (c) in paragraph BC145, the Board observed that aggregating units that constitute businesses with similar characteristics could result in the disappearance of an impairment loss that management *knows* exists in a cash-generating unit because the units with which it is aggregated contain sufficient cushions to offset the impairment loss. In the Board's view, if, because of the way an entity is managed, information about goodwill impairment losses is available to management at a particular level, that information should also be available to the users of the entity's financial statements.

BC150A In 2006 IFRS 8 replaced IAS 14 and changed the basis for identifying segments. Under IAS 14, two sets of segments were identified–one based on related products and services, and the other on geographical areas. Under IFRS 8, operating segments are identified on the basis of internal reports that are regularly reviewed by the entity's chief operating decision maker in order to allocate resources to the segment and assess its performance. The objective of the change was to improve the disclosure of segment information, not to change the requirements of IAS 36 relating to the allocation of goodwill for impairment testing. The previous wording of the requirement in IAS 36 that each unit or group of units to which goodwill is allocated shall "not be larger than a segment based on either the entity's primary or the entity's secondary reporting format determined in accordance with IAS 14" has been amended by IFRS 8 to "not be larger than an operating segment determined in accordance with IFRS 8". The arguments set out above in support of the original requirement based on segments determined in accordance with IAS 14 support the revised requirements based on segments determined in accordance with the requirements in IFRS 8.

BC150B Entities adopting IFRS 8 must reconsider the allocation of goodwill to cash-generating units because of the definition of operating segment introduced by IFRS 8. That definition affects the determination of the largest unit permitted by paragraph 80 of IAS 36 for testing goodwill for impairment. In 2008 the Board was made aware that divergent views had developed regarding the largest unit permitted by IAS 36 for impairment testing of goodwill. One view was that the unit is the operating segment level as defined in paragraph 5 of IFRS 8 *before* the aggregation permitted by paragraph 12 of IFRS 8. The other view was that the unit is the operating segment level as defined in paragraph 5 of IFRS 8 *after* the aggregation permitted by paragraph 12 of IFRS 8. The Board noted that the lowest level of the entity at which management monitors goodwill as required in paragraph 80(a) is the same as the lowest level of operating segments at which the chief operating decision maker regularly reviews operating results as defined in IFRS 8. The Board also noted that the linkage of the entity's goodwill monitoring level with the entity's internal reporting level is intentional, as described in paragraph BC140. The Board noted that aggregating operating segments for goodwill impairment testing into a unit larger than the level at which goodwill is monitored contradicts the rationale underlying IAS 36, as set out in paragraphs BC145–BC150. In addition, meeting the aggregation criteria of similar economic characteristics permitted in IFRS 8 does not automatically result in groups of cash-generating units that are expected to benefit from the synergies of allocated goodwill. Similarly, the aggregated segments do not necessarily represent business operations that are economically interdependent or work in concert to recover the goodwill being assessed for impairment. Therefore, in *Improvements to IFRSs* issued in April 2009, the Board amended paragraph 80(b) to state that the required unit for goodwill impairment in IAS 36 is not larger than the operating segment level as defined in paragraph 5 of IFRS 8 before the permitted aggregation.

Completing the initial allocation of goodwill (paragraphs 84 and 85)

BC151 If the initial allocation of goodwill acquired in a business combination cannot be completed before the end of the annual period in which the business combination is effected, the Exposure Draft proposed, and the revised Standard requires, that the initial allocation should be completed before the end of the first annual period beginning after the acquisition date. In contrast, ED 3 proposed, and IFRS 3 requires, that if the initial accounting for a business combination can be determined only provisionally by the end of the period in which the combination is effected, the acquirer should:

(a) account for the combination using those provisional values; and

(b) recognise any adjustments to those provisional values as a result of completing the initial accounting within twelve months of the acquisition date.*

BC152 Some respondents to the Exposure Draft questioned why the period to complete the initial allocation of goodwill should differ from the period to complete the initial accounting for a business combination. The Board's view is that acquirers should be allowed a longer period to complete the goodwill allocation, because that allocation often might not be able to be performed until after the initial accounting for the combination is complete. This is because the cost of the combination or the fair values at the acquisition date of the acquiree's identifiable assets, liabilities or contingent liabilities, and therefore the amount of goodwill acquired in the combination, would not be finalised until the initial accounting for the combination in accordance with IFRS 3 is complete.

Disposal of a portion of a cash-generating unit containing goodwill (paragraph 86)

BC153 The Exposure Draft proposed that when an entity disposes of an operation within a cash-generating unit to which goodwill has been allocated, the goodwill associated with that operation should be:

(a) included in the carrying amount of the operation when determining the gain or loss on disposal; and

(b) measured on the basis of the relative values of the operation disposed of and the portion of the cash-generating unit retained.

BC154 This proposal has been carried forward in the Standard with one modification. The Standard requires the goodwill associated with the operation disposed of to be measured on the basis of the relative values of the operation disposed of and the portion of the cash-generating unit retained, unless the entity can demonstrate that some other method better reflects the goodwill associated with the operation disposed of.

* In the second phase of its business combinations project, the Board clarified that adjustments to provisional values should be made only to reflect new information obtained about facts and circumstances that existed as of the acquisition date that, if known, would have affected the measurement of the amounts recognised as of that date. Such adjustments should be made within the measurement period, which shall not exceed one year from the acquisition date.

BC155 In developing the Exposure Draft, the Board concluded that the proposed level of the impairment test would mean that goodwill could not be identified or associated with an asset group at a level lower than the cash-generating unit to which the goodwill is allocated, except arbitrarily. However, the Board also concluded that when an operation within that cash-generating unit is being disposed of, it is appropriate to presume that some amount of goodwill is associated with that operation. Thus, an allocation of the goodwill should be required when the part of the cash-generating unit being disposed of constitutes an operation.

BC156 Some respondents to the Exposure Draft suggested that although in most circumstances goodwill could not be identified or associated with an asset group at a level lower than the cash-generating unit or group of cash-generating units to which it is allocated for impairment testing, there may be some instances when this is not so. For example, assume an acquiree is integrated with one of the acquirer's pre-existing cash-generating units that did not include any goodwill in its carrying amount. Assume also that almost immediately after the business combination the acquirer disposes of a loss-making operation within the cash-generating unit. The Board agreed with respondents that in such circumstances, it might reasonably be concluded that no part of the carrying amount of goodwill has been disposed of, and therefore no part of its carrying amount should be derecognised by being included in the determination of the gain or loss on disposal.

Reorganisation of reporting structure (paragraph 87)

BC157 The Exposure Draft proposed that when an entity reorganises its reporting structure in a way that changes the composition of cash-generating units to which goodwill has been allocated, the goodwill should be reallocated to the units affected using a relative value approach similar to that used when an entity disposes of an operation within a cash-generating unit.

BC158 In developing the Exposure Draft, the Board concluded that a reorganisation that changes the composition of a cash-generating unit to which goodwill has been allocated gives rise to the same allocation problem as disposing of an operation within that unit. Therefore, the same allocation methodology should be used in both cases.

BC159 As a result, and consistently with the Board's decision to modify its proposal on allocating goodwill when an entity disposes of an operation, the revised Standard requires an entity that reorganises its reporting structure in a way that changes the composition of one or more cash-generating units to which goodwill has been allocated:

(a) to reallocate the goodwill to the units affected; and

(b) to perform this reallocation using a relative value approach similar to that used when an entity disposes of an operation within a cash-generating unit (group of cash-generating units), unless the entity can demonstrate that some other method better reflects the goodwill associated with the reorganised units (groups of units).

Recognition and measurement of impairment losses (paragraphs 88-99 and 104)

Background to the proposals in the Exposure Draft

BC160 The Exposure Draft proposed a two-step approach for impairment testing goodwill. The first step involved using a screening mechanism for identifying potential goodwill impairments, whereby goodwill allocated to a cash-generating unit would be identified as potentially impaired only when the carrying amount of the unit exceeded its recoverable amount. If an entity identified the goodwill allocated to a cash-generating unit as potentially impaired, an entity would then determine whether the goodwill allocated to the unit was impaired by comparing its recoverable amount, measured as the 'implied value' of the goodwill, with its carrying amount. The implied value of goodwill would be measured as a residual, being the excess of:

(a) the recoverable amount of the cash-generating unit to which the goodwill has been allocated, over

(a) the net fair value of the identifiable assets, liabilities and contingent liabilities the entity would recognise if it acquired the cash-generating unit in a business combination on the date of the impairment test (excluding any identifiable asset that was acquired in a business combination but not recognised separately from goodwill at the acquisition date).

BC161 In developing the Exposure Draft, the Board's discussion focused first on how the recoverable amount of goodwill allocated to a cash-generating unit could be separated from the recoverable amount of the unit as a whole, given that goodwill generated internally after a business combination could not be measured separately. The Board concluded that a method similar to the method an acquirer uses to allocate the cost of a business combination to the net assets acquired could be used to measure the recoverable amount of goodwill after its initial recognition. Thus, the Board decided that some measure of the net assets of a cash-generating unit to which goodwill has been allocated should be subtracted from the recoverable amount of that unit to determine a current implied value for the goodwill. The Board concluded that the measure of the net assets of a cash-generating unit described in paragraph BC160(b) would result in the best estimate of the current implied value of the goodwill, given that goodwill generated internally after a business combination could not be measured separately.

BC162 Having decided on the most appropriate measure of the recoverable amount of goodwill, the Board then considered how often an entity should be required to test goodwill for impairment. Consistently with its conclusions about indefinite-lived intangibles, the Board concluded that non-amortisation of goodwill increases the reliance that must be placed on impairment tests to ensure that the carrying amount of goodwill does not exceed its recoverable amount. Accordingly, the Board decided that goodwill should be tested for impairment annually. However, the Board also concluded that the annual test is not a substitute for management being aware of events occurring or circumstances changing between annual tests indicating a possible impairment of goodwill. Therefore, the Board decided that an entity should also be required to test goodwill for impairment whenever there is an indication of possible impairment.

BC163 After the Board decided on the frequency of impairment testing, it expressed some concern that the proposed test would not be cost-effective. This concern related primarily to the requirement to determine the fair value of each identifiable asset, liability and contingent liability within a cash-generating unit that would be recognised by the entity if it had acquired the cash-generating unit in a business combination on the date of the impairment test (to estimate the implied value of goodwill).

BC164 Therefore, the Board decided to propose as a first step in the impairment test for goodwill a screening mechanism similar to that in SFAS 142. Under SFAS 142, goodwill is tested for impairment by first comparing the fair value of the reporting unit to which the goodwill has been allocated for impairment testing purposes with the carrying amount of that unit. If the fair value of the unit exceeds its carrying amount, the goodwill is regarded as not impaired. An entity need estimate the implied fair value of goodwill (using an approach consistent with that described in paragraph BC160) only if the fair value of the unit is less than its carrying amount.

The Board's redeliberations

BC165 Many respondents disagreed with the proposal to adopt a two-step approach to impairment testing goodwill. In particular, the second step of the proposed impairment test and the method for measuring any impairment loss for the goodwill caused considerable concern. Respondents provided the following conceptual arguments against the proposed approach:

(a) by drawing on only some aspects of the SFAS 142 two-step approach, the result is a hybrid between fair values and value in use. More particularly, not measuring goodwill's implied value as the difference between the unit's fair value and the net fair value of the identifiable net assets in the unit, but instead measuring it as the difference between the unit's recoverable amount (ie higher of value in use and fair value less costs to sell) and the net fair value of the identifiable net assets in the unit, results in a measure of goodwill that conceptually is neither fair value nor recoverable amount. This raises questions about the conceptual validity of measuring goodwill impairment losses as the difference between goodwill's implied value and carrying amount.

(b) it seems inconsistent to consider goodwill separately for impairment testing when other assets within a unit are not considered separately but are instead considered as part of the unit as a whole, particularly given that goodwill, unlike many other assets, cannot generate cash inflows independently of other assets. The previous version of IAS 36 is premised on the notion that if a series of independent cash flows can be generated only by a group of assets operating together, impairment losses should be considered only for that group of assets as a whole—individual assets within the group should not be considered separately.

(c) concluding that the recoverable amount of goodwill—which cannot generate cash inflows independently of other assets— should be measured separately for measuring impairment losses makes it difficult to understand how the Board could in the future reasonably conclude that such an approach to measuring impairment losses is also not appropriate for other assets. In other words, if it adopts the proposed two-step approach for goodwill, the Board could in effect be committing itself to an 'individual asset/fair value' approach for measuring impairments of all other assets. A decision on this issue should be made only as part of a broad reconsideration of the appropriate measurement objective for impairment testing generally.

(d) if goodwill is considered separately for impairment testing using an implied value calculation when other assets within a unit are considered only as part of the unit as a whole, there will be asymmetry: unrecognised goodwill will shield the carrying value of other assets from impairment, but the unrecognised value of other assets will not shield the carrying amount of goodwill from impairment. This seems unreasonable given that the unrecognised value of those other assets cannot then be recognised. Additionally, the carrying amount of a unit will be less than its recoverable amount whenever an impairment loss for goodwill exceeds the unrecognised value of the other assets in the unit.

BC166 Additionally, respondents, field visit participants and North American round-table participants raised the following concerns about the practicability and costs of applying the proposed two-step approach:

(a) many companies would be required regularly to perform the second step of the impairment test, and therefore would need to determine the fair values of each identifiable asset, liability and contingent liability within the impaired unit(s) that the entity would recognise if it acquired the unit(s) in a business combination on the date of the impairment test. Although determining these fair values would not, for some companies, pose significant practical challenges (because, for example, fair value information for their significant assets is readily available), most would need to engage, on a fairly wide scale and at significant cost, independent valuers for some or all of the unit's assets. This is particularly the case for identifying and measuring the fair values of unrecognised internally generated intangible assets.

(b) determining the fair values of each identifiable asset, liability and contingent liability within an impaired unit is likely to be impracticable for multi-segmented manufacturers that operate multi-product facilities servicing more than one cash-generating unit. For example, assume an entity's primary basis of segmentation is geographical (eg Europe, North America, South America, Asia, Oceania and Africa) and that its secondary basis of segmentation is based on product groups (vaccinations, over-the-counter medicines, prescription medicines and vitamins/dietary supplements).[*] Assume also that:

(i) the lowest level within the entity at which the goodwill is monitored for internal management purposes is one level below primary segment (eg the vitamins business in North America), and that goodwill is therefore tested for impairment at this level;

(ii) the plants and distribution facilities in each geographical region manufacture and distribute for all product groups; and

(iii) to determine the carrying amount of each cash-generating unit containing goodwill, the carrying amount of each plant and distribution facility has been allocated between each product group it services.

If, for example, the recoverable amount of the North American vitamins unit were less than its carrying amount, measuring the implied value of goodwill in that unit would require a valuation exercise to be undertaken for *all* North American assets so that a portion of each asset's fair value can then be allocated to the North American vitamins

[*] In 2006 IAS 14 was replaced by IFRS 8 *Operating Segments*, which does not require disclosure of primary and secondary segment information. See paragraph BC150A.

unit. These valuations are likely to be extremely costly and virtually impossible to complete within a reasonable time period (field visit participants' estimates ranged from six to twelve months). The degree of impracticability will be even greater for those entities that monitor, and therefore test, goodwill at the segment level.

BC167 In considering the above comments, the Board noted that:

(a) all of the US registrant field visit participants and North American round-table participants that have had to perform the second step of the SFAS 142 impairment test were compelled to engage, at significant cost, independent valuers.

(b) the impairment model proposed in the Exposure Draft, although based on the two-step approach in SFAS 142, differed from the SFAS 142 test and would be unlikely to result in convergence for the following reasons:

(i) the recoverable amount of a unit to which goodwill is allocated in accordance with IAS 36 would be the higher of the unit's value in use and fair value less costs to sell, rather than fair value. Many of the US registrant field visit participants stated that the measure of recoverable amount they would use under IAS 36 would differ from the fair value measure they would be required to use under SFAS 142.

(ii) the level at which goodwill is tested for impairment in accordance with SFAS 142 will often be higher than the level at which it would be tested under IAS 36. Many of the US registrant field visit participants stated that goodwill would be tested for impairment in accordance with IAS 36 at a lower level than under SFAS 142 because of either: (1) the limit SFAS 142 places on how far goodwill can be 'pushed down' for impairment testing (ie one level below an operating segment); or (2) the requirement in SFAS 142 to aggregate components with similar economic characteristics. Nevertheless, these participants unanimously agreed that the IAS 36 approach provides users and management with more useful information. The Board also noted that many of the North American round-table participants stated that they (or, in the case of audit firm participants, their clients) manage and have available information about their investments in goodwill at a level lower than a reporting unit as defined in SFAS 142. Many of these participants expressed a high level of dissatisfaction at being prevented by SFAS 142 from recognising goodwill impairments that they knew existed at these lower levels, but 'disappeared' once the lower level units were aggregated with other units containing sufficient 'cushions' to offset the impairment loss.

BC168 The Board also noted that, unlike SFAS 142, it had as its starting point an impairment model in IAS 36 that integrates the impairment testing of *all* assets within a cash-generating unit, including goodwill. Unlike US generally accepted accounting principles (GAAP), which use an undiscounted cash flow screening mechanism for impairment testing long-lived assets other than goodwill, IAS 36 requires the recoverable amount of an asset or cash-generating unit to be measured whenever there is an indication of possible impairment. Therefore, if at the time of impairment testing a 'larger' unit to which goodwill has been allocated there is an indication of a possible impairment in an asset or 'smaller' cash-generating unit included in that larger unit, an entity is required to test that asset or smaller unit for impairment first. Consequently, the Board concluded that it would be reasonable in an IAS 36 context to presume that an impairment loss for the larger unit would, after all other assets and smaller units are assessed for impairment, be likely to relate to the goodwill in the unit. Such a presumption would not be reasonable if an entity were following US GAAP.

BC169 The Board considered converging fully with the SFAS 142 approach. However, although supporting convergence, the Board was concerned that the SFAS 142 approach would not provide better information than an approach under which goodwill is tested for impairment at a lower level (thereby removing many of the 'cushions' protecting the goodwill from impairment) but with the amount of any impairment loss for goodwill measured in accordance with the one-step approach in the previous version of IAS 36.

BC170 The Board concluded that the complexity and costs of applying the two-step approach proposed in the Exposure Draft would outweigh the benefits of that approach. Therefore, the Board decided to retain the approach to measuring impairments of goodwill included in the previous version of IAS 36. Thus, the Standard requires any excess of the carrying amount of a cash-generating unit (group of units) to which goodwill has been allocated over its recoverable amount to be recognised first as an impairment loss for goodwill. Any excess remaining after the carrying amount of goodwill has been reduced to zero is then recognised by being allocated to the other assets of the unit pro rata with their carrying amounts.

Changes as a result of 2008 revisions to IFRS 3 (Appendix C)

BC170A As a result of the changes to IFRS 3 (as revised in 2008), the requirements in Appendix C of the Standard and the related illustrative examples have been amended to reflect the two ways of measuring non-controlling interests: at fair value and as a proportion of the identifiable net assets of the acquiree. Appendix C has also been modified to clarify the requirements of the Standard.

Timing of impairment tests (paragraphs 96-99)

BC171 To reduce the costs of applying the test, and consistently with the proposals in the Exposure Draft, the Standard permits the annual impairment test for a cash-generating unit (group of units) to which goodwill has been allocated to be performed at any time during an annual period, provided the test is performed at the same time every year. Different cash-generating units (groups of units) may be tested for impairment at different times. However, if some or all of the goodwill allocated to a unit (group of units) was acquired in a business combination during the current annual period, that unit (group of units) must be tested for impairment before the end of the current annual period.

BC172 The Board observed that acquirers can sometimes 'overpay' for an acquiree, resulting in the amount initially recognised for the business combination and the resulting goodwill exceeding the recoverable amount of the investment. The Board concluded that the users of an entity's financial statements are provided with representationally faithful, and therefore useful, information about a business combination if such an impairment loss is recognised by the acquirer in the annual period in which the business combination occurs.

BC173 The Board was concerned that it might be possible for entities to delay recognising such an impairment loss until the annual period after the business combination if the Standard included only a requirement to impairment test cash-generating units (groups of units) to which goodwill has been allocated on an annual basis at any time during a period. Therefore, the Board decided to include in the Standard the added requirement that if some or all of the goodwill allocated to a unit (group of units) was acquired in a business combination during the current annual period, the unit (group of units) should be tested for impairment before the end of that period.

Sequence of impairment tests (paragraph 97)

BC174 The Standard requires that if the assets (cash-generating units) constituting the cash-generating unit (group of units) to which goodwill has been allocated are tested for impairment at the same time as the unit (group of units) containing the goodwill, those other assets (units) should be tested for impairment before the unit (group of units) containing the goodwill.

BC175 The Board observed that assets or cash-generating units making up a unit or group of units to which goodwill has been allocated might need to be tested for impairment at the same time as the unit or group of units containing the goodwill when there is an indication of a possible impairment of the asset or smaller unit. The Board concluded that to assess whether the unit or group of units containing the goodwill, and therefore whether the goodwill, is impaired, the carrying amount of the unit or group of units containing the goodwill would need first to be adjusted by recognising any impairment losses relating to the assets or smaller units within that unit or group of units.

Carrying forward a recoverable amount calculation (paragraph 99)

BC176 Consistently with the impairment test for indefinite-lived intangibles, the Standard permits the most recent detailed calculation of the recoverable amount of a cash-generating unit (group of units) to which goodwill has been allocated to be carried forward from a preceding period for use in the current period's impairment test, provided all of the criteria in paragraph 99 are met.

BC177 Integral to the Board's decision that goodwill should be tested for impairment annually was the view that many entities should be able to conclude that the recoverable amount of a cash-generating unit (group of units) to which goodwill has been allocated is greater than its carrying amount without actually recomputing recoverable amount. However, again consistently with its conclusions about indefinite-lived intangibles, the Board concluded that this would be the case only if the last recoverable amount determination exceeded the carrying amount of the unit (group of units) by a substantial margin, and nothing had happened since that last determination to make the likelihood of an impairment loss other than remote. The Board concluded that in such circumstances, permitting a detailed calculation of the recoverable amount of a cash-generating unit (group of units) to which goodwill has been allocated to be carried forward from the preceding period for use in the current period's impairment test would significantly reduce the costs of applying the impairment test, without compromising its integrity.

Allocating an impairment loss between the assets of a cash-generating unit (paragraphs 104-107)

BCZ178 IAS 36 includes requirements for the allocation of an impairment loss for a cash-generating unit that differ from the proposals in E55. In particular, E55 proposed that an impairment loss should be allocated:

(a) first, to goodwill;

(b) secondly, to intangible assets for which no active market exists;

(b) thirdly, to assets whose net selling price* is less than their carrying amount; and

(d) then, to the other assets of the unit on a pro-rata basis based on the carrying amount of each asset in the unit.

BCZ179 The underlying reasons for making this proposal were that:

(a) an impairment loss for a cash-generating unit should be allocated, in priority, to assets with the most subjective values. Goodwill and intangible assets for which there is no active market were considered to be in that category. Intangible assets for which there is no active market were considered to be similar to goodwill (IASC was thinking of brand names, publishing titles etc).

(b) if the net selling price of an asset is less than its carrying amount, this was considered a reasonable basis for allocating part of the impairment loss to that asset rather than to other assets.

BCZ180 Many commentators on E55 objected to the proposal on the grounds that:

(a) not all intangible assets for which no active market exists are similar to goodwill (for example, licences and franchise rights). They disagreed that the value of intangible assets is always more subjective than the value of tangible assets (for example, specialised plant and equipment).

(b) the concept of cash-generating units implies a global approach for the assets of the units and not an asset-by-asset approach.

In response to these comments, IASC decided to withdraw E55's proposal for the allocation of an impairment loss to intangible assets and assets whose net selling price is less than their carrying amount.

BCZ181 IASC rejected a proposal that an impairment loss for a cash-generating unit should be allocated first to any obviously impaired asset. IASC believed that if the recoverable amount of an obviously impaired asset can be determined for the individual asset, there is no need to estimate the recoverable amount of the asset's cash-generating unit. If the recoverable amount of an individual asset cannot be determined, it cannot be said that the asset is obviously impaired because an impairment loss for a cash-generating unit relates to all of the assets of that unit.

Reversing impairment losses for assets other than goodwill (paragraphs 110-123)

BCZ182 IAS 36 requires that an impairment loss for an asset other than goodwill should be reversed if, and only if, there has been a change in the estimates used to determine an asset's recoverable amount since the last impairment loss was recognised.

* In IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, issued by the IASB in 2004, the term, 'net selling price' was replaced in IAS 36 by 'fair value less costs to sell'.

BCZ183 Opponents of reversals of impairment losses argue that:

(a) reversals of impairment losses are contrary to the historical cost accounting system. When the carrying amount is reduced, recoverable amount becomes the new cost basis for an asset. Consequently, reversing an impairment loss is no different from revaluing an asset upward. Indeed, in many cases, recoverable amount is similar to the measurement basis used for the revaluation of an asset. Hence, reversals of impairment losses should be either prohibited or recognised directly in equity as a revaluation.

(b) reversals of impairment losses introduce volatility in reported earnings. Periodic, short-term income measurements should not be affected by unrealised changes in the measurement of a long-lived asset.

(c) the result of reversals of impairment losses would not be useful to users of financial statements since the amount of a reversal under IAS 36 is limited to an amount that does not increase the carrying amount of an asset above its depreciated historical cost. Neither the amount reversed nor the revised carrying amount have any information content.

(d) in many cases, reversals of impairment losses will result in the implicit recognition of internally generated goodwill.

(e) reversals of impairment losses open the door to abuse and income 'smoothing' in practice.

(f) follow-up to verify whether an impairment loss needs to be reversed is costly.

BCZ184 IASC's reasons for requiring reversals of impairment losses were the following:

(a) it is consistent with the *Framework* and the view that future economic benefits that were not previously expected to flow from an asset have been reassessed as probable.

(b) a reversal of an impairment loss is not a revaluation and is consistent with the historical cost accounting system as long as the reversal does not result in the carrying amount of an asset exceeding its original cost less amortisation/depreciation, had the impairment loss not been recognised. Accordingly, the reversal of an impairment loss should be recognised in the income statement and any amount in excess of the depreciated historical cost should be accounted for as a revaluation.

(c) impairment losses are recognised and measured based on estimates. Any change in the measurement of an impairment loss is similar to a change in estimate. IAS 8 *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies*[*] requires that a change in accounting estimate should be included in the determination of the net profit or loss in (a) the period of the change, if the change affects the period only, or (b) the period of the change and future periods, if the change affects both.

[*] IAS 8 *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies* was superseded in 2003 by IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

(d) reversals of impairment losses provide users with a more useful indication of the potential for future benefits of an asset or group of assets.

(e) results of operations will be more fairly stated in the current period and in future periods because depreciation or amortisation will not reflect a previous impairment loss that is no longer relevant. Prohibition of reversals of impairment losses may lead to abuses such as recording a significant loss one year with the resulting lower amortisation/depreciation charge and higher profits in subsequent years.

BCZ185 The majority of commentators on E55 supported IASC's proposals for reversals of impairment losses.

BCZ186 IAS 36 does not permit an enterprise to recognise a reversal of an impairment loss just because of the unwinding of the discount. IASC supported this requirement for practical reasons only. Otherwise, if an impairment loss is recognised and recoverable amount is based on value in use, a reversal of the impairment loss would be recognised in each subsequent year for the unwinding of the discount. This is because, in most cases, the pattern of depreciation of an asset is different from the pattern of value in use. IASC believed that, when there is no change in the assumptions used to estimate recoverable amount, the benefits from recognising the unwinding of the discount each year after an impairment loss has been recognised do not justify the costs involved. However, if a reversal is recognised because assumptions have changed, the discount unwinding effect is included in the amount of the reversal recognised.

Reversing goodwill impairment losses (paragraph 124)

BC187 Consistently with the proposal in the Exposure Draft, the Standard prohibits the recognition of reversals of impairment losses for goodwill. The previous version of IAS 36 required an impairment loss for goodwill recognised in a previous period to be reversed when the impairment loss was caused by a specific external event of an exceptional nature that was not expected to recur, and subsequent external events had occurred that reversed the effect of that event.

BC188 Most respondents to the Exposure Draft agreed that reversals of impairment losses for goodwill should be prohibited. Those that disagreed argued that reversals of impairment losses for goodwill should be treated in the same way as reversals of impairment losses for other assets, but limited to circumstances in which the impairment loss was caused by specific events beyond the entity's control.

BC189 In revising IAS 36, the Board noted that IAS 38 *Intangible Assets* prohibits the recognition of internally generated goodwill. Therefore, if reversals of impairment losses for goodwill were permitted, an entity would need to establish the extent to which a subsequent increase in the recoverable amount of goodwill is attributable to the recovery of the acquired goodwill within a cash-generating unit, rather than an increase in the internally generated goodwill within the unit. The Board concluded that this will seldom, if ever, be possible. Because the acquired goodwill and internally generated goodwill contribute jointly to the same cash flows, any subsequent increase in the recoverable amount of the acquired goodwill is indistinguishable from an increase in the internally generated goodwill. Even if the specific external event that caused the recognition of the impairment loss is reversed, it will seldom, if ever, be possible to determine that the effect of that reversal is a corresponding increase in the recoverable amount of the acquired goodwill. Therefore, the Board concluded that reversals of impairment losses for goodwill should be prohibited.

BC190 The Board expressed some concern that prohibiting the recognition of reversals of impairment losses for goodwill so as to avoid recognising internally generated goodwill might be viewed by some as inconsistent with the impairment test for goodwill. This is because the impairment test results in the carrying amount of goodwill being shielded from impairment by internally generated goodwill. This has been described by some as 'backdoor' capitalisation of internally generated goodwill.

BC191 However, the Board was not as concerned about goodwill being shielded from the recognition of impairment losses by internally generated goodwill as it was about the direct recognition of internally generated goodwill that might occur if reversals of impairment losses for goodwill were permitted. As discussed in paragraph BC135, the Board is of the view that it is not possible to devise an impairment test for acquired goodwill that removes the cushion against the recognition of impairment losses provided by goodwill generated internally after a business combination.

Disclosures for cash-generating units containing goodwill or indefinite-lived intangibles (paragraphs 134 and 135)

Background to the proposals in the Exposure Draft

BC192 The Exposure Draft proposed requiring an entity to disclose a range of information about cash-generating units whose carrying amounts included goodwill or indefinite-lived intangibles. That information included:

(a) the carrying amount of goodwill and the carrying amount of indefinite-lived intangibles.

(b) the basis on which the unit's recoverable amount had been determined (ie value in use or net selling price).

(c) the amount by which the unit's recoverable amount exceeded its carrying amount.

(d) the key assumptions and estimates used to measure the unit's recoverable amount and information about the sensitivity of that recoverable amount to changes in the key assumptions and estimates.

BC193 If an entity reports segment information in accordance with IAS 14 *Segment Reporting*, the Exposure Draft proposed that this information should be disclosed in aggregate for each segment based on the entity's primary reporting format. However, the Exposure Draft also proposed that the information would be disclosed separately for a cash-generating unit when:

(a) the carrying amount of the goodwill or indefinite-lived intangibles allocated to the unit was significant in relation to the total carrying amount of goodwill or indefinite-lived intangibles; or

(b) the basis for determining the unit's recoverable amount differed from the basis used for the other units within the segment whose carrying amounts include goodwill or indefinite-lived intangibles; or

(c) the nature of, or value assigned to the key assumptions or growth rate on which management based its determination of the unit's recoverable amount differed significantly from that used for the other units within the segment whose carrying amounts include goodwill or indefinite-lived intangibles.

BC194 In deciding to propose these disclosure requirements in the Exposure Draft, the Board observed that non-amortisation of goodwill and indefinite-lived intangibles increases the reliance that must be placed on impairment tests of those assets to ensure that their carrying amounts do not exceed their recoverable amounts. However, the nature of impairment tests means that the carrying amounts of such assets and the related assertion that those carrying amounts are recoverable will normally be supported only by management's projections. Therefore, the Board decided to examine ways in which the reliability of the impairment tests for goodwill and indefinite-lived intangibles could be improved. As a first step, the Board considered including a subsequent cash flow test in the revised Standard, similar to that included in UK Financial Reporting Standard 11 *Impairment of Fixed Assets and Goodwill* (FRS 11).

Subsequent cash flow test

BC195 FRS 11 requires an entity to perform a subsequent cash flow test to confirm, ex post, the cash flow projections used to measure a unit's value in use when testing goodwill for impairment. Under FRS 11, for five years following each impairment test for goodwill in which recoverable amount has been based on value in use, the actual cash flows achieved must be compared with those forecast. If the actual cash flows are so much less than those forecast that use of the actual cash flows in the value in use calculation could have required recognition of an impairment in previous periods, the original impairment calculations must be re-performed using the actual cash flows, but without revising any other cash flows or assumptions (except those that change as a direct consequence of the occurrence of the actual cash flows, for example where a major cash inflow has been delayed for a year). Any impairment identified must then be recognised in the current period, unless the impairment has reversed and the reversal of the loss satisfies the criteria in FRS 11 regarding reversals of impairment losses for goodwill.

BC196 The Board noted the following arguments in support of including a similar test in the revised Standard:

(a) it would enhance the reliability of the goodwill impairment test by preventing the possibility of entities avoiding the recognition of impairment losses by using over-optimistic cash flow projections in the value in use calculations.

(b) it would provide useful information to users of an entity's financial statements because a record of actual cash flows continually less than forecast cash flows tends to cast doubt on the reliability of current estimates.

BC197 However, the subsequent cash flow test is designed only to prevent entities from avoiding goodwill write-downs. The Board observed that, given current trends in 'big bath' restructuring charges, the greater risk to the quality of financial reporting might be from entities trying to write off goodwill without adequate justification in an attempt to 'manage' the balance sheet. The Board also observed that:

(a) the focus of the test on cash flows ignores other elements in the measurement of value in use. As a result, it does not produce representationally faithful results in a present value measurement system. The Board considered incorporating into the recalculation performed under the test corrections of estimates of other elements in the measurement of value in use. However, the Board concluded that specifying which elements to include would be problematic. Moreover, adding corrections of estimates of those other elements to the test would, in effect, transform the test into a requirement to perform a comprehensive recalculation of value in use for each of the five annual reporting periods following an impairment test.

(b) the amount recognised as an impairment loss under the test is the amount of the impairment that would have been recognised, provided changes in estimates of remaining cash flows and changes in discount and growth rates are ignored. Therefore, it is a hypothetical amount that does not provide decision-useful information—it is neither an estimate of a current amount nor a prediction of ultimate cash flows.

(c) the requirement to perform the test for each of the five annual reporting periods following an impairment test could result in an entity having to maintain as many as five sets of 5-year computations for each cash-generating unit to which goodwill has been allocated. Therefore, the test is likely to be extremely burdensome, particularly if an entity has a large number of such units, without producing understandable or decision-useful information.

BC198 Therefore, the Board decided not to propose a subsequent cash flow test in the Exposure Draft. However, the Board remained committed to finding some way of improving the reliability of the impairment tests for goodwill and indefinite-lived intangibles, and decided to explore improving that reliability through disclosure requirements.

Including disclosure requirements in the revised Standard

BC199 In developing the Exposure Draft, the Board observed that the *Framework* identifies reliability as one of the key qualitative characteristics that information must possess to be useful to users in making economic decisions. To be reliable, information must be free from material error and bias and be able to be depended upon to represent faithfully that which it purports to represent. The *Framework* identifies relevance as another key qualitative characteristic that information must possess to be useful to users in making economic decisions. To be relevant, information must help users to evaluate past, present or future events, or confirm or correct their past evaluations.

BC200 The Board observed that information that assists users in evaluating the reliability of other information included in the financial statements is itself relevant, increasing in relevance as the reliability of that other information decreases. For example, information that assists users in evaluating the reliability of the amount recognised for a provision is relevant because it helps users to evaluate the effect of both a past event (ie the economic consequences of the past event giving rise to the present obligation) and a future event (ie the amount of the expected future outflow of economic benefits required to settle the obligation). Accordingly, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* requires an entity to disclose, for each class of provision, information about the uncertainties surrounding the amount and timing of expected outflows of economic benefits, and the major assumptions concerning future events that may affect the amount required to settle the obligation and have been reflected in the amount of the provision.

BC201 The Board concluded that because information that assists users in evaluating the reliability of other information is itself relevant, an entity should disclose information that assists users in evaluating the reliability of the estimates used by management to support the carrying amounts of goodwill and indefinite-lived intangibles.

BC202 The Board also concluded that such disclosures would provide users with more useful information for evaluating the reliability of the impairment tests for goodwill and indefinite-lived intangibles than the information that would be provided by a subsequent cash flow test.

BC203 The Board then considered how some balance might be achieved between the objective of providing users with useful information for evaluating the reliability of the estimates used by management to support the carrying amounts of goodwill and indefinite-lived intangibles, and the potential magnitude of those disclosures.

BC204 The Board decided that a reasonable balance might be achieved between the objective of the disclosures and their potential magnitude by requiring:

(a) information to be disclosed on an aggregate basis for each segment based on the entity's primary reporting format that includes in its carrying amount goodwill or indefinite-lived intangibles; but

(b) information for a particular cash-generating unit within that segment to be excluded from the aggregate information and disclosed separately when either:

(i) the basis (ie net selling price or value in use), methodology or key assumptions used to measure its recoverable amount differ from those used to measure the recoverable amounts of the other units in the segment; or

(ii) the carrying amount of the goodwill or indefinite-lived intangibles in the unit is significant in relation to the total carrying amount of goodwill or indefinite-lived intangibles.

The Board's redeliberations

BC205 After considering respondents' and field visit participants' comments, the Board confirmed its previous conclusion that information that assists users in evaluating the reliability of other information is itself relevant, increasing in relevance as the reliability of that other information decreases. Therefore, entities should be required to disclose information that assists users in evaluating the reliability of the estimates used by management to support the carrying amounts of goodwill and indefinite-lived intangibles. The Board noted that almost all field visit participants and many respondents expressed explicit support of its conclusion that, because non-amortisation of goodwill and indefinite-lived intangibles increases the reliance that must be placed on impairment tests of those assets, some additional disclosure is necessary to provide users with information for evaluating the reliability of those impairment tests.

BC206 However, it was clear from field visit participants' responses that the proposed disclosures could not be meaningfully aggregated at the segment level to the extent the Board had hoped might be the case. As a result, the proposal to require the information to be disclosed on an aggregate basis for each segment, but with disaggregated disclosures for cash-generating units in the circumstances set out in paragraph BC193 would not result in a reasonable balance between the objective of the disclosures and their potential magnitude.

BC207 The Board was also sympathetic to field visit participants' and respondents' concerns that the proposed disclosures went beyond their intended objective of providing users with relevant information for evaluating the reliability of the impairment tests for goodwill and indefinite-lived intangibles. For example, field visit participants and respondents argued that:

(a) it would be extremely difficult to distil the recoverable amount calculations into concise but meaningful disclosures because those calculations typically are complex and do not normally result in a single point estimate of recoverable amount—a single value for recoverable amount would normally be determined only when the bottom-end of the recoverable amount range is less than a cash-generating unit's carrying amount. These difficulties make it doubtful that the information, particularly the sensitivity analyses, could be produced on a timely basis.

(b) disclosing the proposed information, particularly the values assigned to, and the sensitivity of, each key assumption on which recoverable amount calculations are based, could cause significant commercial harm to an entity. Users of financial statements might, for example, use the quantitative disclosures as the basis for initiating litigation against the entity, its board of directors or management in the highly likely event that those assumptions prove less than accurate. The increased litigation risk would either encourage management to use super-conservative assumptions, thereby resulting in improper asset write-downs, or compel management to engage independent experts to develop all key assumptions and perform the recoverable amount calculations. Additionally, many of the field visit participants expressed concern over the possible impact that disclosing such information might have on their ability to defend themselves in various legal proceedings.

BC208 Therefore, the Board considered the following two interrelated issues:

(a) if the proposed disclosures went beyond their intended objective, what information *should* be disclosed so that users have sufficient information for evaluating the reliability of impairment tests for goodwill and indefinite-lived intangibles?

(b) how should this information be presented so that there is an appropriate balance between providing users with information for evaluating the reliability of the impairment tests, and the potential magnitude of those disclosures?

BC209 As a result of its redeliberations, the Board decided:

(a) not to proceed with the proposal to require information for evaluating the reliability of the impairment tests for goodwill and indefinite-lived intangibles to be disclosed in aggregate for each segment and separately for cash-generating units within a segment in specified circumstances. Instead, the Standard requires this information to be disclosed only for each cash-generating unit (group of units) for which the carrying amount of goodwill or indefinite-lived intangibles allocated to that unit (group of units) is significant in comparison with the entity's total carrying amount of goodwill or indefinite-lived intangibles.

(b) not to proceed with the proposal to require an entity to disclose the amount by which the recoverable amount of a cash-generating unit exceeds its carrying amount. Instead, the Standard requires an entity to disclose this information only if a reasonably possible change in a key assumption on which management has based its determination of the unit's (group of units') recoverable amount would cause the unit's (group of units') carrying amount to exceed its recoverable amount.

(c) not to proceed with the proposal to require an entity to disclose the value assigned to each key assumption on which management based its recoverable amount determination, and the amount by which that value must change, after incorporating any consequential effects of that change on the other variables used to measure recoverable amount, in order for the unit's recoverable amount to be equal to its carrying amount. Instead, the Standard requires an entity to disclose a description of each key assumption on which management has based its recoverable amount determination, management's approach to determining the value(s) assigned to each key assumption, whether those value(s) reflect past experience or, if appropriate, are consistent with external sources of information, and, if not, how and why they differ from past experience or external sources of information. However, if a reasonably possible change in a key assumption would cause the unit's (group of units') carrying amount to exceed its recoverable amount, the entity is also required to disclose the value assigned to the key assumption, and the amount by which that value must change, after incorporating any consequential effects of that change on the other variables used to measure recoverable amount, in order for the unit's (group of units') recoverable amount to be equal to its carrying amount.

(d) to require information about key assumptions to be disclosed also for any key assumption that is relevant to the recoverable amount determination of multiple cash-generating units (groups of units) that individually contain insignificant amounts of goodwill or indefinite-lived intangibles, but contain, in aggregate, significant amounts of goodwill or indefinite-lived intangibles.

Changes as a result of *Improvements to IFRSs* (2008)*

BC209A The Board noted that the disclosures that IAS 36 requires when value in use is used to determine recoverable amount differ from those required when fair value less costs to sell is used. These differing requirements appear inconsistent when a similar valuation methodology (discounted cash flows) has been used. Therefore, as part of *Improvements to IFRSs* issued in May 2008, the Board decided to require the same disclosures for fair value less costs to sell and value in use when discounted cash flows are used to estimate recoverable amount.

Transitional provisions (paragraphs 138-140)

BC210 If an entity elects to apply IFRS 3 from any date before the effective dates outlined in IFRS 3, it is also required to apply IAS 36 from that same date. Paragraphs BC181-BC184 of the Basis for Conclusions on IFRS 3 outline the Board's deliberations on this issue.†

BC211 Otherwise, IAS 36 is applied:

(a) to goodwill and intangible assets acquired in business combinations for which the agreement date is on or after 31 March 2004; and

(b) to all other assets prospectively from the beginning of the first annual period beginning on or after 31 March 2004.

BC212 In developing the requirements set out in paragraph BC211, the Board considered whether entities should be required:

(a) to apply retrospectively the revised impairment test for goodwill; and

(b) to apply retrospectively the requirement prohibiting reversals of impairment losses for goodwill and therefore eliminate any reversals recognised before the date the revised Standard was issued.

BC213 The Board concluded that retrospective application of the revised impairment test for goodwill would be problematic for the following reasons:

(a) it was likely to be impossible in many cases because the information needed may not exist or may no longer be obtainable.

(b) it would require the determination of estimates that would have been made at a prior date, and therefore would raise the problem of how the effect of hindsight could be separated from the factors existing at the date of the impairment test.

BC214 The Board also noted that the requirement for goodwill to be tested for impairment annually, irrespective of whether there is any indication that it may be impaired, will ensure that by the end of the first period in which the Standard is effective, all recognised goodwill acquired before its effective date would be tested for impairment.

* This heading and paragraph BC209A were added by *Improvements to IFRSs* issued in May 2008.

† The Board issued a revised IFRS 3 in 2008. This paragraph relates to IFRS 3 as issued in 2004.

BC215 In the case of reversals of impairment losses for goodwill, the Board acknowledged that requiring the elimination of reversals recognised before the revised Standard's effective date might seem appropriate, particularly given the Board's reasons for prohibiting reversals of impairment losses for goodwill (see paragraphs BC187-BC191). The Board concluded, however, that the previous amortisation of that goodwill, combined with the requirement for goodwill to be tested for impairment at least annually, ensures that the carrying amount of the goodwill does not exceed its recoverable amount at the end of the reporting period in which the Standard is effective. Therefore, the Board concluded that the Standard should apply on a prospective basis.

Transitional impairment test for goodwill

BC216 Given that one of the objectives of the first phase of the Business Combinations project was to seek international convergence on the accounting for goodwill, the Board considered whether IAS 36 should include a transitional goodwill impairment test similar to that included in SFAS 142. SFAS 142 requires goodwill to be tested for impairment annually, and between annual tests if an event occurs or circumstances change and would be more likely than not to reduce the fair value of a reporting unit below its carrying amount. The transitional provisions in SFAS 142 require the impairment test for goodwill to be applied prospectively. However, a transitional goodwill impairment test must be performed as of the *beginning* of the fiscal year in which SFAS 142 is applied in its entirety. An impairment loss recognised as a result of a transitional test is recognised as the effect of a change in accounting principle, rather than as an impairment loss. In addition to the transitional test, SFAS 142 requires an entity to perform the required annual goodwill impairment test in the year that SFAS 142 is initially applied in its entirety. In other words, the transitional goodwill impairment test may not be regarded as the initial year's annual test unless an entity designates the beginning of its fiscal year as the date for its annual goodwill impairment test.

BC217 The FASB concluded that goodwill that was not regarded as impaired under US GAAP before SFAS 142 was issued could be determined to be impaired if the SFAS 142 impairment test was applied to that goodwill at the date an entity initially applied SFAS 142. This is because, under previous US GAAP, entities typically tested goodwill for impairment using undiscounted estimates of future cash flows. The FASB further concluded that:

(a) the preponderance of any transitional impairment losses was likely to result from the change in methods and treating those losses as stemming from changes in accounting principles would therefore be more representationally faithful.

(b) given that a transitional impairment loss should be reported as a change in accounting principle, the transitional goodwill impairment test should ideally apply as of the date SFAS 142 is initially applied.

BC218 The Board observed that under the previous version of IAS 36, goodwill that was amortised over a period exceeding 20 years was required to be tested for impairment at least at each financial year-end. Goodwill that was amortised over a period not exceeding 20 years was required to be tested for impairment at the balance sheet date if there was an indication that it might be impaired. The revised Standard requires goodwill to be tested for impairment annually or more frequently if there is an indication the goodwill might be impaired. It also carries forward from the previous version of IAS 36 (a) the indicators of impairment, (b) the measure of recoverable amount (ie higher of value in use and fair value less costs to sell), and (c) the requirement for an impairment loss for a cash-generating unit to be allocated first to reduce the carrying amount of any goodwill allocated to the unit.

BC219 Therefore, goodwill tested for impairment in accordance with the previous version of the revised Standard immediately before the beginning of the reporting period in which the revised Standard becomes effective (because it was being amortised over a period exceeding 20 years or because there was an indicator of impairment) could not be identified as impaired under IAS 36 at the beginning of the period in which it becomes effective. This is because application of the Standard results in a goodwill impairment loss being identified only if the carrying amount of the cash-generating unit (group of units) to which the goodwill has been allocated exceeds its recoverable amount, and the impairment test in the previous version of IAS 36 ensures that this will not be the case.

BC220 The Board concluded that there would be only one possible situation in which a transitional impairment test might give rise to the recognition of an impairment loss for goodwill. This would be when goodwill being amortised over a period not exceeding 20 years was, immediately before the beginning of the period in which the revised Standard becomes effective, impaired in the absence of any indicator of impairment that ought reasonably to have been considered by the entity. The Board concluded that this is likely to be a rare occurrence.

BC221 The Board observed that any such impairment loss would nonetheless be recognised as a consequence of applying the requirement in IAS 36 to test goodwill for impairment at least annually. Therefore, the only benefit of applying a transitional impairment test would be, in those rare cases, to separate the impairment loss arising before the period in which the revised Standard is effective from any impairment loss arising after the beginning of that period.

BC222 The Board concluded that given the rare circumstances in which this issue would arise, the benefit of applying a transitional goodwill impairment test would be outweighed by the added costs of the test. Therefore, the Board decided that the revised Standard should not require a transitional goodwill impairment test.

Transitional impairment test for indefinite-lived intangibles

BC223 SFAS 142 also requires a transitional impairment test to be applied, as of the beginning of the fiscal year in which that Standard is initially applied, to intangible assets recognised before the effective date of SFAS 142 that are reassessed as having indefinite useful lives. An impairment loss arising from that transitional impairment test is recognised as the effect of a change in accounting principle rather than as an impairment loss. As with goodwill:

(a) intangible assets that cease being amortised upon initial application of SFAS 142 are tested for impairment in accordance with SFAS 142 using a different method from what had previously applied to those assets. Therefore, it is possible that such an intangible asset not previously regarded as impaired might be determined to be impaired under SFAS 142.

(b) the FASB concluded that the preponderance of any transitional impairment losses would be likely to result from the change in impairment testing methods. Treating those losses as stemming from changes in accounting principles is therefore more representationally faithful.

BC224 The Board considered whether IAS 36 should include a transitional impairment test for indefinite-lived intangibles similar to that in SFAS 142.

BC225 The Board observed that the previous version of IAS 38 *Intangible Assets* required an intangible asset being amortised over a period exceeding 20 years to be tested for impairment at least at each financial year-end in accordance with the previous version of IAS 36. An intangible asset being amortised over a period not exceeding 20 years was required, under the previous version of IAS 36, to be tested for impairment at the balance sheet date only if there was an indication the asset might be impaired. The revised Standard requires an indefinite-lived intangible to be tested for impairment at least annually. However, it also requires that the recoverable amount of such an asset should continue to be measured as the higher of the asset's value in use and fair value less costs to sell.

BC226 As with goodwill, the Board concluded that the revised Standard should not require a transitional impairment test for indefinite-lived intangibles because:

(a) the only circumstance in which a transitional impairment test might give rise to the recognition of an impairment loss would be when an indefinite-lived intangible previously being amortised over a period not exceeding 20 years was, immediately before the beginning of the period in which the revised Standard is effective, impaired in the absence of any indicator of impairment that ought reasonably to have been considered by the entity.

(b) any such impairment loss would nonetheless be recognised as a consequence of applying the requirement in the Standard to test such assets for impairment at least annually. Therefore, the only benefit of such a test would be to separate the impairment loss arising before the period in which the revised Standard is effective from any impairment loss arising after the beginning of that period.

(c) given the extremely rare circumstances in which this issue is likely to arise, the benefit of applying a transitional impairment test is outweighed by the added costs of the test.

Early application (paragraph 140)

BC227 The Board noted that the issue of any Standard demonstrates its opinion that application of the Standard will result in more useful information being provided to users about an entity's financial position, performance or cash flows. On that basis, a case exists for permitting, and indeed encouraging, entities to apply IAS 36 before its effective date. However, the Board also considered that permitting a revised Standard to be applied before its effective date potentially diminishes comparability between entities in the period(s) leading up to that effective date, and has the effect of providing entities with an option.

BC228 The Board concluded that the benefit of providing users with more useful information about an entity's financial position, performance and cash flows by permitting early application of IAS 36 outweighs the disadvantages of potentially diminished comparability. Therefore, entities are encouraged to apply the requirements of IAS 36 before its effective date. However, given that the revision of IAS 36 is part of an integrated package, IAS 36 requires IFRS 3 and IAS 38 (as revised in 2004) to be applied at the same time.

Transitional provision for *Improvements to IFRSs* (2009)

BC228A The Board considered the transition provisions and effective date of the amendment to paragraph 80(b). The Board noted that the assessment of goodwill impairment might involve the use of hindsight in determining the fair values of the cash-generating units at the end of a past reporting period. Considering practicability, the Board decided that the effective date should be for annual periods beginning on or after 1 January 2010 although the Board noted that the effective date of IFRS 8 is 1 January 2009. Therefore, the Board decided that an entity should apply the amendment to paragraph 80(b) made by *Improvements to IFRSs* issued in April 2009 prospectively for annual periods beginning on or after 1 January 2010.

Summary of main changes from the Exposure Draft

BC229 The following are the main changes from the Exposure Draft:

(a) the Exposure Draft proposed that an intangible asset with an indefinite useful life should be tested for impairment at the end of each annual period by comparing its carrying amount with its recoverable amount. The Standard requires such an intangible asset to be tested for impairment annually by comparing its carrying amount with its recoverable amount. The impairment test may be performed at any time during an annual period, provided it is performed at the same time every year, and different intangible assets may be tested for impairment at different times. However, if such an intangible asset was initially recognised during the current annual period, the Standard requires that intangible asset to be tested for impairment before the end of the current annual period.

(b) the Exposure Draft proposed that the cash flow projections used to measure value in use should be based on reasonable and supportable assumptions that take into account both past actual cash flows and management's past ability to forecast cash flows accurately. This proposal has not been included in the Standard. Instead, the Standard includes guidance clarifying that management:

(i) should assess the reasonableness of the assumptions on which its current cash flow projections are based by examining the causes of differences between past cash flow projections and actual cash flows; and

(ii) should ensure that the assumptions on which its current cash flow projections are based are consistent with past actual outcomes, provided the effects of subsequent events or circumstances that did not exist when those actual cash flows were generated make this appropriate.

(c) the Exposure Draft proposed that if an active market exists for the output produced by an asset or a group of assets, that asset or group of assets should be identified as a cash-generating unit, even if some or all of the output is used internally. In such circumstances, management's best estimate of future market prices for the output should be used in estimating the future cash flows used to determine the unit's value in use. The Exposure Draft also proposed that when estimating future cash flows to determine the value in use of cash-generating units using the output, management's best estimate of future market prices for the output should be used. The Standard similarly requires that if an active market exists for the output produced by an asset or a group of assets, that asset or group of assets should be identified as a cash-generating unit, even if some or all of the output is used internally. However, the Standard clarifies that if the cash inflows generated by *any* asset or cash-generating unit are affected by internal transfer pricing, an entity should use management's best estimate of future price(s) that could be achieved in arm's length transactions in estimating:

(i) the future cash inflows used to determine the asset's or cash-generating unit's value in use; and

(ii) the future cash outflows used to determine the value in use of other assets or cash-generating units affected by the internal transfer pricing.

(d) the Exposure Draft proposed that goodwill acquired in a business combination should be allocated to one or more cash-generating units, with each of those units representing the smallest cash-generating unit to which a portion of the carrying amount of the goodwill could be allocated on a reasonable and consistent basis. The Exposure Draft also proposed that:

(i) a portion of the carrying amount of goodwill should be regarded as capable of being allocated to a cash-generating unit on a reasonable and consistent basis only when that unit represents the lowest level at which management monitors the return on investment in assets that include the goodwill.

(ii) each cash-generating unit should not be larger than a segment based on the entity's primary reporting format determined in accordance with IAS 14 *Segment Reporting*.

The Standard requires goodwill acquired in a business combination to be allocated to each of the acquirer's cash-generating units, or groups of cash-generating units, that are expected to benefit from the synergies of the combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units or groups of units. The Standard also requires each unit or group of units to which the goodwill is so allocated: (1) to represent the lowest level within the entity at which the goodwill is monitored for internal management purposes; and (2) to be not larger than a segment based on either the entity's primary or the entity's secondary reporting format determined in accordance with IAS 14.

(e) the Exposure Draft proposed that when an entity disposes of an operation within a cash-generating unit to which goodwill has been allocated, the goodwill associated with that operation should be:

(i) included in the carrying amount of the operation when determining the gain or loss on disposal; and

(ii) measured on the basis of the relative values of the operation disposed of and the portion of the cash-generating unit retained.

This proposal has been included in the Standard with one modification. The Standard requires the goodwill associated with the operation disposed of to be measured on the basis of the relative values of the operation disposed of and the portion of the cash-generating unit retained, unless the entity can demonstrate that some other method better reflects the goodwill associated with the operation disposed of.

(f) the Exposure Draft proposed that when an entity reorganises its reporting structure in a way that changes the composition of cash-generating units to which goodwill has been allocated, the goodwill should be reallocated to the units affected using a relative value approach similar to that used when an entity disposes of an operation within a cash-generating unit. The Standard similarly requires an entity that reorganises its reporting structure in a way that changes the composition of one or more cash-generating units to which goodwill has been allocated to reallocate the goodwill to the units (groups of units) affected. However, the Standard requires this reallocation to be performed using a relative value approach similar to that used when an entity disposes of an operation within a cash-generating unit, unless the entity can demonstrate that some other method better reflects the goodwill associated with the reorganised units (groups of units).

(g) the Exposure Draft proposed a two-step approach for impairment testing goodwill. The first step involved using a screening mechanism for identifying potential goodwill impairments, whereby goodwill allocated to a cash-generating unit would be identified as potentially impaired only when the carrying amount of the unit exceeded its recoverable amount. If an entity identified the goodwill allocated to a cash-generating unit as potentially impaired, an entity would then determine whether the goodwill allocated to the unit was impaired by comparing its recoverable amount, measured as the implied value of the goodwill, with its carrying amount. The implied value of goodwill would be measured as a residual, being the excess of the recoverable amount of the cash-generating unit to which the goodwill has been allocated, over the net fair value of the identifiable assets, liabilities and contingent liabilities the entity would recognise if it acquired the cash-generating unit in a business combination on the date of the impairment test. The Standard requires any excess of the carrying amount of a cash-generating unit (group of units) to which goodwill has been allocated over its recoverable amount to be recognised first as an impairment loss for goodwill. Any excess remaining after the carrying amount of goodwill has been reduced to zero is then recognised by being allocated to the other assets of the unit pro rata with their carrying amounts.

(h) the Exposure Draft proposed requiring an entity to disclose information about cash-generating units whose carrying amounts included goodwill or indefinite-lived intangibles. That information included the carrying amount of goodwill and the carrying amount of indefinite-lived intangibles, the basis on which the unit's recoverable amount had been determined (ie value in use or net selling price), the amount by which the unit's recoverable amount exceeded its carrying amount, the key assumptions and estimates used to measure the unit's recoverable amount and information about the sensitivity of that recoverable amount to changes in the key assumptions and estimates. If an entity reports segment information in accordance with IAS 14, the Exposure Draft proposed that this information should be disclosed in aggregate for each segment based on the entity's primary reporting format. However, the Exposure Draft also proposed that the information would be disclosed separately for a cash-generating unit if specified criteria were met. The Standard:

(i) does not require information for evaluating the reliability of the impairment tests for goodwill and indefinite-lived intangibles to be disclosed in aggregate for each segment and separately for cash-generating units within a segment when specified criteria are met. Instead, the Standard requires this information to be disclosed for each cash-generating unit (group of units) for which the carrying amount of goodwill or indefinite-lived intangibles allocated to that unit (group of units) is significant in comparison with the entity's total carrying amount of goodwill or indefinite-lived intangibles.

(ii) does not require an entity to disclose the amount by which the recoverable amount of a cash-generating unit exceeds its carrying amount. Instead, the Standard requires an entity to disclose this information only if a reasonably possible change in a key assumption on which management has based its determination of the unit's (group of units') recoverable amount would cause the unit's (group of units') carrying amount to exceed its recoverable amount.

(iii) does not require an entity to disclose the value assigned to each key assumption on which management has based its recoverable amount determination, and the amount by which that value must change, after incorporating any consequential effects of that change on the other variables used to measure recoverable amount, in order for the unit's recoverable amount to be equal to its carrying amount. Instead, the Standard requires an entity to disclose a description of each key assumption on which management has based its recoverable amount determination, management's approach to determining the value(s) assigned to each key assumption, whether those value(s) reflect past experience or, if appropriate, are consistent with external sources of information, and, if not, how and why they differ from past experience or external sources of information. However, if a reasonably possible change in a key assumption would cause the unit's (group of units') carrying amount to exceed its recoverable amount, the entity is also required to disclose the value assigned to the key assumption, and the amount by which that value must change, after incorporating any consequential effects of that change on the other variables used to measure recoverable amount, in order for the unit's (group of units') recoverable amount to be equal to its carrying amount.

(iv) requires information about key assumptions to be disclosed for any key assumption that is relevant to the recoverable amount determination of multiple cash-generating units (groups of units) that individually contain insignificant amounts of goodwill or indefinite-lived intangibles, but which contain, in aggregate, significant amounts of goodwill or indefinite-lived intangibles.

History of the development of a standard on impairment of assets

BCZ230 In June 1996, IASC decided to prepare an International Accounting Standard on Impairment of Assets. The reasons for developing a Standard on impairment of assets were:

(a) to combine the requirements for identifying, measuring, recognising and reversing an impairment loss in one Standard to ensure that those requirements are consistent;

(b) the previous requirements and guidance in International Accounting Standards were not detailed enough to ensure that enterprises identified, recognised and measured impairment losses in a similar way, eg there was a need to eliminate certain alternatives for measuring an impairment loss, such as the former option not to use discounting; and

(c) IASC decided in March 1996 to explore whether the amortisation period of intangible assets and goodwill could, in certain rare circumstances, exceed 20 years if those assets were subject to detailed and reliable annual impairment tests.

BCZ231 In April 1997, IASC approved Exposure Draft E55 *Impairment of Assets*. IASC received more than 90 comment letters from over 20 countries. IASC also performed a field test of E55's proposals. More than 20 companies from various business sectors and from 10 different countries participated in the field test. About half of the field test participants prepared their financial statements using International Accounting Standards and the other half reported using other Standards. Field test participants completed a detailed questionnaire and most of them were visited by IASC staff to discuss the results of the application of E55's proposals to some of their assets. A brief summary of the comment letters received on E55 and the results of the field test was published in IASC *Insight* in December 1997.

BCZ232 In October 1997, IASC, together with the Accounting Standards Boards in Australia, Canada, New Zealand, the United Kingdom and the United States, published a discussion paper entitled *International Review of Accounting Standards Specifying a Recoverable Amount Test for Long-Lived Assets* (Jim Paul, from the staff of the Australian Accounting Research Foundation, was the principal author). This discussion paper resulted from the discussions of a 'working group' consisting of some Board members and senior staff members from the standard-setting bodies listed above and IASC. The paper:

(a) noted the key features of the working group members' existing or proposed accounting standards that require an impairment test, and compared those standards; and

(b) proposed the views of the working group on the major issues.

BCZ233 In April 1998, after considering the comments received on E55 and the results of the field test, IASC approved IAS 36 *Impairment of Assets*.

Dissenting opinions

Dissent of Anthony T Cope, James J Leisenring and Geoffrey Whittington

DO1 Messrs Cope and Leisenring and Professor Whittington dissent from the issue of IAS 36.

DO2 Messrs Cope and Leisenring and Professor Whittington dissent because they object to the impairment test that the Standard requires for goodwill.

DO3 Messrs Cope and Leisenring agree with the prohibition, in paragraph 54 of IFRS 3 *Business Combinations,* of amortisation of goodwill.[*] Research and experience have demonstrated that the amortisation of goodwill produces data that is meaningless, and perhaps even misleading. However, if goodwill is not amortised, its special nature mandates that it should be accounted for with caution. The Basis for Conclusions on IAS 36 (paragraph BC131F) states that "if a rigorous and operational impairment test [for goodwill] could be devised, more useful information would be provided to users of an entity's financial statements under an approach in which goodwill is not amortised, but instead tested for impairment annually or more frequently if events or changes in circumstances indicate that the goodwill might be impaired." Messrs Cope and Leisenring agree with that statement. However, they believe that the impairment test to which a majority of the Board has agreed lacks the rigour to satisfy that condition.

DO4 Messrs Cope and Leisenring share the reservations of some Board members, as noted in paragraph BC130 of the Basis for Conclusions on IAS 36, about an impairment test based on measuring the recoverable amount of an asset, and particularly an asset with an indefinite life, as the higher of fair value less costs to sell or value in use. Messrs Cope and Leisenring are content, however, for the time being to defer consideration of that general measurement issue, pending more research and debate on measurement principles. (They note that the use of fair value would achieve significant convergence with US GAAP.) But a much more rigorous effort must be made to determine the recoverable amount of goodwill, however measured, than the Board's revised impairment test. The 'two-step' method originally proposed by the Board in the Exposure Draft of Proposed Amendments to IAS 36 and IAS 38 was a more useful approach to determining the 'implied value' of goodwill. That test should have been retained.

DO5 Messrs Cope and Leisenring recognise that some constituents raised objections to the complexity and potential cost of the requirements proposed in the Exposure Draft. However, they believe that many commentators misunderstood the level at which the Board intended impairment testing to be undertaken. This was demonstrated during the field-testing of the Exposure Draft. Furthermore, the provisions of paragraph 99 of IAS 36, specifying when impairment testing need not be undertaken, provide generous relief from the necessity of making frequent calculations. They would have preferred to meet those objections by specifying that the goodwill impairment test should be at the level set out in US Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 142 *Goodwill and Other Intangible Assets*.

[*] The Board issued a revised IFRS 3 in 2008. The amortisation of goodwill is prohibited, but the paragraph reference no longer exists in IFRS 3 (as revised in 2008).

DO6 Professor Whittington believes that there are two aspects of the proposed impairment test that are particularly unsatisfactory. First, the failure to eliminate the shield from impairment provided by the internally generated goodwill of the acquiring entity at acquisition. This is discussed in paragraph DO7. Second, the lack of a subsequent cash flow test. This is discussed in paragraphs DO8-DO10. The inability to eliminate the shield from impairment provided by internally generated goodwill accruing after the acquisition date is also a problem. However, there is no obvious practical way of dealing with this problem within the framework of conventional impairment tests.

DO7 When an acquired business is merged with an acquirer's existing operations, the impairment test in IAS 36 does not take account of the acquirer's pre-existing internally generated goodwill. Thus, the pre-existing internally generated goodwill of the acquirer provides a shield against impairment additional to that provided by subsequent internally generated goodwill. Professor Whittington believes that the impairment test would be more rigorous if it included a requirement similar to that in UK Financial Reporting Standard 11 *Impairment of Fixed Assets and Goodwill*, which recognises, for purposes of impairment testing, the implied value of the acquirer's goodwill existing at the time of acquisition.

DO8 The subsequent cash flow test is discussed in paragraphs BC195-BC198 of the Basis for Conclusions on IAS 36. A subsequent cash flow test substitutes in past impairment tests the cash flows that actually occurred for those that were estimated at the time of the impairment tests, and requires a write-down if the revised estimates would have created an impairment loss for goodwill. It is thus a correction of an estimate. Such a test is incorporated in FRS 11.

DO9 The Board's reasons for rejecting the subsequent cash flow test are given in paragraph BC197(a)-(c). The preamble to paragraph BC197 claims that the subsequent cash flow test is misdirected because excessive write-downs of goodwill may be a problem that should be prevented. However, the subsequent cash flow test requires only realistic write-downs (based on actual outcomes), not excessive ones. If the statement in paragraph BC197 is correct, this may point to another deficiency in the impairment testing process that requires a different remedy.

DO10 Paragraph BC197(a) asserts that "it does not produce representationally faithful results" because it ignores other elements in the measurement of value in use. As explained above, it merely substitutes the outcome cash flow for the estimate, which should have a clear meaning and provides a safeguard against over-optimism in the estimation of cash flows. If corrections of estimates of other elements, such as variations that have occurred in interest rates, were considered important in this context, they could be incorporated in the calculation. Paragraph BC197(b) seems to raise the same point as paragraph BC197(a), as to the meaning of the impairment loss under the test. Paragraph BC197(c) complains about the excessive burden that a subsequent cash flow test might impose. Professor Whittington notes that the extent of the burden depends, of course, upon the frequency with which the test is applied. He also notes that the extensive disclosure requirements currently associated with the impairment test might be reduced if the subsequent cash flow test were in place.

HKAS 36 IE
Revised ~~May 2009~~March 2010

Illustrative Examples
Hong Kong Accounting Standard 36

Impairment of Assets

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

Contents

IAS 36 Impairment of Assets
Illustrative examples

These examples accompany, but are not part of, IAS 36. All the examples assume that the entities concerned have no transactions other than those described. In the examples monetary amounts are denominated in 'currency units (CU)'.

Example 1 - Identification of cash-generating units

The purpose of this example is:

(a) to indicate how cash-generating units are identified in various situations; and

(b) to highlight certain factors that an entity may consider in identifying the cash-generating unit to which an asset belongs.

A - Retail store chain

Background

IE1 Store X belongs to a retail store chain M. X makes all its retail purchases through M's purchasing centre. Pricing, marketing, advertising and human resources policies (except for hiring X's cashiers and sales staff) are decided by M. M also owns five other stores in the same city as X (although in different neighbourhoods) and 20 other stores in other cities. All stores are managed in the same way as X. X and four other stores were purchased five years ago and goodwill was recognised.

What is the cash-generating unit for X (X's cash-generating unit)?

Analysis

IE2 In identifying X's cash-generating unit, an entity considers whether, for example:

(a) internal management reporting is organised to measure performance on a store-by-store basis; and

(b) the business is run on a store-by-store profit basis or on a region/city basis.

IE3 All M's stores are in different neighbourhoods and probably have different customer bases. So, although X is managed at a corporate level, X generates cash inflows that are largely independent of those of M's other stores. Therefore, it is likely that X is a cash-generating unit.

IE4 If X's cash-generating unit represents the lowest level within M at which the goodwill is monitored for internal management purposes, M applies to that cash-generating unit the impairment test described in paragraph 90 of IAS 36. If information about the carrying amount of goodwill is not available and monitored for internal management purposes at the level of X's cash-generating unit, M applies to that cash-generating unit the impairment test described in paragraph 88 of IAS 36.

B - Plant for an intermediate step in a production process

Background

IE5 A significant raw material used for plant Y's final production is an intermediate product bought from plant X of the same entity. X's products are sold to Y at a transfer price that passes all margins to X. Eighty per cent of Y's final production is sold to customers outside of the entity. Sixty per cent of X's final production is sold to Y and the remaining 40 per cent is sold to customers outside of the entity.

For each of the following cases, what are the cash-generating units for X and Y?

Case 1: X could sell the products it sells to Y in an active market. Internal transfer prices are higher than market prices.

Case 2: There is no active market for the products X sells to Y.

Analysis

Case 1

IE6 X could sell its products in an active market and, so, generate cash inflows that would be largely independent of the cash inflows from Y. Therefore, it is likely that X is a separate cash-generating unit, although part of its production is used by Y (see paragraph 70 of IAS 36).

IE7 It is likely that Y is also a separate cash-generating unit. Y sells 80 per cent of its products to customers outside of the entity. Therefore, its cash inflows can be regarded as largely independent.

IE8 Internal transfer prices do not reflect market prices for X's output. Therefore, in determining value in use of both X and Y, the entity adjusts financial budgets/forecasts to reflect management's best estimate of future prices that could be achieved in arm's length transactions for those of X's products that are used internally (see paragraph 70 of IAS 36).

Case 2

IE9 It is likely that the recoverable amount of each plant cannot be assessed independently of the recoverable amount of the other plant because:

(a) the majority of X's production is used internally and could not be sold in an active market. So, cash inflows of X depend on demand for Y's products. Therefore, X cannot be considered to generate cash inflows that are largely independent of those of Y.

(b) the two plants are managed together.

IE10 As a consequence, it is likely that X and Y together are the smallest group of assets that generates cash inflows that are largely independent.

C - Single product entity

Background

IE11 Entity M produces a single product and owns plants A, B and C. Each plant is located in a different continent. A produces a component that is assembled in either B or C. The combined capacity of B and C is not fully utilised. M's products are sold worldwide from either B or C. For example, B's production can be sold in C's continent if the products can be delivered faster from B than from C. Utilisation levels of B and C depend on the allocation of sales between the two sites.

For each of the following cases, what are the cash-generating units for A, B and C?

Case 1: There is an active market for A's products.

Case 2: There is no active market for A's products.

Analysis

Case 1

IE12 It is likely that A is a separate cash-generating unit because there is an active market for its products (see Example B - Plant for an intermediate step in a production process, Case 1).

IE13 Although there is an active market for the products assembled by B and C, cash inflows for B and C depend on the allocation of production across the two sites. It is unlikely that the future cash inflows for B and C can be determined individually. Therefore, it is likely that B and C together are the smallest identifiable group of assets that generates cash inflows that are largely independent.

IE14 In determining the value in use of A and B plus C, M adjusts financial budgets/forecasts to reflect its best estimate of future prices that could be achieved in arm's length transactions for A's products (see paragraph 70 of IAS 36).

Case 2

IE15 It is likely that the recoverable amount of each plant cannot be assessed independently because:

(a) there is no active market for A's products. Therefore, A's cash inflows depend on sales of the final product by B and C.

(b) although there is an active market for the products assembled by B and C, cash inflows for B and C depend on the allocation of production across the two sites. It is unlikely that the future cash inflows for B and C can be determined individually.

IE16 As a consequence, it is likely that A, B and C together (ie M as a whole) are the smallest identifiable group of assets that generates cash inflows that are largely independent.

D - Magazine titles

Background

IE17 A publisher owns 150 magazine titles of which 70 were purchased and 80 were self-created. The price paid for a purchased magazine title is recognised as an intangible asset. The costs of creating magazine titles and maintaining the existing titles are recognised as an expense when incurred. Cash inflows from direct sales and advertising are identifiable for each magazine title. Titles are managed by customer segments. The level of advertising income for a magazine title depends on the range of titles in the customer segment to which the magazine title relates. Management has a policy to abandon old titles before the end of their economic lives and replace them immediately with new titles for the same customer segment.

What is the cash-generating unit for an individual magazine title?

Analysis

IE18 It is likely that the recoverable amount of an individual magazine title can be assessed. Even though the level of advertising income for a title is influenced, to a certain extent, by the other titles in the customer segment, cash inflows from direct sales and advertising are identifiable for each title. In addition, although titles are managed by customer segments, decisions to abandon titles are made on an individual title basis.

IE19 Therefore, it is likely that individual magazine titles generate cash inflows that are largely independent of each other and that each magazine title is a separate cash-generating unit.

E - Building half-rented to others and half-occupied for own use

Background

IE20 M is a manufacturing company. It owns a headquarters building that used to be fully occupied for internal use. After down-sizing, half of the building is now used internally and half rented to third parties. The lease agreement with the tenant is for five years.

What is the cash-generating unit of the building?

Analysis

IE21 The primary purpose of the building is to serve as a corporate asset, supporting M's manufacturing activities. Therefore, the building as a whole cannot be considered to generate cash inflows that are largely independent of the cash inflows from the entity as a whole. So, it is likely that the cash-generating unit for the building is M as a whole.

IE22 The building is not held as an investment. Therefore, it would not be appropriate to determine the value in use of the building based on projections of future market related rents.

Example 2 - Calculation of value in use and recognition of an impairment loss

In this example, tax effects are ignored.

Background and calculation of value in use

IE23 At the end of 20X0, entity T acquires entity M for CU10,000. M has manufacturing plants in three countries.

Schedule 1. Data at the end of 20X0

End of 20X0	*Allocation of purchase price*	*Fair value of identifiable assets*	*Goodwill*
	CU	CU	CU[(a)]
Activities in Country A	3,000	2,000	1,000
Activities in Country B	2,000	1,500	500
Activities in Country C	5,000	3,500	1,500
Total	10,000	7,000	3,000

(a) Activities in each country represent the lowest level at which the goodwill is monitored for internal management purposes (determined as the difference between the purchase price of the activities in each country, as specified in the purchase agreement, and the fair value of the identifiable assets).

IE23A Because goodwill has been allocated to the activities in each country, each of those activities must be tested for impairment annually or more frequently if there is any indication that it may be impaired (see paragraph 90 of IAS 36).

IE24 The recoverable amounts (ie higher of value in use and fair value less costs to sell) of the cash-generating units are determined on the basis of value in use calculations. At the end of 20X0 and 20X1, the value in use of each cash-generating unit exceeds its carrying amount. Therefore the activities in each country and the goodwill allocated to those activities are regarded as not impaired.

IE25 At the beginning of 20X2, a new government is elected in Country A. It passes legislation significantly restricting exports of T's main product. As a result, and for the foreseeable future, T's production in Country A will be cut by 40 per cent.

IE26 The significant export restriction and the resulting production decrease require T also to estimate the recoverable amount of the Country A operations at the beginning of 20X2.

IE27 T uses straight-line depreciation over a 12-year life for the Country A identifiable assets and anticipates no residual value.

IE28 To determine the value in use for the Country A cash-generating unit (see Schedule 2), T:

(a) prepares cash flow forecasts derived from the most recent financial budgets/forecasts for the next five years (years 20X2-20X6) approved by management.

(b) estimates subsequent cash flows (years 20X7-20Y2) based on declining growth rates. The growth rate for 20X7 is estimated to be 3 per cent. This rate is lower than the average long-term growth rate for the market in Country A.

(c) selects a 15 per cent discount rate, which represents a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the Country A cash-generating unit.

Recognition and measurement of impairment loss

IE29 The recoverable amount of the Country A cash-generating unit is CU1,360.

IE30 T compares the recoverable amount of the Country A cash-generating unit with its carrying amount (see Schedule 3).

IE31 Because the carrying amount exceeds the recoverable amount by CU1,473, T recognises an impairment loss of CU1,473 immediately in profit or loss. The carrying amount of the goodwill that relates to the Country A operations is reduced to zero before reducing the carrying amount of other identifiable assets within the Country A cash-generating unit (see paragraph 104 of IAS 36).

IE32 Tax effects are accounted for separately in accordance with IAS 12 *Income Taxes* (see Illustrative Example 3A).

Schedule 2. Calculation of the value in use of the Country A cash-generating unit at the beginning of 20X2

Year	*Long-term growth rates*	*Future cash flows* CU	*Present value factor at 15% discount rate*[3]	*Discounted future cash flows* CU
20X2 (n=1)		230[1]	0.86957	200
20X3		253[1]	0.75614	191
20X4		273[1]	0.65752	180
20X5		290[1]	0.57175	166
20X6		304[1]	0.49718	151
20X7	3%	313[2]	0.43233	135
20X8	-2%	307[2]	0.37594	115
20X9	-6%	289[2]	0.32690	94
20Y0	-15%	245[2]	0.28426	70
20Y1	-25%	184[2]	0.24719	45
20Y2	-67%	61[2]	0.21494	13
Value in use				1,360

1 Based on management's best estimate of net cash flow projections (after the 40% cut).
2 Based on an extrapolation from preceding year cash flow using declining growth rates.
3 The present value factor is calculated as $k = 1/(1+a)^n$, where a = discount rate and n = period of discount.

Schedule 3. Calculation and allocation of the impairment loss for the Country A cash-generating unit at the beginning of 20X2

Beginning of 20X2	*Goodwill*	*Identifiable assets*	*Total*
	CU	CU	CU
Historical cost	1,000	2,000	3,000
Accumulated depreciation (20X1)	-	(167)	(167)
Carrying amount	1,000	1,833	2,833
Impairment loss	(1,000)	(473)	(1,473)
Carrying amount after impairment loss	-	1,360	1,360

Example 3 Deferred tax effects

A - Deferred tax effects of the recognition of an impairment loss

Use the data for entity T as presented in Example 2, with supplementary information as provided in this example.

IE33 At the beginning of 20X2, the tax base of the identifiable assets of the Country A cash-generating unit is CU900. Impairment losses are not deductible for tax purposes. The tax rate is 40 per cent.

IE34 The recognition of an impairment loss on the assets of the Country A cash-generating unit reduces the taxable temporary difference related to those assets. The deferred tax liability is reduced accordingly.

Beginning of 20X2	*Identifiable assets before impairment loss*	*Impairment loss*	*Identifiable assets after impairment loss*
	CU	CU	CU
Carrying amount (Example 2)	1,833	(473)	1,360
Tax base	900	-	900
Taxable temporary difference	933	(473)	460
Deferred tax liability at 40%	373	(189)	184

IE35 In accordance with IAS 12 *Income Taxes*, no deferred tax relating to the goodwill was recognised initially. Therefore, the impairment loss relating to the goodwill does not give rise to a deferred tax adjustment.

B - Recognition of an impairment loss creates a deferred tax asset

IE36 An entity has an identifiable asset with a carrying amount of CU1,000. Its recoverable amount is CU650. The tax rate is 30 per cent and the tax base of the asset is CU800. Impairment losses are not deductible for tax purposes. The effect of the impairment loss is as follows:

	Before impairment CU	*Effect of impairment* CU	*After impairment* CU
Carrying amount	1,000	(350)	650
Tax base	800	-	800
Taxable (deductible) temporary difference	200	(350)	(150)
Deferred tax liability (asset) at 30%	60	(105)	(45)

IE37 In accordance with IAS 12, the entity recognises the deferred tax asset to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised.

Example 4 Reversal of an impairment loss

Use the data for entity T as presented in Example 2, with supplementary information as provided in this example. In this example, tax effects are ignored.

Background

IE38 In 20X3, the government is still in office in Country A, but the business situation is improving. The effects of the export laws on T's production are proving to be less drastic than initially expected by management. As a result, management estimates that production will increase by 30 per cent. This favourable change requires T to re-estimate the recoverable amount of the net assets of the Country A operations (see paragraphs 110 and 111 of IAS 36). The cash-generating unit for the net assets of the Country A operations is still the Country A operations.

IE39 Calculations similar to those in Example 2 show that the recoverable amount of the Country A cash-generating unit is now CU1,910.

Reversal of impairment loss

IE40 T compares the recoverable amount and the net carrying amount of the Country A cash-generating unit.

Schedule 1. Calculation of the carrying amount of the Country A cash-generating unit at the end of 20X3

	Goodwill	*Identifiable assets*	*Total*
	CU	CU	CU
Beginning of 20X2 (Example 2)			
Historical cost	1,000	2,000	3,000
Accumulated depreciation	-	(167)	(167)
Impairment loss	(1,000)	(473)	(1,473)
Carrying amount after impairment loss	-	1,360	1,360
End of 20X3			
Additional depreciation (2 years)[(a)]	-	(247)	(247)
Carrying amount	-	1,113	1,113
Recoverable amount			1,910
Excess of recoverable amount over carrying amount			797

(a) After recognition of the impairment loss at the beginning of 20X2, T revised the depreciation charge for the Country A identifiable assets (from CU166.7 per year to CU123.6 per year), based on the revised carrying amount and remaining useful life (11 years).

IE41 There has been a favourable change in the estimates used to determine the recoverable amount of the Country A net assets since the last impairment loss was recognised. Therefore, in accordance with paragraph 114 of IAS 36, T recognises a reversal of the impairment loss recognised in 20X2.

IE42 In accordance with paragraphs 122 and 123 of IAS 36, T increases the carrying amount of the Country A identifiable assets by CU387 (see Schedule 3), ie up to the lower of recoverable amount (CU1,910) and the identifiable assets' depreciated historical cost (CU1,500) (see Schedule 2). This increase is recognised immediately in profit or loss.

IE43 In accordance with paragraph 124 of IAS 36, the impairment loss on goodwill is not reversed.

Schedule 2. Determination of the depreciated historical cost of the Country A identifiable assets at the end of 20X3

End of 20X3	*Identifiable assets* CU
Historical cost	2,000
Accumulated depreciation *(166.7 × 3 years)*	(500)
Depreciated historical cost	1,500
Carrying amount (Schedule 1)	1,113
Difference	387

Schedule 3. Carrying amount of the Country A assets at the end of 20X3

End of 20X3	*Goodwill* CU	*Identifiable assets* CU	*Total* CU
Gross carrying amount	1,000	2,000	3,000
Accumulated amortisation	-	(414)	(414)
Accumulated impairment loss	(1,000)	(473)	(1,473)
Carrying amount	-	1,113	1,113
Reversal of impairment loss	0	387	387
Carrying amount after reversal of impairment loss	-	1,500	1,500

Example 5 Treatment of a future restructuring

In this example, tax effects are ignored.

Background

IE44 At the end of 20X0, entity K tests a plant for impairment. The plant is a cash-generating unit. The plant's assets are carried at depreciated historical cost. The plant has a carrying amount of CU3,000 and a remaining useful life of 10 years.

IE45 The plant's recoverable amount (ie higher of value in use and fair value less costs to sell) is determined on the basis of a value in use calculation. Value in use is calculated using a pre-tax discount rate of 14 per cent.

IE46 Management approved budgets reflect that:

(a) at the end of 20X3, the plant will be restructured at an estimated cost of CU100. Since K is not yet committed to the restructuring, a provision has not been recognised for the future restructuring costs.

(b) there will be future benefits from this restructuring in the form of reduced future cash outflows.

IE47 At the end of 20X2, K becomes committed to the restructuring. The costs are still estimated to be CU100 and a provision is recognised accordingly. The plant's estimated future cash flows reflected in the most recent management approved budgets are given in paragraph IE51 and a current discount rate is the same as at the end of 20X0.

IE48 At the end of 20X3, actual restructuring costs of CU100 are incurred and paid. Again, the plant's estimated future cash flows reflected in the most recent management approved budgets and a current discount rate are the same as those estimated at the end of 20X2.

At the end of 20X0

Schedule 1. Calculation of the plant's value in use at the end of 20X0

Year	*Future cash flows* CU	*Discounted at 14%* CU
20X1	300	263
20X2	280	215
20X3	420 [1]	283
20X4	520 [2]	308
20X5	350 [2]	182
20X6	420 [2]	191
20X7	480 [2]	192
20X8	480 [2]	168
20X9	460 [2]	141
20X10	400 [2]	108
Value in use		2,051

1 Excludes estimated restructuring costs reflected in management budgets.
2 Excludes estimated benefits expected from the restructuring reflected in management budgets.

IE49 The plant's recoverable amount (ie value in use) is less than its carrying amount. Therefore, K recognises an impairment loss for the plant.

Schedule 2. Calculation of the impairment loss at the end of 20X0

	Plant CU
Carrying amount before impairment loss	3,000
Recoverable amount (Schedule 1)	2,051
Impairment loss	(949)
Carrying amount after impairment loss	2,051

At the end of 20X1

IE50 No event occurs that requires the plant's recoverable amount to be re-estimated. Therefore, no calculation of the recoverable amount is required to be performed.

At the end of 20X2

IE51 The entity is now committed to the restructuring. Therefore, in determining the plant's value in use, the benefits expected from the restructuring are considered in forecasting cash flows. This results in an increase in the estimated future cash flows used to determine value in use at the end of 20X0. In accordance with paragraphs 110 and 111 of IAS 36, the recoverable amount of the plant is re-determined at the end of 20X2.

Schedule 3. Calculation of the plant's value in use at the end of 20X2

Year	*Future cash flows* CU	*Discounted at 14%* CU
20X3	420 [1]	368
20X4	570 [2]	439
20X5	380 [2]	256
20X6	450 [2]	266
20X7	510 [2]	265
20X8	510 [2]	232
20X9	480 [2]	192
20X10	410 [2]	144
Value in use		2,162

1 Excludes estimated restructuring costs because a liability has already been recognised.

2 Includes estimated benefits expected from the restructuring reflected in management budgets.

IE52 The plant's recoverable amount (value in use) is higher than its carrying amount (see Schedule 4). Therefore, K reverses the impairment loss recognised for the plant at the end of 20X0.

Schedule 4. Calculation of the reversal of the impairment loss at the end of 20X2

	Plant CU
Carrying amount at the end of 20X0 (Schedule 2)	2,051
End of 20X2	
Depreciation charge (for 20X1 and 20X2–Schedule 5)	(410)
Carrying amount before reversal	1,641
Recoverable amount (Schedule 3)	2,162
Reversal of the impairment loss	521
Carrying amount after reversal	2,162
Carrying amount: depreciated historical cost (Schedule 5)	2,400 [(a)]

(a) The reversal does not result in the carrying amount of the plant exceeding what its carrying amount would have been at depreciated historical cost. Therefore, the full reversal of the impairment loss is recognised.

At the end of 20X3

IE53 There is a cash outflow of CU100 when the restructuring costs are paid. Even though a cash outflow has taken place, there is no change in the estimated future cash flows used to determine value in use at the end of 20X2. Therefore, the plant's recoverable amount is not calculated at the end of 20X3.

Schedule 5. Summary of the carrying amount of the plant

End of year	*Depreciated historical cost* CU	*Recoverable amount* CU	*Adjusted depreciation charge* CU	*Impairment loss* CU	*Carrying amount after impairment* CU
20X0	3,000	2,051	0	(949)	2,051
20X1	2,700	nc	(205)	0	1,846
20X2	2,400	2,162	(205)	521	2,162
20X3	2,100	nc	(270)	0	1,892

nc = not calculated as there is no indication that the impairment loss may have increased/decreased.

Example 6 Treatment of future costs

In this example, tax effects are ignored.

Background

IE54 At the end of 20X0, entity F tests a machine for impairment. The machine is a cash-generating unit. It is carried at depreciated historical cost and its carrying amount is CU150,000. It has an estimated remaining useful life of 10 years.

IE55 The machine's recoverable amount (ie higher of value in use and fair value less costs to sell) is determined on the basis of a value in use calculation. Value in use is calculated using a pre-tax discount rate of 14 per cent.

IE56 Management approved budgets reflect:

(a) estimated costs necessary to maintain the level of economic benefit expected to arise from the machine in its current condition; and

(b) that in 20X4, costs of CU25,000 will be incurred to enhance the machine's performance by increasing its productive capacity.

IE57 At the end of 20X4, costs to enhance the machine's performance are incurred. The machine's estimated future cash flows reflected in the most recent management approved budgets are given in paragraph IE60 and a current discount rate is the same as at the end of 20X0.

At the end of 20X0

Schedule 1. Calculation of the machine's value in use at the end of 20X0

Year	*Future cash flows CU*	*Discounted at 14% CU*
20X1	22,165[1]	19,443
20X2	21,450[1]	16,505
20X3	20,550[1]	13,871
20X4	24,725[1,2]	14,639
20X5	25,325[1,3]	13,153
20X6	24,825[1,3]	11,310
20X7	24,123[1,3]	9,640
20X8	25,533[1,3]	8,951
20X9	24,234[1,3]	7,452
20X10	22,850[1,3]	6,164
Value in use		121,128

1 Includes estimated costs necessary to maintain the level of economic benefit expected to arise from the machine in its current condition.

2 Excludes estimated costs to enhance the machine's performance reflected in management budgets.

3 Excludes estimated benefits expected from enhancing the machine's performance reflected in management budgets.

IE58 The machine's recoverable amount (value in use) is less than its carrying amount. Therefore, F recognises an impairment loss for the machine.

Schedule 2. Calculation of the impairment loss at the end of 20X0

	Machine *CU*
Carrying amount before impairment loss	150,000
Recoverable amount (Schedule 1)	121,128
Impairment loss	(28,872)
Carrying amount after impairment loss	121,128

Years 20X1 - 20X3

IE59 No event occurs that requires the machine's recoverable amount to be re-estimated. Therefore, no calculation of recoverable amount is required to be performed.

At the end of 20X4

IE60 The costs to enhance the machine's performance are incurred. Therefore, in determining the machine's value in use, the future benefits expected from enhancing the machine's performance are considered in forecasting cash flows. This results in an increase in the estimated future cash flows used to determine value in use at the end of 20X0. As a consequence, in accordance with paragraphs 110 and 111 of IAS 36, the recoverable amount of the machine is recalculated at the end of 20X4.

Schedule 3. Calculation of the machine's value in use at the end of 20X4

Year	*Future cash flows*[(a)] *CU*	*Discounted at 14%* *CU*
20X5	30,321	26,597
20X6	32,750	25,200
20X7	31,721	21,411
20X8	31,950	18,917
20X9	33,100	17,191
20X10	27,999	12,756
Value in use		122,072

(a) Includes estimated benefits expected from enhancing the machine's performance reflected in management budgets.

IE61 The machine's recoverable amount (ie value in use) is higher than the machine's carrying amount and depreciated historical cost (see Schedule 4). Therefore, K reverses the impairment loss recognised for the machine at the end of 20X0 so that the machine is carried at depreciated historical cost.

Schedule 4. Calculation of the reversal of the impairment loss at the end of 20X4

	Machine CU
Carrying amount at the end of 20X0 (Schedule 2)	121,128
End of 20X4	
Depreciation charge (20X1 to 20X4 – Schedule 5)	(48,452)
Costs to enhance the asset's performance	25,000
Carrying amount before reversal	97,676
Recoverable amount (Schedule 3)	122,072
Reversal of the impairment loss	17,324
Carrying amount after reversal	115,000
Carrying amount: depreciated historical cost (Schedule 5)	115,000 [(a)]

(a) The value in use of the machine exceeds what its carrying amount would have been at depreciated historical cost. Therefore, the reversal is limited to an amount that does not result in the carrying amount of the machine exceeding depreciated historical cost.

Schedule 5. Summary of the carrying amount of the machine

Year	*Depreciated historical cost* *CU*	*Recoverable amount* *CU*	*Adjusted depreciation charge* *CU*	*Impairment loss* *CU*	*Carrying amount after impairment* *CU*
20X0	150,000	121,128	0	(28,872)	121,128
20X1	135,000	nc	(12,113)	0	109,015
20X2	120,000	nc	(12,113)	0	96,902
20X3	105,000	nc	(12,113)	0	84,789
20X4	90,000		(12,113)		
enhancement	25,000		-		
	115,000	122,072	(12,113)	17,324	115,000
20X5	95,833	nc	(19,167)	0	95,833

nc = not calculated as there is no indication that the impairment loss may have increased/decreased.

Example 7 Impairment testing cash-generating units with goodwill and ~~Minority~~non-controlling interests*

Example 7A Non-controlling interests measured initially as a proportionate share of the net identifiable assets

In this example, tax effects are ignored.

Background

IE62 ~~Entity X~~Parent acquires an 80 per cent ownership interest in ~~Entity Y~~Subsidiary for CU2,100~~1,600~~ on 1 January 20X3. At that date, Subsidiary's~~Y's~~ net identifiable ~~net~~ assets have a fair value of CU1,500. ~~Y has no contingent liabilities. Therefore, X~~ Parent chooses to measure the non-controlling interests as the proportionate interest of Subsidiary's net identifiable assets of CU300 (20% of CU1,500). Goodwill of CU900 is the difference between the aggregate of the consideration transferred and the amount of the non-controlling interests (CU2,100 + CU300) and the net identifiable assets (CU1,500).~~recognises in its consolidated financial statements:~~

~~(a) goodwill of CU400, being the difference between the cost of the business combination of CU1,600 and X's 80 per cent interest in Y's identifiable net assets;~~

~~(b) Y's identifiable net assets at their fair value of CU1,500; and~~

~~(c) a minority interest of CU300, being the 20 per cent interest in Y's identifiable net assets held by parties outside X.~~

IE63 The assets of Subsidiary~~Y~~ together are the smallest group of assets that generate cash inflows that are largely independent of the cash inflows from other assets or groups of assets. Therefore Subsidiary~~Y~~ is a cash-generating unit. Because other cash-generating units of Parent are expected to benefit from the synergies of the combination, the goodwill of CU500 related to those synergies has been allocated to other cash-generating units within Parent. Because the~~is~~ cash-generating unit comprising Subsidiary includes goodwill within its carrying amount, it must be tested for impairment annually, or more frequently if there is an indication that it may be impaired (see paragraph 90 of IAS 36).

IE64 At the end of 20X3, Parent~~X~~ determines that the recoverable amount of cash-generating unit Subsidiary~~Y~~ is CU1,000. The carrying amount of the net assets of Subsidiary, excluding goodwill, is CU1,350. ~~X uses straight-line depreciation over a 10-year life for Y's identifiable assets and anticipates no residual value.~~

Testing Subsidiary (cash-generating unit)~~Y~~ for impairment

IE65 ~~A portion of~~ Goodwill attributable to non-controlling interests is included in Subsidiary's~~Y's~~ recoverable amount of CU1,000 but has not been recognised in Parent's consolidated financial statements~~is attributable to the unrecognised minority interest in goodwill~~. Therefore, in accordance with paragraph ~~92~~C4 of Appendix C of IAS 36, the carrying amount of Subsidiary ~~Y must be notionally adjusted~~is grossed up to include goodwill attributable to the ~~minority~~non-controlling interests, before being compared

* Amendments to the example effective for annual periods beginning on or after 1 July 2009.

with the recoverable amount of CU1,000. Goodwill attributable to Parent's 80 per cent interest in Subsidiary at the acquisition date is CU400 after allocating CU500 to other cash-generating units within Parent. Therefore, goodwill attributable to the 20 per cent non-controlling interests in Subsidiary at the acquisition date is CU100.

Schedule 1. Testing Subsidiary~~Y~~ for impairment at the end of 20X3

End of 20X3	*Goodwill of Subsidiary* CU	*Net ~~I~~identifiable ~~net~~ assets* CU	*Total* CU
~~Gross carrying amount~~	~~400~~	~~1,500~~	~~1,900~~
~~Accumulated depreciation~~	~~-~~	~~(150)~~	~~(150)~~
Carrying amount	400	1,350	1,750
Unrecognised ~~minority~~ non-controlling interests	100 ~~*~~	-	100
~~Notionally a~~Adjusted carrying amount	500	1,350	1,850
Recoverable amount			1,000
Impairment loss			850

~~* Goodwill attributable to X's 80% interest in Y at the acquisition date is CU400. Therefore, goodwill notionally attributable to the 20% minority interest in Y at the acquisition date is CU100.~~

Allocating the impairment loss

IE66 In accordance with paragraph 104 of IAS 36, the impairment loss of CU850 is allocated to the assets in the unit by first reducing the carrying amount of goodwill ~~to zero~~.

IE67 Therefore, CU500 of the CU850 impairment loss for the unit is allocated to the goodwill. In accordance with paragraph C6 of Appendix C of IAS 36, if the partially-owned subsidiary is itself a cash-generating unit, the goodwill impairment loss is allocated to the controlling and non-controlling interests on the same basis as that on which profit or loss is allocated. In this example, profit or loss is allocated on the basis of relative ownership interests. ~~However, b~~Because the goodwill is recognised only to the extent of ~~X~~Parent's 80 per cent ownership interest in Subsidiary~~Y~~, ~~X~~Parent recognises only 80 per cent of that goodwill impairment loss (ie CU400).

IE68 The remaining impairment loss of CU350 is recognised by reducing the carrying amounts of ~~Y~~Subsidiary's identifiable assets (see Schedule 2).

Schedule 2. Allocation of the impairment loss for Subsidiary~~Y~~ at the end of 20X3

End of 20X3	*Goodwill*	*Net ~~I~~identifiable ~~net~~ assets*	*Total*
	CU	CU	CU
~~Gross carrying amount~~	~~400~~	~~1,500~~	~~1,900~~
~~Accumulated depreciation~~	~~–~~	~~(150)~~	~~(150)~~
Carrying amount	400	1,350	1,750
Impairment loss	(400)	(350)	(750)
Carrying amount after impairment loss	-	1,000	1,000

Example 7B Non-controlling interests measured initially at fair value and the related subsidiary is a stand-alone cash-generating unit

In this example, tax effects are ignored.

Background

IE68A Parent acquires an 80 per cent ownership interest in Subsidiary for CU2,100 on 1 January 20X3. At that date, Subsidiary's net identifiable assets have a fair value of CU1,500. Parent chooses to measure the non-controlling interests at fair value, which is CU350. Goodwill of CU950 is the difference between the aggregate of the consideration transferred and the amount of the non-controlling interests (CU2,100 + CU350) and the net identifiable assets (CU1,500).

IE68B The assets of Subsidiary together are the smallest group of assets that generate cash inflows that are largely independent of the cash inflows from other assets or groups of assets. Therefore, Subsidiary is a cash-generating unit. Because other cash-generating units of Parent are expected to benefit from the synergies of the combination, the goodwill of CU500 related to those synergies has been allocated to other cash-generating units within Parent. Because Subsidiary includes goodwill within its carrying amount, it must be tested for impairment annually, or more frequently if there is an indication that it might be impaired (see paragraph 90 of IAS 36).

Testing subsidiary for impairment

IE68C At the end of 20X3, Parent determines that the recoverable amount of cash-generating unit Subsidiary is CU1,650. The carrying amount of the net assets of Subsidiary, excluding goodwill, is CU1,350.

Schedule 1. Testing Subsidiary for impairment at the end of 20X3

End of 20X3	*Goodwill*	*Net identifiable assets*	*Total*
	CU	CU	CU
Carrying amount	450	1,350	1,800
Recoverable amount			1,650
Impairment loss			150

Allocating the impairment loss

IE68D In accordance with paragraph 104 of IAS 36, the impairment loss of CU150 is allocated to the assets in the unit by first reducing the carrying amount of goodwill.

IE68E Therefore, the full amount of impairment loss of CU150 for the unit is allocated to the goodwill. In accordance with paragraph C6 of Appendix C of IAS 36, if the partially-owned subsidiary is itself a cash-generating unit, the goodwill impairment loss is allocated to the controlling and non-controlling interests on the same basis as that on which profit or loss is allocated.

Example 7C Non-controlling interests measured initially at fair value and the related subsidiary is part of a larger cash-generating unit

In this example, tax effects are ignored.

Background

IE68F Suppose that, for the business combination described in paragraph IE68A of Example 7B, the assets of Subsidiary will generate cash inflows together with other assets or groups of assets of Parent. Therefore, rather than Subsidiary being the cash-generating unit for the purposes of impairment testing, Subsidiary becomes part of a larger cash-generating unit, Z. Other cash-generating units of Parent are also expected to benefit from the synergies of the combination. Therefore, goodwill related to those synergies, in the amount of CU500, has been allocated to those other cash-generating units. Z's goodwill related to previous business combinations is CU800.

IE68G Because Z includes goodwill within its carrying amount, both from Subsidiary and from previous business combinations, it must be tested for impairment annually, or more frequently if there is an indication that it might be impaired (see paragraph 90 of IAS 36).

Testing subsidiary for impairment

IE68H At the end of 20X3, Parent determines that the recoverable amount of cash-generating unit Z is CU3,300. The carrying amount of the net assets of Z, excluding goodwill, is CU2,250.

Schedule 3. Testing Z for impairment at the end of 20X3

End of 20X3	*Goodwill*	*Net identifiable assets*	*Total*
	CU	CU	CU
Carrying amount	1,250	2,250	3,500
Recoverable amount			3,300
Impairment loss			200

Allocating the impairment loss

IE68I In accordance with paragraph 104 of IAS 36, the impairment loss of CU200 is allocated to the assets in the unit by first reducing the carrying amount of goodwill. Therefore, the full amount of impairment loss of CU200 for cash-generating unit Z is allocated to the goodwill. In accordance with paragraph C7 of Appendix C of IAS 36, if the partially-owned Subsidiary forms part of a larger cash-generating unit, the goodwill impairment loss would be allocated first to the parts of the cash-generating unit, Z, and then to the controlling and non-controlling interests of the partially-owned Subsidiary.

IE68J Parent allocates the impairment loss to the parts of the cash-generating unit on the basis of the relative carrying values of the goodwill of the parts before the impairment. In this example Subsidiary is allocated 36 per cent of the impairment (450/1,250). The impairment loss is then allocated to the controlling and non-controlling interests on the same basis as that on which profit or loss is allocated.

Example 8 Allocation of corporate assets

In this example, tax effects are ignored.

Background

IE69 Entity M has three cash-generating units: A, B and C. The carrying amounts of those units do not include goodwill. There are adverse changes in the technological environment in which M operates. Therefore, M conducts impairment tests of each of its cash-generating units. At the end of 20X0, the carrying amounts of A, B and C are CU100, CU150 and CU200 respectively.

IE70 The operations are conducted from a headquarters. The carrying amount of the headquarters is CU200: a headquarters building of CU150 and a research centre of CU50. The relative carrying amounts of the cash-generating units are a reasonable indication of the proportion of the headquarters building devoted to each cash-generating unit. The carrying amount of the research centre cannot be allocated on a reasonable basis to the individual cash-generating units.

IE71 The remaining estimated useful life of cash-generating unit A is 10 years. The remaining useful lives of B, C and the headquarters are 20 years. The headquarters is depreciated on a straight-line basis.

IE72 The recoverable amount (ie higher of value in use and fair value less costs to sell) of each cash-generating unit is based on its value in use. Value in use is calculated using a pre-tax discount rate of 15 per cent.

Identification of corporate assets

IE73 In accordance with paragraph 102 of IAS 36, M first identifies all the corporate assets that relate to the individual cash-generating units under review. The corporate assets are the headquarters building and the research centre.

IE74 M then decides how to deal with each of the corporate assets:

(a) the carrying amount of the headquarters building can be allocated on a reasonable and consistent basis to the cash-generating units under review; and

(b) the carrying amount of the research centre cannot be allocated on a reasonable and consistent basis to the individual cash-generating units under review.

Allocation of corporate assets

IE75 The carrying amount of the headquarters building is allocated to the carrying amount of each individual cash-generating unit. A weighted allocation basis is used because the estimated remaining useful life of A's cash-generating unit is 10 years, whereas the estimated remaining useful lives of B and C's cash-generating units are 20 years.

Schedule 1. Calculation of a weighted allocation of the carrying amount of the headquarters building

End of 20X0	*A* CU	*B* CU	*C* CU	*Total* CU
Carrying amount	100	150	200	450
Useful life	10 years	20 years	20 years	
Weighting based on useful life	1	2	2	
Carrying amount after weighting	100	300	400	800
Pro-rata allocation of the building	12% *(100/ 800)*	38% *(300/800)*	50% *(400/800)*	100%
Allocation of the carrying amount of the building (based on pro-rata above)	19	56	75	150
Carrying amount (after allocation of the building)	119	206	275	600

Determination of recoverable amount and calculation of impairment losses

IE76 Paragraph 102 of IAS 36 requires first that the recoverable amount of each individual cash-generating unit be compared with its carrying amount, including the portion of the carrying amount of the headquarters building allocated to the unit, and any resulting impairment loss recognised. Paragraph 102 of IAS 36 then requires the recoverable amount of M as a whole (ie the smallest group of cash-generating units that includes the research centre) to be compared with its carrying amount, including both the headquarters building and the research centre.

Schedule 2. Calculation of A, B, C and M's value in use at the end of 20X0

		A		*B*		*C*		*M*
Year	*Future cash flows*	*Discount at 15%*	*Future cash flows*	*Discount at 15%*	*Future cash flows*	*Discount at 15%*	*Future cash flows*	*Discount at 15%*
	CU	*CU*	*CU*	*CU*	*CU*	*CU*	*CU*	*CU*
1	18	16	9	8	10	9	39	34
2	31	23	16	12	20	15	72	54
3	37	24	24	16	34	22	105	69
4	42	24	29	17	44	25	128	73
5	47	24	32	16	51	25	143	71
6	52	22	33	14	56	24	155	67
7	55	21	34	13	60	22	162	61
8	55	18	35	11	63	21	166	54
9	53	15	35	10	65	18	167	48
10	48	12	35	9	66	16	169	42
11			36	8	66	14	132	28
12			35	7	66	12	131	25
13			35	6	66	11	131	21
14			33	5	65	9	128	18
15			30	4	62	8	122	15
16			26	3	60	6	115	12
17			22	2	57	5	108	10
18			18	1	51	4	97	8
19			14	1	43	3	85	6
20			10	1	35	2	71	4
Value in use		199		164		271		720[(a)]

(a) It is assumed that the research centre generates additional future cash flows for the entity as a whole. Therefore, the sum of the value in use of each individual cash-generating unit is less than the value in use of the business as a whole. The additional cash flows are not attributable to the headquarters building.

Schedule 3. Impairment testing A, B and C

End of 20X0	*A*	*B*	*C*
	CU	CU	CU
Carrying amount (after allocation of the building) (Schedule 1)	119	206	275
Recoverable amount (Schedule 2)	199	164	271
Impairment loss	0	(42)	(4)

IE77 The next step is to allocate the impairment losses between the assets of the cash-generating units and the headquarters building.

Schedule 4. Allocation of the impairment losses for cash-generating units B and C

Cash-generating unit	*B*	*C*
	CU	CU
To headquarters building	(12) *(42 × 56/206)*	(1)*(4 × 75/275)*
To assets in cash-generating unit	(30)*(42 × 150/206)*	(3)*(4 × 200/275)*
	(42)	(4)

IE78 Because the research centre could not be allocated on a reasonable and consistent basis to A, B and C's cash-generating units, M compares the carrying amount of the smallest group of cash-generating units to which the carrying amount of the research centre can be allocated (ie M as a whole) to its recoverable amount.

Schedule 5. Impairment testing the smallest group of cash-generating units to which the carrying amount of the research centre can be allocated (ie M as a whole)

End of 20X0	*A*	*B*	*C*	*Building*	*Research centre*	*M*
	CU	CU	CU	CU	CU	CU
Carrying amount	100	150	200	150	50	650
Impairment loss arising from the first step of the test	-	(30)	(3)	(13)	-	(46)
Carrying amount after the first step of the test	100	120	197	137	50	604
Recoverable amount (Schedule 2)						720
Impairment loss for the 'larger' cash-generating unit						0

IE79 Therefore, no additional impairment loss results from the application of the impairment test to M as a whole. Only an impairment loss of CU46 is recognised as a result of the application of the first step of the test to A, B and C.

Example 9 Disclosures about cash-generating units with goodwill or intangible assets with indefinite useful lives

The purpose of this example is to illustrate the disclosures required by paragraphs 134 and 135 of IAS 36.

Background

IE80 Entity M is a multinational manufacturing firm that uses geographical segments ~~as its primary format~~ for reporting segment information. M's three reportable segments ~~based on that format~~ are Europe, North America and Asia. Goodwill has been allocated for impairment testing purposes to three individual cash-generating units—two in Europe (units A and B) and one in North America (unit C)—and to one group of cash-generating units (comprising operation XYZ) in Asia. Units A, B and C and operation XYZ each represent the lowest level within M at which the goodwill is monitored for internal management purposes.

IE81 M acquired unit C, a manufacturing operation in North America, in December 20X2. Unlike M's other North American operations, C operates in an industry with high margins and high growth rates, and with the benefit of a 10-year patent on its primary product. The patent was granted to C just before M's acquisition of C. As part of accounting for the acquisition of C, M recognised, in addition to the patent, goodwill of CU3,000 and a brand name of CU1,000. M's management has determined that the brand name has an indefinite useful life. M has no other intangible assets with indefinite useful lives.

IE82 The carrying amounts of goodwill and intangible assets with indefinite useful lives allocated to units A, B and C and to operation XYZ are as follows:

	Goodwill	*Intangible assets with indefinite useful lives*
	CU	CU
A	350	
B	450	
C	3,000	1,000
XYZ	1,200	
Total	5,000	1,000

IE83 During the year ending 31 December 20X3, M determines that there is no impairment of any of its cash-generating units or group of cash-generating units containing goodwill or intangible assets with indefinite useful lives. The recoverable amounts (ie higher of value in use and fair value less costs to sell) of those units and group of units are determined on the basis of value in use calculations. M has determined that the recoverable amount calculations are most sensitive to changes in the following assumptions:

Units A and B	*Unit C*	*Operation XYZ*
Gross margin during the budget period (budget period is 4 years)	5-year US government bond rate during the budget period (budget period is 5 years)	Gross margin during the budget period (budget period is 5 years)
Raw materials price inflation during the budget period	Raw materials price inflation during the budget period	Japanese yen/US dollar exchange rate during the budget period
Market share during the budget period	Market share during the budget period	Market share during the budget period
Growth rate used to extrapolate cash flows beyond the budget period	Growth rate used to extrapolate cash flows beyond the budget period	Growth rate used to extrapolate cash flows beyond the budget period

IE84 Gross margins during the budget period for A, B and XYZ are estimated by M based on average gross margins achieved in the period immediately before the start of the budget period, increased by 5 per cent per year for anticipated efficiency improvements. A and B produce complementary products and are operated by M to achieve the same gross margins.

IE85 Market shares during the budget period are estimated by M based on average market shares achieved in the period immediately before the start of the budget period, adjusted each year for any anticipated growth or decline in market shares. M anticipates that:

(a) market shares for A and B will differ, but will each grow during the budget period by 3 per cent per year as a result of ongoing improvements in product quality.

(b) C's market share will grow during the budget period by 6 per cent per year as a result of increased advertising expenditure and the benefits from the protection of the 10-year patent on its primary product.

(c) XYZ's market share will remain unchanged during the budget period as a result of the combination of ongoing improvements in product quality and an anticipated increase in competition.

IE86 A and B purchase raw materials from the same European suppliers, whereas C's raw materials are purchased from various North American suppliers. Raw materials price inflation during the budget period is estimated by M to be consistent with forecast consumer price indices published by government agencies in the relevant European and North American countries.

IE87 The 5-year US government bond rate during the budget period is estimated by M to be consistent with the yield on such bonds at the beginning of the budget period. The Japanese yen/US dollar exchange rate is estimated by M to be consistent with the average market forward exchange rate over the budget period.

IE88 M uses steady growth rates to extrapolate beyond the budget period cash flows for A, B, C and XYX. The growth rates for A, B and XYZ are estimated by M to be consistent with publicly available information about the long-term average growth rates for the markets in which A, B and XYZ operate. However, the growth rate for C exceeds the long-term average growth rate for the market in which C operates. M's management is of the opinion that this is reasonable in the light of the protection of the 10-year patent on C's primary product.

IE89 M includes the following disclosure in the notes to its financial statements for the year ending 31 December 20X3.

Impairment Tests for Goodwill and Intangible Assets with Indefinite Lives

Goodwill has been allocated for impairment testing purposes to three individual cash-generating units—two in Europe (units A and B) and one in North America (unit C)—and to one group of cash-generating units (comprising operation XYZ) in Asia. The carrying amount of goodwill allocated to unit C and operation XYZ is significant in comparison with the total carrying amount of goodwill, but the carrying amount of goodwill allocated to each of units A and B is not. Nevertheless, the recoverable amounts of units A and B are based on some of the same key assumptions, and the aggregate carrying amount of goodwill allocated to those units is significant.

Operation XYZ

The recoverable amount of operation XYZ has been determined based on a value in use calculation. That calculation uses cash flow projections based on financial budgets approved by management covering a five-year period, and a discount rate of 8.4 per cent. Cash flows beyond that five-year period have been extrapolated using a steady 6.3 per cent growth rate. This growth rate does not exceed the long-term average growth rate for the market in which XYZ operates. Management believes that any reasonably possible change in the key assumptions on which XYZ's recoverable amount is based would *not* cause XYZ's carrying amount to exceed its recoverable amount.

Unit C

The recoverable amount of unit C has also been determined based on a value in use calculation. That calculation uses cash flow projections based on financial budgets approved by management covering a five-year period, and a discount rate of 9.2 per cent. C's cash flows beyond the five-year period are extrapolated using a steady 12 per cent growth rate. This growth rate exceeds by 4 percentage points the long-term average growth rate for the market in which C operates. However, C benefits from the protection of a 10-year patent on its primary product, granted in December 20X2. Management believes that a 12 per cent growth rate is reasonable in the light of that patent. Management also believes that any reasonably possible change in the key assumptions on which C's recoverable amount is based would *not* cause C's carrying amount to exceed its recoverable amount.

Units A and B

The recoverable amounts of units A and B have been determined on the basis of value in use calculations. Those units produce complementary products, and their recoverable amounts are based on some of the same key assumptions. Both value in use calculations use cash flow projections based on financial budgets approved by management covering a four-year period, and a discount rate of 7.9 per cent. Both sets of cash flows beyond the four-year period are extrapolated using a steady 5 per cent growth rate. This growth rate does not exceed the long-term average growth rate for the market in which A and B operate. Cash flow projections during the budget period for both A and B are also based on the same expected gross margins during the budget period and the same raw materials price inflation during the budget period. Management believes that any reasonably possible change in any of these key assumptions would *not* cause the aggregate carrying amount of A and B to exceed the aggregate recoverable amount of those units.

	Operation XYZ	*Unit C*	*Units A and B (in aggregate)*
Carrying amount of goodwill	CU1,200	CU3,000	CU800
Carrying amount of brand name with indefinite useful life	-	CU1,000	-
Key assumptions used in value in use calculations [(a)]			
• Key assumption	• Budgeted gross margins	• 5-year US government bond rate	• Budgeted gross margins
• Basis for determining value(s) assigned to key assumption	• Average gross margins achieved in period immediately before the budget period, increased for expected efficiency improvements.	• Yield on 5-year US government bonds at the beginning of the budget period.	• Average gross margins achieved in period immediately before the budget period, increased for expected efficiency improvements.
	• Values assigned to key assumption reflect past experience, except for efficiency improvements. Management believes improvements of 5% per year are reasonably achievable.	• Value assigned to key assumption is consistent with external sources of information.	• Values assigned to key assumption reflect past experience, except for efficiency improvements. Management believes improvements of 5% per year are reasonably achievable.
			continued…

(a) The key assumptions shown in this table for units A and B are only those that are used in the recoverable amount calculations for both units.

…continued			
• Key assumption • Basis for determining value(s) assigned to key assumption	• Japanese yen/ US dollar exchange rate during the budget period • Average market forward exchange rate over the budget period. • Value assigned to key assumption is consistent with external sources of information.	• Raw materials price inflation • Forecast consumer price indices during the budget period for North American countries from which raw materials are purchased. • Value assigned to key assumption is consistent with external sources of information.	• Raw materials price inflation • Forecast consumer price indices during the budget period for European countries from which raw materials are purchased. • Value assigned to key assumption is consistent with external sources of information.
• Key assumption • Basis for determining value(s) assigned to key assumption	• Budgeted market share • Average market share in period immediately before the budget period. • Value assigned to key assumption reflects past experience. No change in market share expected as a result of ongoing product quality improvements coupled with anticipated increase in competition.	• Budgeted market share • Average market share in period immediately before the budget period, increased each year for anticipated growth in market share. • Management believes market share growth of 6% per year is reasonably achievable due to increased advertising expenditure, the benefits from the protection of the 10-year patent on C's primary product, and the expected synergies to be achieved from operating C as part of M's North American segment.	

Table of Concordance

This table shows how the contents of SSAP 31 and the current version of HKAS 36 correspond. Paragraphs are treated as corresponding if they broadly address the same matter even though their guidance may differ.

Superseded paragraph	Current paragraph
Objective	1
1	2
2	3
3	4
4	5
5	6
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8	9
9	12
10	13
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12	15
13	16
14	17
15	18
16	19
17	20
18	21
19	22
20	23
21	25
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23	27

Superseded paragraph	Current paragraph
24	28
25	29
26	31
27	33
28	35
29	36
30	37
31	38
32	39
33	40
34	41
35	42
36	43
37	44
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40	47
41	48
42	49
43	50
44	51
45	52
46	53
47	54

Superseded paragraph	**Current paragraph**
48	55
49	56
50	57, A16
51	A17
52	A18
53	A15
54	A19
55	A20
56	A21
57	58
58	59
59	60
60	61
61	62
62	63
63	64
64	65
65	66
66	67
67	68
68	69
69	70
70	71
71	72
72	73
73	74
74	75
75	76
76	77

Superseded paragraph	**Current paragraph**
77	78
78	79
79	81
80-82	80, 82, 88, 90
83	None
84	100
85	101
86	102
87	103
88	104
89	105
90	None
91	106
92	107
93	108
94	109
95	110
96	111
97	112
98	113
99	114
100	115
101	116
102	117
103	118
104	119
105	120
106	121
107	122

Superseded paragraph	**Current paragraph**
108	123
109	124
110	125
111	124
112	None
113	126
114	127
115	128
116	129
117	130
118	131
119	132
120	138, 139
121	None
122	139
A1	IE1
A2	IE2
A3	IE3
A4	IE4
A5	IE5
A6	IE6
A7	IE7
A8	IE8
A9	IE9
A10	IE10
A11	IE11
A12	IE12
A13	IE13
A14	IE14

Superseded paragraph	**Current paragraph**
A15	IE15
A16	IE16
A17	IE17
A18	IE18
A19	IE19
A20	IE20
A21	IE21
A22	IE22
A23	IE23
A24	IE27
A25	IE25
A26	IE23A, IE24, IE26
A27	None
A28	IE28
A29	IE29
A30	IE30
A31	IE31
A32	IE32
A33	IE33
A34	IE34
A35	IE35
A36	IE36
A37	IE37
A38	IE38
A39	IE39
A40	IE40
A41	IE41
A42	IE42

Superseded paragraph	Current paragraph
A43	IE43
A44	IE44
A45	IE45
A46	IE46
A47	IE47
A48	IE48
A49	IE48
A50	IE50
A51	IE51
A52	IE52
A53	IE53
A54	IE54
A55	IE55
A56	IE56
A57	IE57
A58	IE58
A59	IE59
A60	IE60
A61	IE61
A62	None
A63	None
A64	None
A65	None
A66	None
A67	None
A68	None
A69	None

Superseded paragraph	Current paragraph
A70	None
A71	None
A72	IE69
A73	IE70
A74	IE71
A75	IE72
A76	IE73
A77	IE74
A78	IE75
A79	IE76
A80	IE76
A81	IE77
A82	IE78
A83	IE79
None	10,11
None	24
None	30
None	32
None	34
None	83-87
None	89
None	91-99
None	133-137
None	140, 141
None	A1-A14
None	IE62-IE68
None	IE80-IE89

HKAS 37
~~Issued November 2004~~ Revised March 2010

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beginning on or after 1 January 2005

Hong Kong Accounting Standard 37

Provisions, Contingent Liabilities and Contingent Assets

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

Contents

HONG KONG ACCOUNTING STANDARD 37

PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

APPENDICES

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D. **Examples: disclosure**

E. **Comparison with International Accounting Standards**

Hong Kong Accounting Standard 37 *Provisions, Contingent Liabilities and Contingent Assets* (HKAS 37) is set out in paragraphs 1-96. All the paragraphs have equal authority. HKAS 37 should be read in the context of its objective, the *Preface to Hong Kong Financial Reporting Standards* and the *Framework for the Preparation and Presentation of Financial Statements*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Introduction

IN1 HKAS 37 prescribes the accounting and disclosure for all provisions, contingent liabilities and contingent assets, except:

(a) those resulting from financial instruments that are carried at fair value;

(b) those resulting from executory contracts, except where the contract is onerous. Executory contracts are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent;

(c) those arising in insurance entities from contracts with policyholders; or

(d) those covered by another Standard.

Provisions

IN2 The Standard defines provisions as liabilities of uncertain timing or amount. A provision should be recognised when, and only when :

(a) an entity has a present obligation (legal or constructive) as a result of a past event;

(b) it is probable (ie more likely than not) that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(c) a reliable estimate can be made of the amount of the obligation. The Standard notes that it is only in extremely rare cases that a reliable estimate will not be possible.

IN3 The Standard defines a constructive obligation as an obligation that derives from an entity's actions where :

(a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and

(b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

IN4 In rare cases, for example in a lawsuit, it may not be clear whether an entity has a present obligation. In these cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the end of the reporting period. An entity recognises a provision for that present obligation if the other recognition criteria described above are met. If it is more likely than not that no present obligation exists, the entity discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote.

IN5 The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period, in other words, the amount that an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time.

IN6 The Standard requires that an entity should, in measuring a provision:

(a) take risks and uncertainties into account. However, uncertainty does not justify the creation of excessive provisions or a deliberate overstatement of liabilities;

(b) discount the provisions, where the effect of the time value of money is material, using a pre-tax discount rate (or rates) that reflect(s) current market assessments of the time value of money and those risks specific to the liability that have not been reflected in the best estimate of the expenditure. Where discounting is used, the increase in the provision due to the passage of time is recognised as an interest expense;

(c) take future events, such as changes in the law and technological changes, into account where there is sufficient objective evidence that they will occur; and

(d) not take gains from the expected disposal of assets into account, even if the expected disposal is closely linked to the event giving rise to the provision.

IN7 An entity may expect reimbursement of some or all of the expenditure required to settle a provision (for example, through insurance contracts, indemnity clauses or suppliers' warranties). An entity should:

(a) recognise a reimbursement when, and only when, it is virtually certain that reimbursement will be received if the entity settles the obligation. The amount recognised for the reimbursement should not exceed the amount of the provision; and

(b) recognise the reimbursement as a separate asset. In the statement of comprehensive income, the expense relating to a provision may be presented net of the amount recognised for a reimbursement.

IN8 Provisions should be reviewed at the end of each reporting period and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision should be reversed.

IN9 A provision should be used only for expenditures for which the provision was originally recognised.

Provisions – specific applications

IN10 The Standard explains how the general recognition and measurement requirements for provisions should be applied in three specific cases: future operating losses ; onerous contracts ; and restructurings.

IN11 Provisions should not be recognised for future operating losses. An expectation of future operating losses is an indication that certain assets of the operation may be impaired. In this case, an entity tests these assets for impairment under HKAS 36 *Impairment of Assets*.

IN12 If an entity has a contract that is onerous, the present obligation under the contract should be recognised and measured as a provision. An onerous contract is one in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

IN13 The Standard defines a restructuring as a programme that is planned and controlled by management, and materially changes either:

(a) the scope of a business undertaken by an entity; or

(b) the manner in which that business is conducted.

IN14 A provision for restructuring costs is recognised only when the general recognition criteria for provisions are met. In this context, a constructive obligation to restructure arises only when an entity:

(a) has a detailed formal plan for the restructuring identifying at least:

(i) the business or part of a business concerned;

(ii) the principal locations affected;

(iii) the location, function, and approximate number of employees who will be compensated for terminating their services;

(iv) the expenditures that will be undertaken; and

(v) when the plan will be implemented; and

(b) has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

IN15 A management or board decision to restructure does not give rise to a constructive obligation at the end of the reporting period unless the entity has, before the end of the reporting period:

(a) started to implement the restructuring plan; or

(b) communicated the restructuring plan to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the entity will carry out the restructuring.

IN16 Where a restructuring involves the sale of an operation, no obligation arises for the sale until the entity is committed to the sale, ie there is a binding sale agreement.

IN17 A restructuring provision should include only the direct expenditures arising from the restructuring, which are those that are both:

(a) necessarily entailed by the restructuring; and

(b) not associated with the ongoing activities of the entity. Thus, a restructuring provision does not include such costs as: retraining or relocating continuing staff; marketing; or investment in new systems and distribution networks.

Contingent liabilities

IN18 The Standard defines a contingent liability as:

(a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or

(b) a present obligation that arises from past events but is not recognised because:

(i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

(ii) the amount of the obligation cannot be measured with sufficient reliability.

IN19 An entity should not recognise a contingent liability. An entity should disclose a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote.

Contingent assets

IN20 The Standard defines a contingent asset as a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity. An example is a claim that an entity is pursuing through legal processes, where the outcome is uncertain.

IN21 An entity should not recognise a contingent asset. A contingent asset should be disclosed where an inflow of economic benefits is probable.

IN22 When the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.

Effective date

IN23 The Standard becomes operative for annual financial statements covering periods beginning on or after 1 January 2005. Earlier application is encouraged.

Hong Kong Accounting Standard 37
Provisions, Contingent Liabilities and Contingent Assets

Objective

The objective of this Standard is to ensure that appropriate recognition criteria and measurement bases are applied to provisions, contingent liabilities and contingent assets and that sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount.

Scope

1 This Standard shall be applied by all entities in accounting for provisions, contingent liabilities and contingent assets, except:

(a) those resulting from executory contracts, except where the contract is onerous;

(b) [deleted]

(c) those covered by another Standard.

2 This Standard does not apply to financial instruments (including guarantees) that are within the scope of HKAS 39 *Financial Instruments: Recognition and Measurement*.

3 Executory contracts are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent. This Standard does not apply to executory contracts unless they are onerous.

4 [Deleted]

5[*] ~~Where~~ When another Standard deals with a specific type of provision, contingent liability or contingent asset, an entity applies that Standard instead of this Standard. For example, ~~HKFRS 3 *Business Combinations* addresses the treatment by an acquirer of contingent liabilities assumed in a business combination. Similarly, certain~~some types of provisions are ~~also~~ addressed in Standards on:

(a) construction contracts (see HKAS 11 *Construction Contracts*);

(b) income taxes (see HKAS 12 *Income Taxes)*;

(c) leases (see HKAS 17 *Leases*). However, as HKAS 17 contains no specific requirements to deal with operating leases that have become onerous, this Standard applies to such cases;

(d) employee benefits (see HKAS 19 *Employee Benefits*); and

(e) insurance contracts (see HKFRS 4 *Insurance Contracts*). However, this Standard applies to provisions, contingent liabilities and contingent assets of an insurer, other than those arising from its contractual obligations and rights under insurance contracts within the scope of HKFRS 4.

6 Some amounts treated as provisions may relate to the recognition of revenue, for example where an entity gives guarantees in exchange for a fee. This Standard does not address the recognition of revenue. HKAS 18 *Revenue* identifies the circumstances in which revenue is recognised and provides practical guidance on the application of the recognition criteria. This Standard does not change the requirements of HKAS 18.

7 This Standard defines provisions as liabilities of uncertain timing or amount. In some countries the term "provision" is also used in the context of items such as depreciation, impairment of assets and doubtful debts: these are adjustments to the carrying amounts of assets and are not addressed in this Standard.

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

8 Other Standards specify whether expenditures are treated as assets or as expenses. These issues are not addressed in this Standard. Accordingly, this Standard neither prohibits nor requires capitalisation of the costs recognised when a provision is made.

9 This Standard applies to provisions for restructurings (including discontinued operations). When a restructuring meets the definition of a discontinued operation, additional disclosures may be required by HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations.*

Definitions

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

A *provision* **is a liability of uncertain timing or amount.**

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.**

An *obligating event* **is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation.**

A *legal obligation* **is an obligation that derives from:**

(**a)** **a contract (through its explicit or implicit terms);**

(**b)** **legislation; or**

(**c)** **other operation of law.**

A *constructive obligation* **is an obligation that derives from an entity's actions where:**

(a) **by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and**

(b) **as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.**

A *contingent liability* **is:**

(a) **a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or**

(b) **a present obligation that arises from past events but is not recognised because:**

(i) **it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or**

(ii) **the amount of the obligation cannot be measured with sufficient reliability.**

A *contingent asset* **is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.**

An *onerous contract* **is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.**

A *restructuring* **is a programme that is planned and controlled by management, and materially changes either:**

(a) **the scope of a business undertaken by an entity; or**

(b) the manner in which that business is conducted.

Provisions and other liabilities

11 Provisions can be distinguished from other liabilities such as trade payables and accruals because there is uncertainty about the timing or amount of the future expenditure required in settlement. By contrast:

(a) trade payables are liabilities to pay for goods or services that have been received or supplied and have been invoiced or formally agreed with the supplier; and

(b) accruals are liabilities to pay for goods or services that have been received or supplied but have not been paid, invoiced or formally agreed with the supplier, including amounts due to employees (for example, amounts relating to accrued vacation pay). Although it is sometimes necessary to estimate the amount or timing of accruals, the uncertainty is generally much less than for provisions.

Accruals are often reported as part of trade and other payables, whereas provisions are reported separately.

Relationship between provisions and contingent liabilities

12 In a general sense, all provisions are contingent because they are uncertain in timing or amount. However, within this Standard the term "contingent" is used for liabilities and assets that are not recognised because their existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity. In addition, the term "contingent liability" is used for liabilities that do not meet the recognition criteria.

13 This Standard distinguishes between:

(a) provisions -which are recognised as liabilities (assuming that a reliable estimate can be made) because they are present obligations and it is probable that an outflow of resources embodying economic benefits will be required to settle the obligations; and

(b) contingent liabilities - which are not recognised as liabilities because they are either:

(i) possible obligations, as it has yet to be confirmed whether the entity has a present obligation that could lead to an outflow of resources embodying economic benefits; or

(ii) present obligations that do not meet the recognition criteria in this Standard (because either it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or a sufficiently reliable estimate of the amount of the obligation cannot be made).

Recognition

Provisions

14 A provision shall be recognised when:

(a) an entity has a present obligation (legal or constructive) as a result of a past event;

(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(c) a reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision shall be recognised.

Present obligation

15 **In rare cases it is not clear whether there is a present obligation. In these cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the ~~balance sheet date~~end of the reporting period.**

16 In almost all cases it will be clear whether a past event has given rise to a present obligation. In rare cases, for example in a lawsuit, it may be disputed either whether certain events have occurred or whether those events result in a present obligation. In such a case, an entity determines whether a present obligation exists at the ~~balance sheet date~~end of the reporting period by taking account of all available evidence, including, for example, the opinion of experts. The evidence considered includes any additional evidence provided by events after the ~~balance sheet date~~reporting period. On the basis of such evidence:

(a) where it is more likely than not that a present obligation exists at the ~~balance sheet date~~end of the reporting period, the entity recognises a provision (if the recognition criteria are met); and

(b) where it is more likely that no present obligation exists at the ~~balance sheet date~~end of the reporting period, the entity discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote (see paragraph 86).

Past event

17 A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the entity has no realistic alternative to settling the obligation created by the event. This is the case only:

(a) where the settlement of the obligation can be enforced by law; or

(b) in the case of a constructive obligation, where the event (which may be an action of the entity) creates valid expectations in other parties that the entity will discharge the obligation.

18 Financial statements deal with the financial position of an entity at the end of its reporting period and not its possible position in the future. Therefore, no provision is recognised for costs that need to be incurred to operate in the future. The only liabilities recognised in an entity's ~~balance sheet~~ statement of financial position are those that exist at the ~~balance sheet date~~end of the reporting period.

19 It is only those obligations arising from past events existing independently of an entity's future actions (i.e. the future conduct of its business) that are recognised as provisions. Examples of such obligations are penalties or clean-up costs for unlawful environmental damage, both of which would lead to an outflow of resources embodying economic benefits in settlement regardless of the future actions of the entity. Similarly, an entity recognises a provision for the decommissioning costs of an oil installation or a nuclear power station to the extent that the entity is obliged to rectify damage already caused. In contrast, because of commercial pressures or legal requirements, an entity may intend or need to carry out expenditure to operate in a particular way in the future (for example, by fitting smoke filters in a certain type of factory). Because the entity can avoid the future expenditure by its future actions, for example by changing its method of operation, it has no present obligation for that future expenditure and no provision is recognised.

20 An obligation always involves another party to whom the obligation is owed. It is not necessary, however, to know the identity of the party to whom the obligation is owed — indeed the obligation may be to the public at large. Because an obligation always involves a commitment to another party, it follows that a management or board decision does not give rise to a constructive obligation at the ~~balance sheet date~~end of the reporting period unless the decision has been communicated before the ~~balance sheet date~~end of the reporting period to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the entity will discharge its responsibilities.

21 An event that does not give rise to an obligation immediately may do so at a later date, because of changes in the law or because an act (for example, a sufficiently specific public statement) by the entity gives rise to a constructive obligation. For example, when environmental damage is caused there may be no obligation to remedy the consequences. However, the causing of the damage will become an obligating event when a new law requires the existing damage to be rectified or when the entity publicly accepts responsibility for rectification in a way that creates a constructive obligation.

22 Where details of a proposed new law have yet to be finalised, an obligation arises only when the legislation is virtually certain to be enacted as drafted. For the purpose of this Standard, such an obligation is treated as a legal obligation. Differences in circumstances surrounding enactment make it impossible to specify a single event that would make the enactment of a law virtually certain. In many cases it will be impossible to be virtually certain of the enactment of a law until it is enacted.

Probable outflow of resources embodying economic benefits

23 For a liability to qualify for recognition there must be not only a present obligation but also the probability of an outflow of resources embodying economic benefits to settle that obligation. For the purpose of this Standard [*], an outflow of resources or other event is regarded as probable if the event is more likely than not to occur, ie the probability that the event will occur is greater than the probability that it will not. Where it is not probable that a present obligation exists, an entity discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote (see paragraph 86).

24 Where there are a number of similar obligations (e.g. product warranties or similar contracts) the probability that an outflow will be required in settlement is determined by considering the class of obligations as a whole. Although the likelihood of outflow for any one item may be small, it may well be probable that some outflow of resources will be needed to settle the class of obligations as a whole. If that is the case, a provision is recognised (if the other recognition criteria are met).

Reliable estimate of the obligation

25 The use of estimates is an essential part of the preparation of financial statements and does not undermine their reliability. This is especially true in the case of provisions, which by their nature are more uncertain than most other ~~balance sheet items~~items in the statement of financial position. Except in extremely rare cases, an entity will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is sufficiently reliable to use in recognising a provision.

26 In the extremely rare case where no reliable estimate can be made, a liability exists that cannot be recognised. That liability is disclosed as a contingent liability (see paragraph 86).

Contingent liabilities

27 An entity shall not recognise a contingent liability.

28 A contingent liability is disclosed, as required by paragraph 86, unless the possibility of an outflow of resources embodying economic benefits is remote.

29 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. The entity recognises a provision for the part of the obligation for which an outflow of resources embodying economic benefits is probable, except in the extremely rare circumstances where no reliable estimate can be made.

30 Contingent liabilities may develop in a way not initially expected. Therefore, they are assessed continually to determine whether an outflow of resources embodying economic benefits has become probable. If it becomes probable that an outflow of future economic benefits will be required for an item previously dealt with as a contingent liability, a provision is recognised in the financial statements of the period in which the change in probability occurs (except in the extremely rare circumstances where no reliable estimate can be made).

[*] The interpretation of "probable" in this Standard as "more likely than not" does not necessarily apply in other Standards.

Contingent assets

31 **An entity shall not recognise a contingent asset.**

32 Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the entity. An example is a claim that an entity is pursuing through legal processes, where the outcome is uncertain.

33 Contingent assets are not recognised in financial statements since this may result in the recognition of income that may never be realised. However, when the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.

34 A contingent asset is disclosed, as required by paragraph 89, where an inflow of economic benefits is probable.

35 Contingent assets are assessed continually to ensure that developments are appropriately reflected in the financial statements. If it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income are recognised in the financial statements of the period in which the change occurs. If an inflow of economic benefits has become probable, an entity discloses the contingent asset (see paragraph 89).

Measurement

Best estimate

36 **The amount recognised as a provision shall be the best estimate of the expenditure required to settle the present obligation at the ~~balance sheet date~~end of the reporting period.**

37 The best estimate of the expenditure required to settle the present obligation is the amount that an entity would rationally pay to settle the obligation at the ~~balance sheet date~~end of the reporting period or to transfer it to a third party at that time. It will often be impossible or prohibitively expensive to settle or transfer an obligation at the ~~balance sheet date~~end of the reporting period. However, the estimate of the amount that an entity would rationally pay to settle or transfer the obligation gives the best estimate of the expenditure required to settle the present obligation at the ~~balance sheet date~~reporting period.

38 The estimates of outcome and financial effect are determined by the judgement of the management of the entity, supplemented by experience of similar transactions and, in some cases, reports from independent experts. The evidence considered includes any additional evidence provided by events after the ~~balance sheet date~~reporting period.

39 Uncertainties surrounding the amount to be recognised as a provision are dealt with by various means according to the circumstances. Where the provision being measured involves a large population of items, the obligation is estimated by weighting all possible outcomes by their associated probabilities. The name for this statistical method of estimation is "expected value". The provision will therefore be different depending on whether the probability of a loss of a given amount is, for example, 60 per cent or 90 per cent. Where there is a continuous range of possible outcomes, and each point in that range is as likely as any other, the mid-point of the range is used.

Example
An entity sells goods with a warranty under which customers are covered for the cost of repairs of any manufacturing defects that become apparent within the first six months after purchase. If minor defects were detected in all products sold, repair costs of 1 million would result. If major defects were detected in all products sold, repair costs of 4 million would result. The entity's past experience and future expectations indicate that, for the coming year, 75 per cent of the goods sold will have no defects, 20 per cent of the goods sold will have minor defects and 5 per cent of the goods sold will have major defects. In accordance with paragraph 24, an entity assesses the probability of an outflow for the warranty obligations as a whole. The expected value of the cost of repairs is: (75% of nil) + (20% of 1m) + (5% of 4m) = 400,000

40 Where a single obligation is being measured, the individual most likely outcome may be the best estimate of the liability. However, even in such a case, the entity considers other possible outcomes. Where other possible outcomes are either mostly higher or mostly lower than the most likely outcome, the best estimate will be a higher or lower amount. For example, if an entity has to rectify a serious fault in a major plant that it has constructed for a customer, the individual most likely outcome may be for the repair to succeed at the first attempt at a cost of 1,000, but a provision for a larger amount is made if there is a significant chance that further attempts will be necessary.

41 The provision is measured before tax, as the tax consequences of the provision, and changes in it, are dealt with under HKAS 12.

Risks and uncertainties

42 The risks and uncertainties that inevitably surround many events and circumstances shall be taken into account in reaching the best estimate of a provision.

43 Risk describes variability of outcome. A risk adjustment may increase the amount at which a liability is measured. Caution is needed in making judgements under conditions of uncertainty, so that income or assets are not overstated and expenses or liabilities are not understated. However, uncertainty does not justify the creation of excessive provisions or a deliberate overstatement of liabilities. For example, if the projected costs of a particularly adverse outcome are estimated on a prudent basis, that outcome is not then deliberately treated as more probable than is realistically the case. Care is needed to avoid duplicating adjustments for risk and uncertainty with consequent overstatement of a provision.

44 Disclosure of the uncertainties surrounding the amount of the expenditure is made under paragraph 85(b).

Present value

45 Where the effect of the time value of money is material, the amount of a provision shall be the present value of the expenditures expected to be required to settle the obligation.

46 Because of the time value of money, provisions relating to cash outflows that arise soon after the ~~balance sheet date~~reporting period are more onerous than those where cash outflows of the same amount arise later. Provisions are therefore discounted, where the effect is material.

47 The discount rate (or rates) shall be a pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money and the risks specific to the liability. The discount rate(s) shall not reflect risks for which future cash flow estimates have been adjusted.

Future events

48 Future events that may affect the amount required to settle an obligation shall be reflected in the amount of a provision where there is sufficient objective evidence that they will occur.

49 Expected future events may be particularly important in measuring provisions. For example, an entity may believe that the cost of cleaning up a site at the end of its life will be reduced by future changes in technology. The amount recognised reflects a reasonable expectation of technically qualified, objective observers, taking account of all available evidence as to the technology that will be available at the time of the clean-up. Thus it is appropriate to include, for example, expected cost reductions associated with increased experience in applying existing technology or the expected cost of applying existing technology to a larger or more complex clean-up operation than has previously been carried out. However, an entity does not anticipate the development of a completely new technology for cleaning up unless it is supported by sufficient objective evidence.

50 The effect of possible new legislation is taken into consideration in measuring an existing obligation when sufficient objective evidence exists that the legislation is virtually certain to be enacted. The variety of circumstances that arise in practice makes it impossible to specify a single event that will provide sufficient, objective evidence in every case. Evidence is required both of what legislation will demand and of whether it is virtually certain to be enacted and implemented in due course. In many cases sufficient objective evidence will not exist until the new legislation is enacted.

Expected disposal of assets

51 Gains from the expected disposal of assets shall not be taken into account in measuring a provision.

52 Gains on the expected disposal of assets are not taken into account in measuring a provision, even if the expected disposal is closely linked to the event giving rise to the provision. Instead, an entity recognises gains on expected disposals of assets at the time specified by the Standard dealing with the assets concerned.

Reimbursements

53 Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement shall be recognised when, and only when, it is virtually certain that reimbursement will be received if the entity settles the obligation. The reimbursement shall be treated as a separate asset. The amount recognised for the reimbursement shall not exceed the amount of the provision.

54 In the ~~income~~ statement of comprehensive income, the expense relating to a provision may be presented net of the amount recognised for a reimbursement.

55 Sometimes, an entity is able to look to another party to pay part or all of the expenditure required to settle a provision (for example, through insurance contracts, indemnity clauses or suppliers' warranties). The other party may either reimburse amounts paid by the entity or pay the amounts directly.

56 In most cases the entity will remain liable for the whole of the amount in question so that the entity would have to settle the full amount if the third party failed to pay for any reason. In this situation, a provision is recognised for the full amount of the liability, and a separate asset for the expected reimbursement is recognised when it is virtually certain that reimbursement will be received if the entity settles the liability.

57 In some cases, the entity will not be liable for the costs in question if the third party fails to pay. In such a case the entity has no liability for those costs and they are not included in the provision.

58 As noted in paragraph 29, an obligation for which an entity is jointly and severally liable is a contingent liability to the extent that it is expected that the obligation will be settled by the other parties.

Changes in provisions

59 **Provisions shall be reviewed at the end of each ~~balance sheet date~~reporting period and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision shall be reversed.**

60 Where discounting is used, the carrying amount of a provision increases in each period to reflect the passage of time. This increase is recognised as borrowing cost.

Use of provisions

61 **A provision shall be used only for expenditures for which the provision was originally recognised.**

62 Only expenditures that relate to the original provision are set against it. Setting expenditures against a provision that was originally recognised for another purpose would conceal the impact of two different events.

Application of the recognition and measurement rules

Future operating losses

63 **Provisions shall not be recognised for future operating losses.**

64 Future operating losses do not meet the definition of a liability in paragraph 10 and the general recognition criteria set out for provisions in paragraph 14.

65 An expectation of future operating losses is an indication that certain assets of the operation may be impaired. An entity tests these assets for impairment under HKAS 36 *Impairment of Assets*.

Onerous contracts

66 **If an entity has a contract that is onerous, the present obligation under the contract shall be recognised and measured as a provision.**

67 Many contracts (for example, some routine purchase orders) can be cancelled without paying compensation to the other party, and therefore there is no obligation. Other contracts establish both rights and obligations for each of the contracting parties. Where events make such a contract onerous, the contract falls within the scope of this Standard and a liability exists which is recognised. Executory contracts that are not onerous fall outside the scope of this Standard.

68 This Standard defines an onerous contract as a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it.

69 Before a separate provision for an onerous contract is established, an entity recognises any impairment loss that has occurred on assets dedicated to that contract (see HKAS 36).

Restructuring

70 The following are examples of events that may fall under the definition of restructuring:

(a) sale or termination of a line of business;

(b) the closure of business locations in a country or region or the relocation of business activities from one country or region to another;

(c) changes in management structure, for example, eliminating a layer of management; and

(d) fundamental reorganisations that have a material effect on the nature and focus of the entity's operations.

71 A provision for restructuring costs is recognised only when the general recognition criteria for provisions set out in paragraph 14 are met. Paragraphs 72-83 set out how the general recognition criteria apply to restructurings.

72 A constructive obligation to restructure arises only when an entity:

(**a) has a detailed formal plan for the restructuring identifying at least:**

(i) the business or part of a business concerned;

(ii) the principal locations affected;

(iii) the location, function, and approximate number of employees who will be compensated for terminating their services;

(iv) the expenditures that will be undertaken; and

(v) when the plan will be implemented; and

(**b) has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.**

73 Evidence that an entity has started to implement a restructuring plan would be provided, for example, by dismantling plant or selling assets or by the public announcement of the main features of the plan. A public announcement of a detailed plan to restructure constitutes a constructive obligation to restructure only if it is made in such a way and in sufficient detail (ie setting out the main features of the plan) that it gives rise to valid expectations in other parties such as customers, suppliers and employees (or their representatives) that the entity will carry out the restructuring.

74 For a plan to be sufficient to give rise to a constructive obligation when communicated to those affected by it, its implementation needs to be planned to begin as soon as possible and to be completed in a timeframe that makes significant changes to the plan unlikely. If it is expected that there will be a long delay before the restructuring begins or that the restructuring will take an unreasonably long time, it is unlikely that the plan will raise a valid expectation on the part of others that the entity is at present committed to restructuring, because the timeframe allows opportunities for the entity to change its plans.

75 A management or board decision to restructure taken before the ~~balance sheet date~~end of the reporting period does not give rise to a constructive obligation at the ~~balance sheet date~~end of the reporting period unless the entity has, before the ~~balance sheet date~~end of the reporting period:

(a) started to implement the restructuring plan; or

(b) announced the main features of the restructuring plan to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the entity will carry out the restructuring.

If an entity starts to implement a restructuring plan, or announces its main features to those affected, only after the ~~balance sheet date~~reporting period, disclosure is required under HKAS 10 *Events after the ~~Balance Sheet Date~~Reporting Period*, if the restructuring is material and non-disclosure could influence the economic decisions ~~of users taken~~that users make on the basis of the financial statements.

76 Although a constructive obligation is not created solely by a management decision, an obligation may result from other earlier events together with such a decision. For example, negotiations with employee representatives for termination payments, or with purchasers for the sale of an operation, may have been concluded subject only to board approval. Once that approval has been obtained and communicated to the other parties, the entity has a constructive obligation to restructure, if the conditions of paragraph 72 are met.

77 In some countries, the ultimate authority is vested in a board whose membership includes representatives of interests other than those of management (e.g. employees) or notification to such representatives may be necessary before the board decision is taken. Because a decision by such a board involves communication to these representatives, it may result in a constructive obligation to restructure.

78 No obligation arises for the sale of an operation until the entity is committed to the sale, ie there is a binding sale agreement.

79 Even when an entity has taken a decision to sell an operation and announced that decision publicly, it cannot be committed to the sale until a purchaser has been identified and there is a binding sale agreement. Until there is a binding sale agreement, the entity will be able to change its mind and indeed will have to take another course of action if a purchaser cannot be found on acceptable terms. When the sale of an operation is envisaged as part of a restructuring, the assets of the operation are reviewed for impairment under HKAS 36. When a sale is only part of a restructuring, a constructive obligation can arise for the other parts of the restructuring before a binding sale agreement exists.

80 A restructuring provision shall include only the direct expenditures arising from the restructuring, which are those that are both:

(**a)** **necessarily entailed by the restructuring; and**

(**b)** **not associated with the ongoing activities of the entity.**

81 A restructuring provision does not include such costs as:

(a) retraining or relocating continuing staff;

(b) marketing; or

(c) investment in new systems and distribution networks.

These expenditures relate to the future conduct of the business and are not liabilities for restructuring at the ~~balance sheet date~~end of the reporting period. Such expenditures are recognised on the same basis as if they arose independently of a restructuring.

82 Identifiable future operating losses up to the date of a restructuring are not included in a provision, unless they relate to an onerous contract as defined in paragraph 10.

83 As required by paragraph 51, gains on the expected disposal of assets are not taken into account in measuring a restructuring provision, even if the sale of assets is envisaged as part of the restructuring.

Disclosure

84 For each class of provision, an entity shall disclose:

(a) the carrying amount at the beginning and end of the period;

(b) additional provisions made in the period, including increases to existing provisions;

(c) amounts used (ie incurred and charged against the provision) during the period;

(d) unused amounts reversed during the period; and

(e) 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.

Comparative information is not required.

85 **An entity shall disclose the following for each class of provision:**

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

(b) **An indication of the uncertainties about the amount or timing of those outflows. Where necessary to provide adequate information, an entity shall disclose the major assumptions made concerning future events, as addressed in paragraph 48; and**

(c) **the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.**

86 **Unless the possibility of any outflow in settlement is remote, an entity shall disclose for each class of contingent liability at the ~~balance sheet date~~end of the reporting period a brief description of the nature of the contingent liability and, where practicable:**

(a) **an estimate of its financial effect, measured under paragraphs 36-52;**

(b) **an indication of the uncertainties relating to the amount or timing of any outflow; and**

(c) **the possibility of any reimbursement.**

87 In determining which provisions or contingent liabilities may be aggregated to form a class, it is necessary to consider whether the nature of the items is sufficiently similar for a single statement about them to fulfil the requirements of paragraphs 85(a) and (b) and 86(a) and (b). Thus, it may be appropriate to treat as a single class of provision amounts relating to warranties of different products, but it would not be appropriate to treat as a single class amounts relating to normal warranties and amounts that are subject to legal proceedings.

88 Where a provision and a contingent liability arise from the same set of circumstances, an entity makes the disclosures required by paragraphs 84-86 in a way that shows the link between the provision and the contingent liability.

89 **Where an inflow of economic benefits is probable, an entity shall disclose a brief description of the nature of the contingent assets at the ~~balance sheet date~~end of the reporting period, and, where practicable, an estimate of their financial effect, measured using the principles set out for provisions in paragraphs 36-52.**

90 It is important that disclosures for contingent assets avoid giving misleading indications of the likelihood of income arising.

91 **Where any of the information required by paragraphs 86 and 89 is not disclosed because it is not practicable to do so, that fact shall be stated.**

92 **In extremely rare cases, disclosure of some or all of the information required by paragraphs 84-89 can be expected to prejudice seriously the position of the entity in a dispute with other parties on the subject matter of the provision, contingent liability or contingent asset. In such cases, an entity need not disclose the information, but shall disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.**

93 [Not used]

94 [Not used]

Effective date

95 **This Standard becomes operative for annual financial statements covering periods beginning on or after 1 January 2005. Earlier application is encouraged.**

96 This Standard supersedes SSAP 28 *Provisions, Contingent Liabilities and Contingent Assets (*issued in January 2001).

Appendix A

Tables - Provisions, contingent liabilities, contingent assets and reimbursements

This appendix accompanies, but is not part of, IAS 37. Its purpose is to summarise the main requirements of the Standard.

Provisions and contingent liabilities

Where, as a result of past events, there may be an outflow of resources embodying future economic benefits in settlement of: (a) a present obligation; or (b) a possible obligation whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.		
There is a present obligation that probably requires an outflow of outflow resources.	**There is a possible obligation or a present obligation that may, but probably will not, require an outflow of resources.**	**There is a possible obligation or a present obligation where the likelihood of an outflow of resources is remote.**
A provision is recognised (paragraph 14).	No provision is recognised (paragraph 27).	No provision is recognised (paragraph 27).
Disclosures are required for the provision (paragraphs 84 and 85).	Disclosures are required for the contingent liability (paragraph 86).	No disclosure is required (paragraph 86).

A contingent liability also arises in the extremely rare case where there is a liability that cannot be recognised because it cannot be measured reliably. Disclosures are required for the contingent liability.

Contingent assets

Where, as a result of past events, there is a possible asset whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.		
The inflow of economic benefits is virtually certain.	**The inflow of economic benefits is probable, but not virtually certain.**	**The inflow is not probable.**
The asset is not contingent (paragraph 33).	No asset is recognised (paragraph 31).	No asset is recognised (paragraph 31).
	Disclosures are required (paragraph 89).	No disclosure is required (paragraph 89).

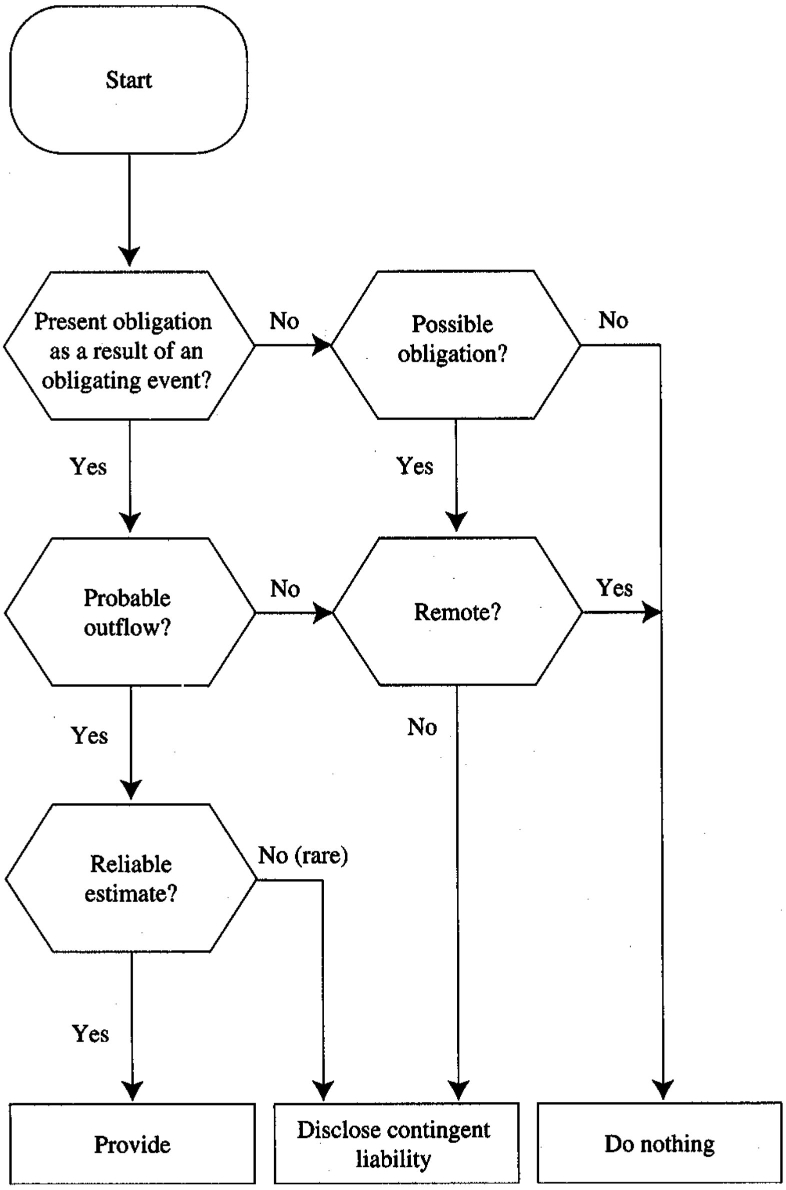
Reimbursements

Some or all of the expenditure required to settle a provision is expected to be reimbursed by another party.		
The entity has the obligation for the part of the expenditure to be reimbursed by the other party.	**The obligation for the amount expected to be reimbursed remains with the entity and it is virtually certain that reimbursement will be received if the entity settles the provision.**	**The obligation for the amount expected to be reimbursed remains with the entity and the reimbursement is not virtually certain if the entity settles the provision.**
The entity has no liability for the amount to be reimbursed (paragraph 57).	The reimbursement is recognised as a separate asset in the ~~balance sheet~~statement of financial position and may be offset against the expense in the ~~income~~ statement of comprehensive income. The amount recognised for the expected reimbursement does not exceed the liability(paragraphs 53 and 54).	The expected reimbursement is not recognised as an asset (paragraph 53).
No disclosure is required.	The reimbursement is disclosed together with the amount recognised for the reimbursement (paragraph 85(c)).	The expected reimbursement is disclosed (paragraph 85(c)).

Appendix B

Decision tree

This appendix accompanies, but is not part of, IAS 37. Its purpose is to summarise the main recognition requirements of the Standard for provisions and contingent liabilities.



Note: in rare cases, it is not clear whether there is a present obligation. In these cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the ~~balance sheet date~~end of the reporting period (paragraph 15 of the Standard).

Appendix C

Examples: recognition

This appendix accompanies, but is not part of, IAS 37.

All the entities in the examples have 31 December year-ends. In all cases, it is assumed that a reliable estimate can be made of any outflows expected. In some examples the circumstances described may have resulted in impairment of the assets - this aspect is not dealt with in the examples.

The cross-references provided in the examples indicate paragraphs of the Standard that are particularly relevant.

References to "best estimate" are to the present value amount, where the effect of the time value of money is material.

Example 1 Warranties

A manufacturer gives warranties at the time of sale to purchasers of its product. Under the terms of the contract for sale the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale. On past experience, it is probable (ie more likely than not) that there will be some claims under the warranties.

Present obligation as a result of a past obligating event - The obligating event is the sale of the product with a warranty, which gives rise to a legal obligation.

An outflow of resources embodying economic benefits in settlement - Probable for the warranties as a whole (see paragraph 24).

Conclusion - A provision is recognised for the best estimate of the costs of making good under the warranty products sold before the ~~balance sheet date~~end of the reporting period (see paragraphs 14 and 24).

Example 2A Contaminated land - legislation virtually certain to be enacted

An entity in the oil industry causes contamination but cleans up only when required to do so under the laws of the particular country in which it operates. One country in which it operates has had no legislation requiring cleaning up, and the entity has been contaminating land in that country for several years. At 31 December 20X0 it is virtually certain that a draft law requiring a clean-up of land already contaminated will be enacted shortly after the year end.

Present obligation as a result of a past obligating event - The obligating event is the contamination of the land because of the virtual certainty of legislation requiring cleaning up.

An outflow of resources embodying economic benefits in settlement - Probable.

Conclusion - A provision is recognised for the best estimate of the costs of the clean-up (see paragraphs 14 and 22).

Example 2B Contaminated land and constructive obligation

An entity in the oil industry causes contamination and operates in a country where there is no environmental legislation. However, the entity has a widely published environmental policy in which it undertakes to clean up all contamination that it causes. The entity has a record of honouring this published policy.

Present obligation as a result of a past obligating event - The obligating event is the contamination of the land, which gives rise to a constructive obligation because the conduct of the entity has created a valid expectation on the part of those affected by it that the entity will clean up contamination.

An outflow of resources embodying economic benefits in settlement - Probable.

Conclusion - A provision is recognised for the best estimate of the costs of clean-up (see paragraphs 10 (the definition of a constructive obligation), 14 and 17).

Example 3 Offshore oilfield

An entity operates an offshore oilfield where its licensing agreement requires it to remove the oil rig at the end of production and restore the seabed. Ninety per cent of the eventual costs relate to the removal of the oil rig and restoration of damage caused by building it, and 10 per cent arise through the extraction of oil. At the ~~balance sheet date~~end of the reporting period, the rig has been constructed but no oil has been extracted.

Present obligation as a result of a past obligating event - The construction of the oil rig creates a legal obligation under the terms of the licence to remove the rig and restore the seabed and is thus an obligating event. At the ~~balance sheet date~~end of the reporting period, however, there is no obligation to rectify the damage that will be caused by extraction of the oil.

An outflow of resources embodying economic benefits in settlement - Probable.

Conclusion - A provision is recognised for the best estimate of ninety per cent of the eventual costs that relate to the removal of the oil rig and restoration of damage caused by building it (see paragraph 14). These costs are included as part of the cost of the oil rig. The ten per cent of costs that arise through the extraction of oil are recognised as a liability when the oil is extracted.

Example 3A Reinstatement of premises

An entity leases office premises where its lease requires it to reinstate the premises at the end of the lease. The eventual costs relate to the restoration of the alterations made to the premises. At the ~~balance sheet date~~end of the reporting period, certain alterations have been made to the premises but the premises have not been put into use.

Present obligation as a result of a past obligating event - The making of the alterations creates a legal obligation under the terms of the lease to restore the alterations made to the premises and is thus an obligating event. At the ~~balance sheet date~~end of the reporting period, however, there is no obligation to rectify the wear and tear that will be caused by the use of the premises.

An outflow of resources embodying economic benefits in settlement - Probable.

Conclusion - A provision is recognised for the best estimate of the eventual costs that relate to the restoration of the alterations made to the premises (see paragraph 14). These costs are included as part of the cost of the alterations.

Example 4 Refunds policy

A retail store has a policy of refunding purchases by dissatisfied customers, even though it is under no legal obligation to do so. Its policy of making refunds is generally known.

Present obligation as a result of a past obligating event - The obligating event is the sale of the product, which gives rise to a constructive obligation because the conduct of the store has created a valid expectation on the part of its customers that the store will refund purchases.

An outflow of resources embodying economic benefits in settlement - Probable, a proportion of goods are returned for refund (see paragraph 24).

Conclusion - A provision is recognised for the best estimate of the costs of refunds (see paragraphs 10 (the definition of a constructive obligation), 14, 17 and 24).

Example 5A Closure of a division - no implementation before ~~balance sheet date~~end of the reporting period

On 12 December 20X0 the board of an entity decided to close down a division. Before the ~~balance sheet date~~end of the reporting period (31 December 20X0) the decision was not communicated to any of those affected and no other steps were taken to implement the decision.

Present obligation as a result of a past obligating event - There has been no obligating event and so there is no obligation.

Conclusion - No provision is recognised (see paragraphs 14 and 72).

Example 5B Closure of a division - communication/implementation before ~~Balance Sheet Date~~end of the reporting period

On 12 December 20X0 the board of an entity decided to close down a division making a particular product. On 20 December 20X0 a detailed plan for closing down the division was agreed by the board; letters were sent to customers warning them to seek an alternative source of supply and redundancy notices were sent to the staff of the division.

Present obligation as a result of a past obligating event - The obligating event is the communication of the decision to the customers and employees, which gives rise to a constructive obligation from that date, because it creates a valid expectation that the division will be closed.

An outflow of resources embodying economic benefits in settlement - Probable.

Conclusion - A provision is recognised at 31 December 20X0 for the best estimate of the costs of closing the division (see paragraphs 14 and 72).

Example 6 Legal requirement to fit smoke filters

Under new legislation, an entity is required to fit smoke filters to its factories by 30 June 20X1. The entity has not fitted the smoke filters.

(a) At ~~the balance sheet date of~~ 31 December 20X0, the end of the reporting period

Present obligation as a result of a past obligating event - There is no obligation because there is no obligating event either for the costs of fitting smoke filters or for fines under the legislation.

Conclusion - No provision is recognised for the cost of fitting the smoke filters (see paragraphs 14 and 17-19).

(b) At ~~the balance sheet date of~~ 31 December 20X1, the end of the reporting period

Present obligation as a result of a past obligating event - There is still no obligation for the costs of fitting smoke filters because no obligating event has occurred (the fitting of the filters). However, an obligation might arise to pay fines or penalties under the legislation because the obligating event has occurred (the non-compliant operation of the factory).

An outflow of resources embodying economic benefits in settlement - Assessment of probability of incurring fines and penalties by non-compliant operation depends on the details of the legislation and the stringency of the enforcement regime.

Conclusion - No provision is recognised for the costs of fitting smoke filters. However, a provision is recognised for the best estimate of any fines and penalties that are more likely than not to be imposed (see paragraphs 14 and 17-19).

Example 7 Staff retraining as a result of changes in the income tax system

The government introduces a number of changes to the income tax system. As a result of these changes, an entity in the financial services sector will need to retrain a large proportion of its administrative and sales workforce in order to ensure continued compliance with financial services regulation. At the ~~balance sheet date~~end of the reporting period, no retraining of staff has taken place.

Present obligation as a result of a past obligating event - There is no obligation because no obligating event (retraining) has taken place.

Conclusion - No provision is recognised (see paragraphs 14 and 17-19).

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Example 8 An onerous contract

An entity operates profitably from a factory that it has leased under an operating lease. During December 20X0 the entity relocates its operations to a new factory. The lease on the old factory continues for the next four years, it cannot be cancelled and the factory cannot be re-let to another user.

Present obligation as a result of a past obligating event - The obligating event is the signing of the lease contract, which gives rise to a legal obligation.

An outflow of resources embodying economic benefits in settlement - When the lease becomes onerous, an outflow of resources embodying economic benefits is probable (Until the lease becomes onerous, the entity accounts for the lease under IAS 17 *Leases*).

Conclusion - A provision is recognised for the best estimate of the unavoidable lease payments (see paragraphs 5(c), 14 and 66).

Example 8A - An onerous contract

Same facts as example 8 except that the old factory can be used as a temporary godown generating a low level of income.

Conclusion - A provision is recognised for the best estimate of the net amount of the unavoidable lease costs i.e. the gross unavoidable lease costs less the probable net revenue expected from the godown operations (see paragraph 5(c), 14 and 66).

Example 9 A single guarantee

On 31 December 20X0, Entity A gives a guarantee of certain borrowings of Entity B, whose financial condition at that time is sound. During 20X1, the financial condition of Entity B deteriorates and at 30 June 20X1 Entity B files for protection from its creditors.

This contract meets the definition of an insurance contract in IFRS 4 *Insurance Contracts*, but is within the scope of IAS 39 *Financial Instruments: Recognition and Measurement*, because it also meets the definition of a financial guarantee contract in IAS 39. If an issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either IAS 39 or IFRS 4 to such financial guarantee contracts. IFRS 4 permits the issuer to continue its existing accounting policies for insurance contracts if specified minimum requirements are satisfied. IFRS 4 also permits changes in accounting policies that meet specified criteria. The following is an example of an accounting policy that IFRS 4 permits and that also complies with the requirements in IAS 39 for financial guarantee contracts within the scope of IAS 39.

(a) At 31 December 20X0

Present obligation as a result of a past obligating event – The obligating event is the giving of the guarantee, which gives rise to a legal obligation.

An outflow of resources embodying economic benefits in settlement – No outflow of benefits is probable at 31 December 20X0.

Conclusion – The guarantee is recognised at fair value.

(b) At 31 December 20X1

Present obligation as a result of a past obligating event – The obligating event is the giving of the guarantee, which gives rise to a legal obligation.

An outflow of resources embodying economic benefits in settlement – At 31 December 20X1, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

Conclusion – The guarantee is subsequently measured at the higher of (a) the best estimate of the obligation (see paragraphs 14 and 23), and (b) the amount initially recognised less, when appropriate, cumulative amortisation in accordance with IAS 18 *Revenue*.

Example 10 A court case

After a wedding in 20X0, ten people died, possibly as a result of food poisoning from products sold by the entity. Legal proceedings are started seeking damages from the entity but it disputes liability. Up to the date of authorisation of the financial statements for the year to 31 December 20X0 for issue, the entity's lawyers advise that it is probable that the entity will not be found liable. However, when the entity prepares the financial statements for the year to 31 December 20X1, its lawyers advise that, owing to developments in the case, it is probable that the entity will be found liable.

(a) At 31 December 20X0

Present obligation as a result of a past obligating event - On the basis of the evidence available when the financial statements were approved, there is no obligation as a result of past events.

Conclusion - No provision is recognised (see paragraphs 15 and 16). The matter is disclosed as a contingent liability unless the probability of any outflow is regarded as remote (paragraph 86).

(b) At 31 December 20X1

Present obligation as a result of a past obligating event - On the basis of the evidence available, there is a present obligation.

An outflow of resources embodying economic benefits in settlement - Probable.

Conclusion - A provision is recognised for the best estimate of the amount to settle the obligation (paragraphs 14-16).

Example 11 Repairs and maintenance

Some assets require, in addition to routine maintenance, substantial expenditure every few years for major refits or refurbishment and the replacement of major components. IAS 16 *Property, Plant and Equipment* gives guidance on allocating expenditure on an asset to its component parts where these components have different useful lives or provide benefits in a different pattern.

Example 11A Refurbishment costs - no legislative requirement

A furnace has a lining that needs to be replaced every five years for technical reasons. At the ~~balance sheet date~~end of the reporting period, the lining has been in use for three years.

Present obligation as a result of a past obligating event - There is no present obligation.

Conclusion - No provision is recognised (see paragraphs 14 and 17-19).

The cost of replacing the lining is not recognised because, at the ~~balance sheet date~~end of the reporting period, no obligation to replace the lining exists independently of the company's future actions - even the intention to incur the expenditure depends on the company deciding to continue operating the furnace or to replace the lining. Instead of a provision being recognised, the depreciation of the lining takes account of its consumption, i.e. it is depreciated over five years. The re-lining costs then incurred are capitalised with the consumption of each new lining shown by depreciation over the subsequent five years.

Example 11B Refurbishment costs - legislative requirement

An airline is required by law to overhaul its aircraft once every three years.

Present obligation as a result of a past obligating event - There is no present obligation.

Conclusion - No provision is recognised (see paragraphs 14 and 17-19)

The costs of overhauling aircraft are not recognised as a provision for the same reasons as the cost of replacing the lining is not recognised as a provision in example 11A. Even a legal requirement to overhaul does not make the costs of overhaul a liability, because no obligation exists to overhaul the aircraft independently of the entity's future actions - the entity could avoid the future expenditure by its future actions, for example by selling the aircraft. Instead of a provision being recognised, the depreciation of the aircraft takes account of the future incidence of maintenance costs, ie an amount equivalent to the expected maintenance costs is depreciated over three years.

Example 12 Self insurance

An entity that operates a chain of retail outlets decides not to insure itself in respect of the risk of minor accidents to its customers: instead it will "self insure". Based on its past experience, it expects to pay $1,500,000 a year in respect of these accidents. Should provision be made for the amount expected to arise in a normal year?

Present obligation as a result of a past obligating event - There is no present obligation, unless an accident has occurred or, taking into account all available evidence, is considered more likely than not to have occurred, on or before the ~~balance sheet date~~end of the reporting period.

Conclusion - No provision is recognised for accidents which have not occurred on or before the ~~balance sheet date~~end of the reporting period. There is no present obligation because there is no other party involved in insuring the risks (see paragraph 20). Therefore, a provision is not set up simply based on average annual past claims. However, for those accidents which, taking into account all available evidence, are considered more likely than not to have occurred on or before the ~~balance sheet date~~end of the reporting period, it would be appropriate to make a provision (see paragraphs 15 and 36). In making such estimates, it is necessary to consider at the time of approving the accounts, the likelihood that there remain any incidents that occurred on or before the ~~balance sheet date~~end of the reporting period, which have not yet been reported to the entity (i.e. claims incurred but not yet reported (IBNR)). The provisions shall be adjusted accordingly (see paragraph 38).

Example 13 - Building management ordinance

The Hong Kong Building Management Ordinance S20(2) suggests the (Owners) Corporation to consider establishing a contingency fund to provide for any expenditure of an unexpected or urgent nature. In line with the above, a Maintenance and Repair Fund is normally established by a property management company in order to provide funds for the estimated cost of anticipated maintenance, redecoration and repair works which will be undertaken in the foreseeable future on the premises. Should the property management company recognise a provision for such repairs and maintenance in the financial statements?

Present obligation as the result of a past obligating event - There is no present obligation.

Conclusion - No provision is recognised (see paragraphs 14 and 17-19).
However, this Standard neither encourages nor prohibits the segregation of funds to meet future obligations as suggested by the Building Management Ordinance.

Appendix D
Examples: disclosures

This appendix accompanies, but is not part of, IAS 37.

Two examples of the disclosures required by paragraph 85 are provided below.

Example 1 Warranties

A manufacturer gives warranties at the time of sale to purchasers of its three product lines. Under the terms of the warranty, the manufacturer undertakes to repair or replace items that fail to perform satisfactorily for two years from the date of sale. At the ~~balance sheet date~~end of the reporting period, a provision of $60,000 has been recognised. The provision has not been discounted as the effect of discounting is not material. The following information is disclosed:

A provision of $60,000 has been recognised for expected warranty claims on products sold during the last three financial years. It is expected that the majority of this expenditure will be incurred in the next financial year, and all will be incurred within two years ~~of the balance sheet date~~after the reporting period.

Example 2 Decommissioning Costs

In 2000, an entity involved in nuclear activities recognises a provision for decommissioning costs of $300 million. The provision is estimated using the assumption that decommissioning will take place in 60-70 years' time. However, there is a possibility that it will not take place until 100-110 years' time, in which case the present value of the costs will be significantly reduced. The following information is disclosed:

A provision of $300 million has been recognised for decommissioning costs. These costs are expected to be incurred between 2060 and 2070; however, there is a possibility that decommissioning will not take place until 2100-2110. If the costs were measured based upon the expectation that they would not be incurred until 2100-2110 the provision would be reduced to $136 million. The provision has been estimated using existing technology, at current prices, and discounted using a real discount rate of 2 per cent.

An example is given below of the disclosures required by paragraph 92 where some of the information required is not given because it can be expected to prejudice seriously the position of the entity.

Example 3 Disclosure Exemption

An entity is involved in a dispute with a competitor, who is alleging that the entity has infringed patents and is seeking damages of $100 million. The entity recognises a provision for its best estimate of the obligation, but discloses none of the information required by paragraphs 84 and 85 of the Standard. The following information is disclosed:

Litigation is in process against the company relating to a dispute with a competitor who alleges that the company has infringed patents and is seeking damages of $100 million. The information usually required by IAS 37 Provisions, Contingent Liabilities and Contingent Assets *is not disclosed on the grounds that it can be expected to prejudice seriously the outcome of the litigation. The directors are of the opinion that the claim can be successfully resisted by the company.*

Appendix E

Comparison with International Accounting Standards

This comparison appendix, which was prepared as at October 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 37.

The International Accounting Standard comparable with HKAS 37 is IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

There are no major textual differences between HKAS 37 and IAS 37.

Note: Example 3A, 8A, 12 and 13 in Appendix C to HKAS 37 are additional Hong Kong examples. No comparable examples are included in Appendix C to IAS 37.

HKAS 38
Revised ~~May 2009~~March 2010

Effective for annual periods
beginning on or after 1 January 2005

Hong Kong Accounting Standard 38

Intangible Assets

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

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CONTENTS

Hong Kong Accounting Standard 38 *Intangible Assets* (HKAS 38) is set out in paragraphs 1-133. All the paragraphs have equal authority. HKAS 38 should be read in the context of its objective and the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Framework for the Preparation and Presentation of Financial Statements*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Introduction

IN1 Hong Kong Accounting Standard 38 *Intangible Assets* (HKAS 38) replaces SSAP 29 *Intangible Assets* (issued in 2001), and should be applied:

(a) on acquisition to the accounting for intangible assets acquired in business combinations for which the agreement date is on or after 1 January 2005.

(b) to all other intangible assets, for annual periods beginning on or after 1 January 2005.

Earlier application is encouraged.

Reasons for issuing HKAS 38

IN2 Pursuant to its convergence policy, the Hong Kong Institute of Certified Public Accountants ("HKICPA") issues HKAS 38 as part of its project on business combinations to converge with the International Accounting Standards Board ("the Board")'s project on business combinations. The project's objective is to improve the quality of the accounting for business combinations and the subsequent accounting for goodwill and intangible assets acquired in business combinations.

IN3 The project has two phases. The first phase resulted in the HKICPA issuing simultaneously HKFRS 3 *Business Combinations* and HKAS 38 and HKAS 36 *Impairment of Assets* to converge with IFRS 3 and the revised versions of IAS 38 and IAS 36 issued by the Board. The first phase of the project focused primarily on:

(a) the method of accounting for business combinations

(b) the initial measurement of the identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination;

(c) the recognition of provisions for terminating or reducing the activities of an acquiree;

(d) the treatment of any excess of the acquirer's interest in the fair values of identifiable net assets acquired in a business combination over the cost of the combination; and

(e) the accounting for goodwill and intangible assets acquired in a business combination.

IN4 Therefore, the HKICPA's intention while issuing HKAS 38 was to reflect only those changes resulting from the Business Combinations project, and *not* to reconsider all of the previous requirements in SSAP 29. The changes are primarily concerned with clarifying the notion of 'identifiability' as it relates to intangible assets, the useful life and amortisation of intangible assets, and the accounting for in-process research and development projects acquired in business combinations.

Summary of main changes

Definition of an intangible asset

IN5 SSAP 29 defined an intangible asset as an identifiable non-monetary asset without physical substance held for use in the production or supply of goods or services, for rental to others, or for administrative purposes. The requirement for the asset to be held for use in the production or supply of goods or services, for rental to others, or for administrative purposes has been removed from the definition of an intangible asset.

IN6 SSAP 29 did not define 'identifiability', but stated that an intangible asset could be distinguished clearly from goodwill if the asset was separable, but that separability was not a necessary condition for identifiability. The Standard states that an asset meets the identifiability criterion in the definition of an intangible asset when it:

(a) is separable, ie capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability; or

(b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

Criteria for initial recognition

IN7 SSAP 29 required an intangible asset to be recognised if, and only if, it was probable that the expected future economic benefits attributable to the asset would flow to the entity, and its cost could be measured reliably. These recognition criteria have been included in the Standard. However, additional guidance has been included to clarify that:

(a) the probability recognition criterion is always considered to be satisfied for intangible assets that are acquired separately or in a business combination.

(b) the fair value of an intangible asset acquired in a business combination can ~~normally~~ be measured with sufficient reliability to be recognised separately from goodwill.~~ If an intangible asset acquired in a business combination has a finite useful life, there is a rebuttable presumption that its fair value can be measured reliably.~~

Subsequent expenditure

IN8 Under SSAP 29, the treatment of subsequent expenditure on an in-process research and development project acquired in a business combination and recognised as an asset separately from goodwill was unclear. The Standard requires such expenditure to be:

(a) recognised as an expense when incurred if it is research expenditure;

(b) recognised as an expense when incurred if it is development expenditure that does not satisfy the criteria in HKAS 38 for recognising such expenditure as an intangible asset; and

(c) recognised as an intangible asset if it is development expenditure that satisfies the criteria in HKAS 38 for recognising such expenditure as an intangible asset.

Useful life

IN9 SSAP 29 was based on the assumption that the useful life of an intangible asset is always finite, and included a rebuttable presumption that the useful life cannot exceed twenty years from the date the asset is available for use. That rebuttable presumption has been removed. The Standard requires an intangible asset to be regarded as having an indefinite useful life when, based on an analysis of all of the relevant factors, there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity.

IN10 SSAP 29 required that if control over the future economic benefits from an intangible asset was achieved through legal rights granted for a finite period, the useful life of the intangible asset could not exceed the period of those rights, unless the rights were renewable and renewal was virtually certain. The Standard requires that:

(a) the useful life of an intangible asset arising from contractual or other legal rights should not exceed the period of those rights, but may be shorter depending on the period over which the asset is expected to be used by the entity; and

(b) if the rights are conveyed for a limited term that can be renewed, the useful life should include the renewal period(s) only if there is evidence to support renewal by the entity without significant cost.

Intangible assets with indefinite useful lives

IN11 The Standard requires that:

(a) an intangible asset with an indefinite useful life should not be amortised.

(b) the useful life of such an asset should be reviewed each reporting period to determine whether events and circumstances continue to support an indefinite useful life assessment for that asset. If they do not, the change in the useful life assessment from indefinite to finite should be accounted for as a change in an accounting estimate.

Impairment testing intangible assets with finite useful lives

IN12 SSAP 29 required the recoverable amount of an intangible asset that was amortised over a period exceeding twenty years from the date it was available for use to be estimated at least at each financial year-end, even if there was no indication that the asset was impaired. This requirement has been removed. Therefore, an entity needs to determine the recoverable amount of an intangible asset with a finite useful life that is amortised over a period exceeding twenty years from the date it is available for use only when, in accordance with HKAS 36, there is an indication that the asset may be impaired.

Disclosure

IN13 If an intangible asset is assessed as having an indefinite useful life, the Standard requires an entity to disclose the carrying amount of that asset and the reasons supporting the indefinite useful life assessment.

Hong Kong Accounting Standard 38
Intangible Assets

Objective

1 The objective of this Standard is to prescribe the accounting treatment for intangible assets that are not dealt with specifically in another Standard. This Standard requires an entity to recognise an intangible asset if, and only if, specified criteria are met. The Standard also specifies how to measure the carrying amount of intangible assets and requires specified disclosures about intangible assets.

Scope

2 This Standard shall be applied in accounting for intangible assets, except:

(a) intangible assets that are within the scope of another Standard;

(b) financial assets, as defined in HKAS 32 *Financial Instruments: Presentation*; and

(c) the recognition and measurement of exploration and evaluation assets (see HKFRS 6 *Exploration for and Evaluation of Mineral Resources*); and

(d) expenditure on the development and extraction of minerals, oil, natural gas and similar non-regenerative resources.

3 If another Standard prescribes the accounting for a specific type of intangible asset, an entity applies that Standard instead of this Standard. For example, this Standard does not apply to:

(a) intangible assets held by an entity for sale in the ordinary course of business (see HKAS 2 *Inventories* and HKAS 11 *Construction Contracts*).

(b) deferred tax assets (see HKAS 12 *Income Taxes*).

(c) leases that are within the scope of HKAS 17 *Leases*.

(d) assets arising from employee benefits (see HKAS 19 *Employee Benefits*).

(e) financial assets as defined in HKAS 32. The recognition and measurement of some financial assets are covered by HKAS 27 *Consolidated and Separate Financial Statements*, HKAS 28 *Investments in Associates* and HKAS 31 *Interests in Joint Ventures*.

(f) goodwill acquired in a business combination (see HKFRS 3 *Business Combinations*).

(g) deferred acquisition costs, and intangible assets, arising from an insurer's contractual rights under insurance contracts within the scope of HKFRS 4 *Insurance Contracts*. HKFRS 4 sets out specific disclosure requirements for those deferred acquisition costs but not for those intangible assets. Therefore, the disclosure requirements in this Standard apply to those intangible assets.

(h) non-current intangible assets classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*.

4 Some intangible assets may be contained in or on a physical substance such as a compact disc (in the case of computer software), legal documentation (in the case of a licence or patent) or film. In determining whether an asset that incorporates both intangible and tangible elements should be treated under HKAS 16 *Property, Plant and Equipment* or as an intangible asset under this Standard, an entity uses judgement to assess which element is more significant. For example, computer software for a computer-controlled machine tool that cannot operate without that specific software is an integral part of the related hardware and it is treated as property, plant and equipment. The same applies to the operating system of a computer. When the software is not an integral part of the related hardware, computer software is treated as an intangible asset.

5 This Standard applies to, among other things, expenditure on advertising, training, start-up, research and development activities. Research and development activities are directed to the development of knowledge. Therefore, although these activities may result in an asset with physical substance (eg a prototype), the physical element of the asset is secondary to its intangible component, ie the knowledge embodied in it.

6 In the case of a finance lease, the underlying asset may be either tangible or intangible. After initial recognition, a lessee accounts for an intangible asset held under a finance lease in accordance with this Standard. Rights under licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights are excluded from the scope of HKAS 17 and are within the scope of this Standard.

7 Exclusions from the scope of a Standard may occur if activities or transactions are so specialised that they give rise to accounting issues that may need to be dealt with in a different way. Such issues arise in the accounting for expenditure on the exploration for, or development and extraction of, oil, gas and mineral deposits in extractive industries and in the case of insurance contracts. Therefore, this Standard does not apply to expenditure on such activities and contracts. However, this Standard applies to other intangible assets used (such as computer software), and other expenditure incurred (such as start-up costs), in extractive industries or by insurers.

Definitions

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

An active market is a market in which all the following conditions exist:

(a) the items traded in the market are homogeneous;

(b) willing buyers and sellers can normally be found at any time; and

(c) prices are available to the public.

~~**The** *agreement date for a business combination* **is the date that a substantive agreement between the combining parties is reached and, in the case of publicly listed entities, announced to the public. In the case of a hostile takeover, the earliest date that a substantive agreement between the combining parties is**~~

~~**reached is the date that a sufficient number of the acquiree's owners have accepted the acquirer's offer for the acquirer to obtain control of the acquiree.**~~

Amortisation **is the systematic allocation of the depreciable amount of an intangible asset over its useful life.**

An *asset* **is a resource:**

(a) controlled by an entity as a result of past events; and

(b) from which future economic benefits are expected to flow to the entity.

Carrying amount **is the amount at which an asset is recognised in the ~~balance sheet~~statement of financial position after deducting any accumulated amortisation and accumulated impairment losses thereon.**

Cost **is the amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction, or, when applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other HKFRSs, eg HKFRS 2** ***Share-based Payment*****.**

Depreciable amount **is the cost of an asset, or other amount substituted for cost, less its residual value.**

Development **is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.**

Entity-specific value **is the present value of the cash flows an entity expects to arise from the continuing use of an asset and from its disposal at the end of its useful life or expects to incur when settling a liability.**

Fair value of an asset **is the amount for which that asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.**

An *impairment loss* **is the amount by which the carrying amount of an asset exceeds its recoverable amount.**

An *intangible asset* **is an identifiable non-monetary asset without physical substance.**

Monetary assets **are money held and assets to be received in fixed or determinable amounts of money.**

Research **is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.**

The *residual value* **of an intangible asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.**

Useful life **is:**

(a) the period over which an asset is expected to be available for use by an entity; or

(b) the number of production or similar units expected to be obtained from the asset by an entity.

Intangible assets

9 Entities frequently expend resources, or incur liabilities, on the acquisition, development, maintenance or enhancement of intangible resources such as scientific or technical knowledge, design and implementation of new processes or systems, licences, intellectual property, market knowledge and trademarks (including brand names and publishing titles). Common examples of items encompassed by these broad headings are computer software, patents, copyrights, motion picture films, customer lists, mortgage servicing rights, fishing licences, import quotas, franchises, customer or supplier relationships, customer loyalty, market share and marketing rights.

10 Not all the items described in paragraph 9 meet the definition of an intangible asset, ie identifiability, control over a resource and existence of future economic benefits. If an item within the scope of this Standard does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognised as an expense when it is incurred. However, if the item is acquired in a business combination, it forms part of the goodwill recognised at the acquisition date (see paragraph 68).

Identifiability

11[*] The definition of an intangible asset requires an intangible asset to be identifiable to distinguish it from goodwill. Goodwill ~~acquired~~ recognised in a business combination is an asset representing~~s a payment made by the acquirer in anticipation of~~ the future economic benefits arising from other assets acquired in a business combination that are not ~~capable of being~~ individually identified and separately recognised. The future economic benefits may result from synergy between the identifiable assets acquired or from assets that, individually, do not qualify for recognition in the financial statements ~~but for which the acquirer is prepared to make a payment in the business combination~~.

12[*] An asset is identifiable if it either ~~meets the identifiability criterion in the definition of an intangible asset when it~~:

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

(b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

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

Control

13 An entity controls an asset if the entity has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits. The capacity of an entity to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law. In the absence of legal rights, it is more difficult to demonstrate control. However, legal enforceability of a right is not a necessary condition for control because an entity may be able to control the future economic benefits in some other way.

14 Market and technical knowledge may give rise to future economic benefits. An entity controls those benefits if, for example, the knowledge is protected by legal rights such as copyrights, a restraint of trade agreement (where permitted) or by a legal duty on employees to maintain confidentiality.

15 An entity may have a team of skilled staff and may be able to identify incremental staff skills leading to future economic benefits from training. The entity may also expect that the staff will continue to make their skills available to the entity. However, an entity usually has insufficient control over the expected future economic benefits arising from a team of skilled staff and from training for these items to meet the definition of an intangible asset. For a similar reason, specific management or technical talent is unlikely to meet the definition of an intangible asset, unless it is protected by legal rights to use it and to obtain the future economic benefits expected from it, and it also meets the other parts of the definition.

16 An entity may have a portfolio of customers or a market share and expect that, because of its efforts in building customer relationships and loyalty, the customers will continue to trade with the entity. However, in the absence of legal rights to protect, or other ways to control, the relationships with customers or the loyalty of the customers to the entity, the entity usually has insufficient control over the expected economic benefits from customer relationships and loyalty for such items (eg portfolio of customers, market shares, customer relationships and customer loyalty) to meet the definition of intangible assets. In the absence of legal rights to protect customer relationships, exchange transactions for the same or similar non-contractual customer relationships (other than as part of a business combination) provide evidence that the entity is nonetheless able to control the expected future economic benefits flowing from the customer relationships. Because such exchange transactions also provide evidence that the customer relationships are separable, those customer relationships meet the definition of an intangible asset.

Future economic benefits

17 The future economic benefits flowing from an intangible asset may include revenue from the sale of products or services, cost savings, or other benefits resulting from the use of the asset by the entity. For example, the use of intellectual property in a production process may reduce future production costs rather than increase future revenues.

Recognition and measurement

18 The recognition of an item as an intangible asset requires an entity to demonstrate that the item meets:

(a) the definition of an intangible asset (see paragraphs 8-17); and

(b) the recognition criteria (see paragraphs 21-23).

This requirement applies to costs incurred initially to acquire or internally generate an intangible asset and those incurred subsequently to add to, replace part of, or service it.

19 Paragraphs 25-32 deal with the application of the recognition criteria to separately acquired intangible assets, and paragraphs 33-43 deal with their application to intangible assets acquired in a business combination. Paragraph 44 deals with the initial measurement of intangible assets acquired by way of a government grant, paragraphs 45-47 with exchanges of intangible assets, and paragraphs 48-50 with the treatment of internally generated goodwill. Paragraphs 51-67 deal with the initial recognition and measurement of internally generated intangible assets.

20 The nature of intangible assets is such that, in many cases, there are no additions to such an asset or replacements of part of it. Accordingly, most subsequent expenditures are likely to maintain the expected future economic benefits embodied in an existing intangible asset rather than meet the definition of an intangible asset and the recognition criteria in this Standard. In addition, it is often difficult to attribute subsequent expenditure directly to a particular intangible asset rather than to the business as a whole. Therefore, only rarely will subsequent expenditure—expenditure incurred after the initial recognition of an acquired intangible asset or after completion of an internally generated intangible asset—be recognised in the carrying amount of an asset. Consistently with paragraph 63, subsequent expenditure on brands, mastheads, publishing titles, customer lists and items similar in substance (whether externally acquired or internally generated) is always recognised in profit or loss as incurred. This is because such expenditure cannot be distinguished from expenditure to develop the business as a whole.

21 An intangible asset shall be recognised if, and only if:

(a) it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and

(b) the cost of the asset can be measured reliably.

22 An entity shall assess the probability of expected future economic benefits using reasonable and supportable assumptions that represent management's best estimate of the set of economic conditions that will exist over the useful life of the asset.

23 An entity uses judgement to assess the degree of certainty attached to the flow of future economic benefits that are attributable to the use of the asset on the basis of the evidence available at the time of initial recognition, giving greater weight to external evidence.

24 An intangible asset shall be measured initially at cost.

Separate acquisition

25[*] Normally, the price an entity pays to acquire separately an intangible asset will reflect~~s~~ expectations about the probability that the expected future economic benefits embodied in the asset will flow to the entity. In other words, the entity expects there to be an inflow of economic benefits, even if there is uncertainty about the timing or the amount of the inflow~~the effect of probability is reflected in the cost of the asset~~. Therefore, the probability recognition criterion in paragraph 21(a) is always considered to be satisfied for separately acquired intangible assets.

26 In addition, the cost of a separately acquired intangible asset can usually be measured reliably. This is particularly so when the purchase consideration is in the form of cash or other monetary assets.

27 The cost of a separately acquired intangible asset comprises:

(a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates; and

(b) any directly attributable cost of preparing the asset for its intended use.

28 Examples of directly attributable costs are:

(a) costs of employee benefits (as defined in HKAS 19) arising directly from bringing the asset to its working condition;

(b) professional fees arising directly from bringing the asset to its working condition; and

(c) costs of testing whether the asset is functioning properly.

29 Examples of expenditures that are not part of the cost of an intangible asset are:

(a) costs of introducing a new product or service (including costs of advertising and promotional activities);

(b) costs of conducting business in a new location or with a new class of customer (including costs of staff training); and

(c) administration and other general overhead costs.

30 Recognition of costs in the carrying amount of an intangible asset ceases when the asset is in the condition necessary for it to be capable of operating in the manner intended by management. Therefore, costs incurred in using or redeploying an intangible asset are not included in the carrying amount of that asset. For example, the following costs are not included in the carrying amount of an intangible asset:

(a) costs incurred while an asset capable of operating in the manner intended by management has yet to be brought into use; and

(b) initial operating losses, such as those incurred while demand for the asset's output builds up.

[*] Amendment effective for annual periods beginning on or after 1 July 2009.

31 Some operations occur in connection with the development of an intangible asset, but are not necessary to bring the asset to the condition necessary for it to be capable of operating in the manner intended by management. These incidental operations may occur before or during the development activities. Because incidental operations are not necessary to bring an asset to the condition necessary for it to be capable of operating in the manner intended by management, the income and related expenses of incidental operations are recognised immediately in profit or loss, and included in their respective classifications of income and expense.

32 If payment for an intangible asset is deferred beyond normal credit terms, its cost is the cash price equivalent. The difference between this amount and the total payments is recognised as interest expense over the period of credit unless it is capitalised in accordance with ~~the capitalisation treatment permitted in~~ HKAS 23 *Borrowing Costs*.

Acquisition as part of a business combination

33* In accordance with HKFRS 3 *Business Combinations*, if an intangible asset is acquired in a business combination, the cost of that intangible asset is its fair value at the acquisition date. The fair value of an intangible asset will reflect~~s market~~ expectations about the probability that the expected future economic benefits embodied in the asset will flow to the entity. In other words, the entity expects there to be an inflow of economic benefits, even if there is uncertainty about the timing or the amount of the inflow~~the effect of probability is reflected in the fair value measurement of the intangible asset~~. Therefore, the probability recognition criterion in paragraph 21(a) is always considered to be satisfied for intangible assets acquired in business combinations. If an asset acquired in a business combination is separable or arises from contractual or other legal rights, sufficient information exists to measure reliably the fair value of the asset. Thus, the reliable measurement criterion in paragraph 21(b) is always considered to be satisfied for intangible assets acquired in business combinations.

34* ~~Therefore, i~~In accordance with this Standard and HKFRS 3 (as revised in 2008), an acquirer recognises at the acquisition date, separately from goodwill, an intangible asset of the acquiree ~~if the asset's fair value can be measured reliably~~, irrespective of whether the asset had been recognised by the acquiree before the business combination. This means that the acquirer recognises as an asset separately from goodwill an in-process research and development project of the acquiree if the project meets the definition of an intangible asset ~~and its fair value can be measured reliably~~. An acquiree's in-process research and development project meets the definition of an intangible asset when it:

(a) meets the definition of an asset; and

(b) is identifiable, ie is separable or arises from contractual or other legal rights.

Measuring the fair value of an intangible asset acquired in a business combination

35* If an intangible asset acquired in a business combination is separable or arises from contractual or other legal rights, sufficient information exists to measure reliably the fair value of the asset.~~The fair value of intangible assets acquired in business combinations can normally be measured with sufficient reliability to be recognised separately from goodwill.~~ When, for the estimates used to measure an intangible asset's

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

fair value, there is a range of possible outcomes with different probabilities, that uncertainty enters into the measurement of the asset's fair value~~, rather than demonstrates an inability to measure fair value reliably. If an intangible asset acquired in a business combination has a finite useful life, there is a rebuttable presumption that its fair value can be measured reliably~~.

36[*] An intangible asset acquired in a business combination might be separable, but only together with a related contract, identifiable~~tangible or intangible~~ asset or liability. ~~For example, a magazine's publishing title might not be able to be sold separately from a related subscriber database, or a trademark for natural spring water might relate to a particular spring and could not be sold separately from the spring.~~ In such cases, the acquirer recognises the intangible~~group of~~ asset~~s as a single asset~~ separately from goodwill~~ if the individual fair values of the assets in the group are not reliably measurable~~, but together with the related item.

37[*] ~~Similarly, the terms 'brand' and 'brand name' are often used as synonyms for trademarks and other marks. However, the former are general marketing terms that are typically used to refer to a group of complementary assets such as a trademark (or service mark) and its related trade name, formulas, recipes and technological expertise.~~ The acquirer may recognise~~s~~ a group of complementary intangible assets as a single asset ~~a group of complementary intangible assets comprising a brand if the individual fair values of the complementary assets are not reliably measurable. If the individual fair values of the complementary assets are reliably measurable, an acquirer may recognise them as a single asset~~ provided the individual assets have similar useful lives. For example, the terms 'brand' and 'brand name' are often used as synonyms for trademarks and other marks. However, the former are general marketing terms that are typically used to refer to a group of complementary assets such as a trademark (or service mark) and its related trade name, formulas, recipes and technological expertise.

38[*] ~~The only circumstances in which it might not be possible to measure reliably the fair value of an intangible asset acquired in a business combination are when the intangible asset arises from legal or other contractual rights and either:~~

~~(a) is not separable; or~~

~~(b) is separable, but there is no history or evidence of exchange transactions for the same or similar assets, and otherwise estimating fair value would be dependent on immeasurable variables.~~[Deleted]

39 Quoted market prices in an active market provide the most reliable estimate of the fair value of an intangible asset (see also paragraph 78). The appropriate market price is usually the current bid price. If current bid prices are unavailable, the price of the most recent similar transaction may provide a basis from which to estimate fair value, provided that there has not been a significant change in economic circumstances between the transaction date and the date at which the asset's fair value is estimated.

40[*] If no active market exists for an intangible asset, its fair value is the amount that the entity would have paid for the asset, at the acquisition date, in an arm's length transaction between knowledgeable and willing parties, on the basis of the best information available. In determining this amount, an entity considers the outcome of recent transactions for similar assets. For example, an entity may apply multiples reflecting current market transactions to factors that drive the profitability of the asset (such as revenue, operating profit or earnings before interest, tax, depreciation and

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

amortisation).

41[*] Entities that are ~~regularly~~ involved in the purchase and sale of ~~unique~~ intangible assets may have developed techniques for estimating their fair values indirectly. These techniques may be used for initial measurement of an intangible asset acquired in a business combination if their objective is to estimate fair value and if they reflect current transactions and practices in the industry to which the asset belongs. These techniques include, ~~when appropriate~~for example:

(a) discounting estimated future net cash flows from the asset; or

~~(a)~~(b) ~~applying multiples reflecting current market transactions to indicators that drive the profitability of the asset (such as revenue, market shares and operating profit) or to the royalty stream that could be obtained from licensing the intangible asset to~~ estimating the costs the entity avoids by owning the intangible asset and not needing:

(i) to license it from another party in an arm's length transaction (as in the 'relief from royalty' approach, using discounted net cash flows) ; or

(ii) to recreate or replace it (as in the cost approach),

~~(b) discounting estimated future net cash flows from the asset.~~

Subsequent expenditure on an acquired in-process research and development project

42 Research or development expenditure that:

(a) relates to an in-process research or development project acquired separately or in a business combination and recognised as an intangible asset; and

(b) is incurred after the acquisition of that project shall be accounted for in accordance with paragraphs 54-62.

43 Applying the requirements in paragraphs 54-62 means that subsequent expenditure on an in-process research or development project acquired separately or in a business combination and recognised as an intangible asset is:

(a) recognised as an expense when incurred if it is research expenditure;

(b) recognised as an expense when incurred if it is development expenditure that does not satisfy the criteria for recognition as an intangible asset in paragraph 57; and

(c) added to the carrying amount of the acquired in-process research or development project if it is development expenditure that satisfies the recognition criteria in paragraph 57.

[*] Amendment effective for annual periods beginning on or after 1 July 2009.

Acquisition by way of a government grant

44 In some cases, an intangible asset may be acquired free of charge, or for nominal consideration, by way of a government grant. This may happen when a government transfers or allocates to an entity intangible assets such as airport landing rights, licences to operate radio or television stations, import licences or quotas or rights to access other restricted resources. In accordance with HKAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*, an entity may choose to recognise both the intangible asset and the grant initially at fair value. If an entity chooses not to recognise the asset initially at fair value, the entity recognises the asset initially at a nominal amount (the other treatment permitted by HKAS 20) plus any expenditure that is directly attributable to preparing the asset for its intended use.

Exchanges of assets

45 One or more intangible assets may be acquired in exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets. The following discussion refers simply to an exchange of one non-monetary asset for another, but it also applies to all exchanges described in the preceding sentence. The cost of such an intangible asset is measured at fair value unless (a) the exchange transaction lacks commercial substance or (b) the fair value of neither the asset received nor the asset given up is reliably measurable. The acquired asset is measured in this way even if an entity cannot immediately derecognise the asset given up. If the acquired asset is not measured at fair value, its cost is measured at the carrying amount of the asset given up.

46 An entity determines whether an exchange transaction has commercial substance by considering the extent to which its future cash flows are expected to change as a result of the transaction. An exchange transaction has commercial substance if:

(a) the configuration (ie risk, timing and amount) of the cash flows of the asset received differs from the configuration of the cash flows of the asset transferred; or

(b) the entity-specific value of the portion of the entity’s operations affected by the transaction changes as a result of the exchange; and

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

For the purpose of determining whether an exchange transaction has commercial substance, the entity-specific value of the portion of the entity’s operations affected by the transaction shall reflect post-tax cash flows. The result of these analyses may be clear without an entity having to perform detailed calculations.

47 Paragraph 21(b) specifies that a condition for the recognition of an intangible asset is that the cost of the asset can be measured reliably. The fair value of an intangible asset for which comparable market transactions do not exist is reliably measurable if (a) the variability in the range of reasonable fair value estimates is not significant for that asset or (b) the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value. If an entity is able to determine reliably the fair value of either the asset received or the asset given up, then the fair value of the asset given up is used to measure cost unless the fair value of the asset received is more clearly evident.

Internally generated goodwill

48 Internally generated goodwill shall not be recognised as an asset.

49 In some cases, expenditure is incurred to generate future economic benefits, but it does not result in the creation of an intangible asset that meets the recognition criteria in this Standard. Such expenditure is often described as contributing to internally generated goodwill. Internally generated goodwill is not recognised as an asset because it is not an identifiable resource (ie it is not separable nor does it arise from contractual or other legal rights) controlled by the entity that can be measured reliably at cost.

50 Differences between the market value of an entity and the carrying amount of its identifiable net assets at any time may capture a range of factors that affect the value of the entity. However, such differences do not represent the cost of intangible assets controlled by the entity.

Internally generated intangible assets

51 It is sometimes difficult to assess whether an internally generated intangible asset qualifies for recognition because of problems in:

(a) identifying whether and when there is an identifiable asset that will generate expected future economic benefits; and

(b) determining the cost of the asset reliably. In some cases, the cost of generating an intangible asset internally cannot be distinguished from the cost of maintaining or enhancing the entity's internally generated goodwill or of running day-to-day operations.

Therefore, in addition to complying with the general requirements for the recognition and initial measurement of an intangible asset, an entity applies the requirements and guidance in paragraphs 52-67 to all internally generated intangible assets.

52 To assess whether an internally generated intangible asset meets the criteria for recognition, an entity classifies the generation of the asset into:

(a) a research phase; and

(b) a development phase.

Although the terms 'research' and 'development' are defined, the terms 'research phase' and 'development phase' have a broader meaning for the purpose of this Standard.

53 If an entity cannot distinguish the research phase from the development phase of an internal project to create an intangible asset, the entity treats the expenditure on that project as if it were incurred in the research phase only.

Research phase

54 No intangible asset arising from research (or from the research phase of an internal project) shall be recognised. Expenditure on research (or on the research phase of an internal project) shall be recognised as an expense when it is incurred.

55 In the research phase of an internal project, an entity cannot demonstrate that an intangible asset exists that will generate probable future economic benefits. Therefore, this expenditure is recognised as an expense when it is incurred.

56 Examples of research activities are:

(a) activities aimed at obtaining new knowledge;

(b) the search for, evaluation and final selection of, applications of research findings or other knowledge;

(c) the search for alternatives for materials, devices, products, processes, systems or services; and

(d) the formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.

Development phase

57 An intangible asset arising from development (or from the development phase of an internal project) shall be recognised if, and only if, an entity can demonstrate all of the following:

(a) the technical feasibility of completing the intangible asset so that it will be available for use or sale.

(b) its intention to complete the intangible asset and use or sell it.

(c) its ability to use or sell the intangible asset.

(d) how the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.

(e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.

(f) its ability to measure reliably the expenditure attributable to the intangible asset during its development.

58 In the development phase of an internal project, an entity can, in some instances, identify an intangible asset and demonstrate that the asset will generate probable future economic benefits. This is because the development phase of a project is further advanced than the research phase.

59 Examples of development activities are:

(a) the design, construction and testing of pre-production or pre-use prototypes and models;

(b) the design of tools, jigs, moulds and dies involving new technology;

(c) the design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production; and

(d) the design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

60 To demonstrate how an intangible asset will generate probable future economic benefits, an entity assesses the future economic benefits to be received from the asset using the principles in HKAS 36 *Impairment of Assets*. If the asset will generate economic benefits only in combination with other assets, the entity applies the concept of cash-generating units in HKAS 36.

61 Availability of resources to complete, use and obtain the benefits from an intangible asset can be demonstrated by, for example, a business plan showing the technical, financial and other resources needed and the entity's ability to secure those resources. In some cases, an entity demonstrates the availability of external finance by obtaining a lender's indication of its willingness to fund the plan.

62 An entity's costing systems can often measure reliably the cost of generating an intangible asset internally, such as salary and other expenditure incurred in securing copyrights or licences or developing computer software.

63 Internally generated brands, mastheads, publishing titles, customer lists and items similar in substance shall not be recognised as intangible assets.

64 Expenditure on internally generated brands, mastheads, publishing titles, customer lists and items similar in substance cannot be distinguished from the cost of developing the business as a whole. Therefore, such items are not recognised as intangible assets.

Cost of an internally generated intangible asset

65 The cost of an internally generated intangible asset for the purpose of paragraph 24 is the sum of expenditure incurred from the date when the intangible asset first meets the recognition criteria in paragraphs 21, 22 and 57. Paragraph 71 prohibits reinstatement of expenditure previously recognised as an expense.

66 The cost of an internally generated intangible asset comprises all directly attributable costs necessary to create, produce, and prepare the asset to be capable of operating in the manner intended by management. Examples of directly attributable costs are:

(a) costs of materials and services used or consumed in generating the intangible asset;

(b) costs of employee benefits (as defined in HKAS 19) arising from the generation of the intangible asset;

(c) fees to register a legal right; and

(d) amortisation of patents and licences that are used to generate the intangible asset.

HKAS 23 specifies criteria for the recognition of interest as an element of the cost of an internally generated intangible asset.

67 The following are not components of the cost of an internally generated intangible asset:

(a) selling, administrative and other general overhead expenditure unless this expenditure can be directly attributed to preparing the asset for use;

(b) identified inefficiencies and initial operating losses incurred before the asset achieves planned performance; and

(c) expenditure on training staff to operate the asset.

Example illustrating paragraph 65
An entity is developing a new production process. During 20X5, expenditure incurred was CU1,000*, of which CU900 was incurred before 1 December 20X5 and CU100 was incurred between 1 December 20X5 and 31 December 20X5. The entity is able to demonstrate that, at 1 December 20X5, the production process met the criteria for recognition as an intangible asset. The recoverable amount of the know-how embodied in the process (including future cash outflows to complete the process before it is available for use) is estimated to be CU500. *At the end of 20X5, the production process is recognised as an intangible asset at a cost of CU100 (expenditure incurred since the date when the recognition criteria were met, ie 1 December 20X5). The CU900 expenditure incurred before 1 December 20X5 is recognised as an expense because the recognition criteria were not met until 1 December 20X5. This expenditure does not form part of the cost of the production process recognised in the ~~balance sheet~~statement of financial position.* During 20X6, expenditure incurred is CU2,000. At the end of 20X6, the recoverable amount of the know-how embodied in the process (including future cash outflows to complete the process before it is available for use) is estimated to be CU1,900. *At the end of 20X6, the cost of the production process is CU2,100 (CU100 expenditure recognised at the end of 20X5 plus CU2,000 expenditure recognised in 20X6). The entity recognises an impairment loss of CU200 to adjust the carrying amount of the process before impairment loss (CU2,100) to its recoverable amount (CU1,900). This impairment loss will be reversed in a subsequent period if the requirements for the reversal of an impairment loss in HKAS 36 are met.*

Recognition of an expense

68[†] Expenditure on an intangible item shall be recognised as an expense when it is incurred unless:

(a) it forms part of the cost of an intangible asset that meets the recognition criteria (see paragraphs 18-67); or

(b) the item is acquired in a business combination and cannot be recognised as an intangible asset. If this is the case, ~~this expenditure (included in the cost of the business combination) shall form part of the amount attributed to~~ it

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

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

forms part of the amount recognised as goodwill at the acquisition date (see HKFRS 3).

69 In some cases, expenditure is incurred to provide future economic benefits to an entity, but no intangible asset or other asset is acquired or created that can be recognised. In the~~se~~ case~~s,~~ of the supply of goods, the entity recognises such expenditure ~~is recognised~~ as an expense when ~~it is incurred.~~it has a right to access those goods. In the case of the supply of services, the entity recognises the expenditure as an expense when it receives the services. For example, ~~except when it forms part of the cost of a business combination,~~ expenditure on research is recognised as an expense when it is incurred (see paragraph 54), except when it is acquired as part of a business combination. Other examples of expenditure that is recognised as an expense when it is incurred include:

(a) expenditure on start-up activities (ie start-up costs), unless this expenditure is included in the cost of an item of property, plant and equipment in accordance with HKAS 16. Start-up costs may consist of establishment costs such as legal and secretarial costs incurred in establishing a legal entity, expenditure to open a new facility or business (ie pre-opening costs) or expenditures for starting new operations or launching new products or processes (ie pre-operating costs).

(b) expenditure on training activities.

(c) expenditure on advertising and promotional activities (including mail order catalogues).

(d) expenditure on relocating or reorganising part or all of an entity.

69A An entity has a right to access goods when it owns them. Similarly, it has a right to access goods when they have been constructed by a supplier in accordance with the terms of a supply contract and the entity could demand delivery of them in return for payment. Services are received when they are performed by a supplier in accordance with a contract to deliver them to the entity and not when the entity uses them to deliver another service, for example, to deliver an advertisement to customers.

70 Paragraph 68 does not preclude an entity from recognising a prepayment as an asset when payment for ~~the delivery of~~ goods ~~or services~~ has been made in advance of the entity obtaining a right to access those goods.~~delivery of goods or the rendering of services.~~ Similarly, paragraph 68 does not preclude an entity from recognising a prepayment as an asset when payment for services has been made in advance of the entity receiving those services.

Past expenses not to be recognised as an asset

71 Expenditure on an intangible item that was initially recognised as an expense shall not be recognised as part of the cost of an intangible asset at a later date.

Measurement after recognition

72 An entity shall choose either the cost model in paragraph 74 or the revaluation model in paragraph 75 as its accounting policy. If an intangible asset is accounted for using the revaluation model, all the other assets in its class shall also be accounted for using the same model, unless there is no active market for those assets.

73 A class of intangible assets is a grouping of assets of a similar nature and use in an entity's operations. The items within a class of intangible assets are revalued simultaneously to avoid selective revaluation of assets and the reporting of amounts in the financial statements representing a mixture of costs and values as at different dates.

Cost model

74 After initial recognition, an intangible asset shall be carried at its cost less any accumulated amortisation and any accumulated impairment losses.

Revaluation model

75 After initial recognition, an intangible asset shall be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated amortisation and any subsequent accumulated impairment losses. For the purpose of revaluations under this Standard, fair value shall be determined by reference to an active market. Revaluations shall be made with such regularity that at the ~~balance sheet date~~end of the reporting period the carrying amount of the asset does not differ materially from its fair value.

76 The revaluation model does not allow:

(a) the revaluation of intangible assets that have not previously been recognised as assets; or

(b) the initial recognition of intangible assets at amounts other than cost.

77 The revaluation model is applied after an asset has been initially recognised at cost. However, if only part of the cost of an intangible asset is recognised as an asset because the asset did not meet the criteria for recognition until part of the way through the process (see paragraph 65), the revaluation model may be applied to the whole of that asset. Also, the revaluation model may be applied to an intangible asset that was received by way of a government grant and recognised at a nominal amount (see paragraph 44).

78 It is uncommon for an active market with the characteristics described in paragraph 8 to exist for an intangible asset, although this may happen. For example, in some jurisdictions, an active market may exist for freely transferable taxi licences, fishing licences or production quotas. However, an active market cannot exist for brands, newspaper mastheads, music and film publishing rights, patents or trademarks, because each such asset is unique. Also, although intangible assets are bought and sold, contracts are negotiated between individual buyers and sellers, and transactions are relatively infrequent. For these reasons, the price paid for one asset may not provide sufficient evidence of the fair value of another. Moreover, prices are often not available to the public.

79 The frequency of revaluations depends on the volatility of the fair values of the intangible assets being revalued. If the fair value of a revalued asset differs materially from its carrying amount, a further revaluation is necessary. Some intangible assets may experience significant and volatile movements in fair value, thus necessitating annual revaluation. Such frequent revaluations are unnecessary for intangible assets with only insignificant movements in fair value.

80 If an intangible asset is revalued, any accumulated amortisation at the date of the revaluation is either:

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

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

81 If an intangible asset in a class of revalued intangible assets cannot be revalued because there is no active market for this asset, the asset shall be carried at its cost less any accumulated amortisation and impairment losses.

82 If the fair value of a revalued intangible asset can no longer be determined by reference to an active market, the carrying amount of the asset shall be its revalued amount at the date of the last revaluation by reference to the active market less any subsequent accumulated amortisation and any subsequent accumulated impairment losses.

83 The fact that an active market no longer exists for a revalued intangible asset may indicate that the asset may be impaired and that it needs to be tested in accordance with HKAS 36.

84 If the fair value of the asset can be determined by reference to an active market at a subsequent measurement date, the revaluation model is applied from that date.

85 If an intangible asset's carrying amount is increased as a result of a revaluation, the increase shall be ~~credited directly to~~ recognised in other comprehensive income and accumulated in equity under the heading of revaluation surplus. However, the increase shall be recognised in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in profit or loss.

86 If an intangible asset's carrying amount is decreased as a result of a revaluation, the decrease shall be recognised in profit or loss. However, the decrease shall be ~~debited directly to equity under the heading of revaluation surplus~~recognised in other comprehensive income to the extent of any credit balance in the revaluation surplus in respect of that asset. The decrease recognised in other comprehensive income reduces the amount accumulated in equity under the heading of revaluation surplus.

87 The cumulative revaluation surplus included in equity may be transferred directly to retained earnings when the surplus is realised. The whole surplus may be realised on the retirement or disposal of the asset. However, some of the surplus may be realised as the asset is used by the entity; in such a case, the amount of the surplus realised is the difference between amortisation based on the revalued carrying amount of the asset and amortisation that would have been recognised based on the asset's historical cost. The transfer from revaluation surplus to retained earnings is not made through ~~the income statement~~profit or loss.

Useful life

88 **An entity shall assess whether the useful life of an intangible asset is finite or indefinite and, if finite, the length of, or number of production or similar units constituting, that useful life. An intangible asset shall be regarded by the entity as having an indefinite useful life when, based on an analysis of all of the relevant factors, there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity.**

89 The accounting for an intangible asset is based on its useful life. An intangible asset with a finite useful life is amortised (see paragraphs 97-106), and an intangible asset with an indefinite useful life is not (see paragraphs 107-110). The Illustrative Examples accompanying this Standard illustrate the determination of useful life for different intangible assets, and the subsequent accounting for those assets based on the useful life determinations.

90 Many factors are considered in determining the useful life of an intangible asset, including:

(a) the expected usage of the asset by the entity and whether the asset could be managed efficiently by another management team;

(b) typical product life cycles for the asset and public information on estimates of useful lives of similar assets that are used in a similar way;

(c) technical, technological, commercial or other types of obsolescence;

(d) the stability of the industry in which the asset operates and changes in the market demand for the products or services output from the asset;

(e) expected actions by competitors or potential competitors;

(f) the level of maintenance expenditure required to obtain the expected future economic benefits from the asset and the entity's ability and intention to reach such a level;

(g) the period of control over the asset and legal or similar limits on the use of the asset, such as the expiry dates of related leases; and

(h) whether the useful life of the asset is dependent on the useful life of other assets of the entity.

91 The term 'indefinite' does not mean 'infinite'. The useful life of an intangible asset reflects only that level of future maintenance expenditure required to maintain the asset at its standard of performance assessed at the time of estimating the asset's useful life, and the entity's ability and intention to reach such a level. A conclusion that the useful life of an intangible asset is indefinite should not depend on planned future expenditure in excess of that required to maintain the asset at that standard of performance.

92 Given the history of rapid changes in technology, computer software and many other intangible assets are susceptible to technological obsolescence. Therefore, it is likely that their useful life is short.

93 The useful life of an intangible asset may be very long or even indefinite. Uncertainty justifies estimating the useful life of an intangible asset on a prudent basis, but it does not justify choosing a life that is unrealistically short.

94* **The useful life of an intangible asset that arises from contractual or other legal rights shall not exceed the period of the contractual or other legal rights, but may be shorter depending on the period over which the entity expects to use the asset. If the contractual or other legal rights are conveyed for a limited term that can be renewed, the useful life of the intangible asset shall include the renewal period(s) only if there is evidence to support renewal by the entity without significant cost. The useful life of a reacquired right recognised as an intangible asset in a business combination is the remaining contractual period of the contract in which the right was granted and shall not include renewal periods.**

95 There may be both economic and legal factors influencing the useful life of an intangible asset. Economic factors determine the period over which future economic benefits will be received by the entity. Legal factors may restrict the period over which the entity controls access to these benefits. The useful life is the shorter of the periods determined by these factors.

96 Existence of the following factors, among others, indicates that an entity would be able to renew the contractual or other legal rights without significant cost:

(a) there is evidence, possibly based on experience, that the contractual or other legal rights will be renewed. If renewal is contingent upon the consent of a third party, this includes evidence that the third party will give its consent;

(b) there is evidence that any conditions necessary to obtain renewal will be satisfied; and

(c) the cost to the entity of renewal is not significant when compared with the future economic benefits expected to flow to the entity from renewal.

If the cost of renewal is significant when compared with the future economic benefits expected to flow to the entity from renewal, the 'renewal' cost represents, in substance, the cost to acquire a new intangible asset at the renewal date.

Intangible assets with finite useful lives

Amortisation period and amortisation method

97 **The depreciable amount of an intangible asset with a finite useful life shall be allocated on a systematic basis over its useful life. Amortisation shall begin when the asset is available for use, ie when it is in the location and condition necessary for it to be capable of operating in the manner intended by management. Amortisation shall cease at the earlier of the date that the asset is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with HKFRS 5 and the date that the asset is derecognised. The amortisation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity. If that pattern cannot be determined reliably, the straight-line method shall be used. The amortisation charge for each period shall be recognised in profit or loss unless this**

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

or another Standard permits or requires it to be included in the carrying amount of another asset.

98 A variety of amortisation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include the straight-line method, the diminishing balance method and the unit of production method. The method used is selected on the basis of the expected pattern of consumption of the expected future economic benefits embodied in the asset and is applied consistently from period to period, unless there is a change in the expected pattern of consumption of those future economic benefits. ~~There is rarely, if ever, persuasive evidence to support an amortisation method for intangible assets with finite useful lives that results in a lower amount of accumulated amortisation than under the straight-line method.~~

99 Amortisation is usually recognised in profit or loss. However, sometimes the future economic benefits embodied in an asset are absorbed in producing other assets. In this case, the amortisation charge constitutes part of the cost of the other asset and is included in its carrying amount. For example, the amortisation of intangible assets used in a production process is included in the carrying amount of inventories (see HKAS 2 *Inventories*).

Residual value

100 The residual value of an intangible asset with a finite useful life shall be assumed to be zero unless:

(a) there is a commitment by a third party to purchase the asset at the end of its useful life; or

(b) there is an active market for the asset and:

(i) residual value can be determined by reference to that market; and

(ii) it is probable that such a market will exist at the end of the asset's useful life.

101 The depreciable amount of an asset with a finite useful life is determined after deducting its residual value. A residual value other than zero implies that an entity expects to dispose of the intangible asset before the end of its economic life.

102 An estimate of an asset's residual value is based on the amount recoverable from disposal using prices prevailing at the date of the estimate for the sale of a similar asset that has reached the end of its useful life and has operated under conditions similar to those in which the asset will be used. The residual value is reviewed at least at each financial year-end. A change in the asset's residual value is accounted for as a change in an accounting estimate in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

103 The residual value of an intangible asset may increase to an amount equal to or greater than the asset's carrying amount. If it does, the asset's amortisation charge is zero unless and until its residual value subsequently decreases to an amount below the asset's carrying amount.

Review of amortisation period and amortisation method

104 The amortisation period and the amortisation method for an intangible asset with a finite useful life shall be reviewed at least at each financial year-end. If the expected useful life of the asset is different from previous estimates, the amortisation period shall be changed accordingly. If there has been a change in the expected pattern of consumption of the future economic benefits embodied in the asset, the amortisation method shall be changed to reflect the changed pattern. Such changes shall be accounted for as changes in accounting estimates in accordance with HKAS 8.

105 During the life of an intangible asset, it may become apparent that the estimate of its useful life is inappropriate. For example, the recognition of an impairment loss may indicate that the amortisation period needs to be changed.

106 Over time, the pattern of future economic benefits expected to flow to an entity from an intangible asset may change. For example, it may become apparent that a diminishing balance method of amortisation is appropriate rather than a straight-line method. Another example is if use of the rights represented by a licence is deferred pending action on other components of the business plan. In this case, economic benefits that flow from the asset may not be received until later periods.

Intangible assets with indefinite useful lives

107 An intangible asset with an indefinite useful life shall not be amortised.

108 In accordance with HKAS 36, an entity is required to test an intangible asset with an indefinite useful life for impairment by comparing its recoverable amount with its carrying amount

(a) annually, and

(b) whenever there is an indication that the intangible asset may be impaired.

Review of useful life assessment

109 The useful life of an intangible asset that is not being amortised shall be reviewed each period to determine whether events and circumstances continue to support an indefinite useful life assessment for that asset. If they do not, the change in the useful life assessment from indefinite to finite shall be accounted for as a change in an accounting estimate in accordance with HKAS 8.

110 In accordance with HKAS 36, reassessing the useful life of an intangible asset as finite rather than indefinite is an indicator that the asset may be impaired. As a result, the entity tests the asset for impairment by comparing its recoverable amount, determined in accordance with HKAS 36, with its carrying amount, and recognising any excess of the carrying amount over the recoverable amount as an impairment loss.

Recoverability of the carrying amount - impairment losses

111 To determine whether an intangible asset is impaired, an entity applies HKAS 36. That Standard explains when and how an entity reviews the carrying amount of its assets, how it determines the recoverable amount of an asset and when it recognises or reverses an impairment loss.

Retirements and disposals

112 An intangible asset shall be derecognised:

(a) on disposal; or

(b) when no future economic benefits are expected from its use or disposal.

113 The gain or loss arising from the derecognition of an intangible asset shall be determined as the difference between the net disposal proceeds, if any, and the carrying amount of the asset. It shall be recognised in profit or loss when the asset is derecognised (unless HKAS 17 requires otherwise on a sale and leaseback). Gains shall not be classified as revenue.

114 The disposal of an intangible asset may occur in a variety of ways (eg by sale, by entering into a finance lease, or by donation). In determining the date of disposal of such an asset, an entity applies the criteria in HKAS 18 *Revenue* for recognising revenue from the sale of goods. HKAS 17 applies to disposal by a sale and leaseback.

115 If in accordance with the recognition principle in paragraph 21 an entity recognises in the carrying amount of an asset the cost of a replacement for part of an intangible asset, then it derecognises the carrying amount of the replaced part. If it is not practicable for an entity to determine the carrying amount of the replaced part, it may use the cost of the replacement as an indication of what the cost of the replaced part was at the time it was acquired or internally generated.

115A[*] In the case of a reacquired right in a business combination, if the right is subsequently reissued (sold) to a third party, the related carrying amount, if any, shall be used in determining the gain or loss on reissue.

116 The consideration receivable on disposal of an intangible asset is recognised initially at its fair value. If payment for the intangible asset is deferred, the consideration received is recognised initially at the cash price equivalent. The difference between the nominal amount of the consideration and the cash price equivalent is recognised as interest revenue in accordance with HKAS 18 reflecting the effective yield on the receivable.

117 Amortisation of an intangible asset with a finite useful life does not cease when the intangible asset is no longer used, unless the asset has been fully depreciated or is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with HKFRS 5.

Disclosure

General

118 An entity shall disclose the following for each class of intangible assets, distinguishing between internally generated intangible assets and other intangible assets:

(a) whether the useful lives are indefinite or finite and, if finite, the useful lives

[*] Amendment effective for annual periods beginning on or after 1 July 2009.

or the amortisation rates used;

(b) the amortisation methods used for intangible assets with finite useful lives;

(c) the gross carrying amount and any accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and end of the period;

(d) the line item(s) of the ~~income statement~~statement of comprehensive income in which any amortisation of intangible assets is included;

(e) a reconciliation of the carrying amount at the beginning and end of the period showing:

(i) additions, indicating separately those from internal development, those acquired separately, and those acquired through business combinations;

(ii) assets classified as held for sale or included in a disposal group classified as held for sale in accordance with HKFRS 5 and other disposals;

(iii) increases or decreases during the period resulting from revaluations under paragraphs 75, 85 and 86 and from impairment losses recognised or reversed ~~directly in equity~~in other comprehensive income in accordance with HKAS 36 (if any);

(iv) impairment losses recognised in profit or loss during the period in accordance with HKAS 36 (if any);

(v) impairment losses reversed in profit or loss during the period in accordance with HKAS 36 (if any);

(vi) any amortisation recognised during the period;

(vii) net exchange differences arising on the translation of the financial statements into the presentation currency, and on the translation of a foreign operation into the presentation currency of the entity; and

(viii) other changes in the carrying amount during the period.

119 A class of intangible assets is a grouping of assets of a similar nature and use in an entity's operations. Examples of separate classes may include:

(a) brand names;

(b) mastheads and publishing titles;

(c) computer software;

(d) licences and franchises;

(e) copyrights, patents and other industrial property rights, service and operating rights;

(f) recipes, formulae, models, designs and prototypes; and

(g) intangible assets under development.

The classes mentioned above are disaggregated (aggregated) into smaller (larger) classes if this results in more relevant information for the users of the financial statements.

120 An entity discloses information on impaired intangible assets in accordance with HKAS 36 in addition to the information required by paragraph 118(e)(iii)-(v).

121 HKAS 8 requires an entity to disclose the nature and amount of a change in an accounting estimate that has a material effect in the current period or is expected to have a material effect in subsequent periods. Such disclosure may arise from changes in:

(a) the assessment of an intangible asset's useful life;

(b) the amortisation method; or

(c) residual values.

122 An entity shall also disclose:

(a) for an intangible asset assessed as having an indefinite useful life, the carrying amount of that asset and the reasons supporting the assessment of an indefinite useful life. In giving these reasons, the entity shall describe the factor(s) that played a significant role in determining that the asset has an indefinite useful life.

(b) a description, the carrying amount and remaining amortisation period of any individual intangible asset that is material to the entity's financial statements.

(c) for intangible assets acquired by way of a government grant and initially recognised at fair value (see paragraph 44):

(i) the fair value initially recognised for these assets;

(ii) their carrying amount; and

(iii) whether they are measured after recognition under the cost model or the revaluation model.

(d) the existence and carrying amounts of intangible assets whose title is restricted and the carrying amounts of intangible assets pledged as security for liabilities.

(e) the amount of contractual commitments for the acquisition of intangible assets.

123 When an entity describes the factor(s) that played a significant role in determining that the useful life of an intangible asset is indefinite, the entity considers the list of factors in paragraph 90.

Intangible assets measured after recognition using the revaluation model

124 If intangible assets are accounted for at revalued amounts, an entity shall disclose the following:

(a) by class of intangible assets:

(i) the effective date of the revaluation;

(ii) the carrying amount of revalued intangible assets; and

(iii) the carrying amount that would have been recognised had the revalued class of intangible assets been measured after recognition using the cost model in paragraph 74;

(b) the amount of the revaluation surplus that relates to intangible assets at the beginning and end of the period, indicating the changes during the period and any restrictions on the distribution of the balance to shareholders; and

(c) the methods and significant assumptions applied in estimating the assets' fair values.

125 It may be necessary to aggregate the classes of revalued assets into larger classes for disclosure purposes. However, classes are not aggregated if this would result in the combination of a class of intangible assets that includes amounts measured under both the cost and revaluation models.

Research and development expenditure

126 An entity shall disclose the aggregate amount of research and development expenditure recognised as an expense during the period.

127 Research and development expenditure comprises all expenditure that is directly attributable to research or development activities (see paragraphs 66 and 67 for guidance on the type of expenditure to be included for the purpose of the disclosure requirement in paragraph 126).

Other information

128 An entity is encouraged, but not required, to disclose the following information:

(a) a description of any fully amortised intangible asset that is still in use; and

(b) a brief description of significant intangible assets controlled by the entity but not recognised as assets because they did not meet the recognition criteria in this Standard or because they were acquired or generated before the version of SSAP 29 *Intangible Assets* issued in 2001 was effective.

Transitional provisions and effective date

129* ~~**If an entity elects in accordance with paragraph 85 of HKFRS 3 *Business Combinations* to apply HKFRS 3 from any date before the effective dates set out in paragraphs 78-84 of HKFRS 3, it also shall apply this Standard prospectively from that same date. Thus, the entity shall not adjust the carrying amount of intangible assets recognised at that date. However, the entity shall, at that date, apply this Standard to reassess the useful lives of its recognised intangible assets. If, as a result of that reassessment, the entity changes its assessment of the useful life of an asset, that change shall be accounted for as a change in an accounting estimate in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.**~~ **[Deleted]**

130* ~~**Otherwise, a**~~**An entity shall apply this Standard:**

(a) **to the accounting for intangible assets acquired in business combinations for which the agreement date is on or after 1 January 2005; and**

(b) **to the accounting for all other intangible assets prospectively from the beginning of the first annual period beginning on or after 1 January 2005. Thus, the entity shall not adjust the carrying amount of intangible assets recognised at that date. However, the entity shall, at that date, apply this Standard to reassess the useful lives of such intangible assets. If, as a result of that reassessment, the entity changes its assessment of the useful life of an asset, that change shall be accounted for as a change in an accounting estimate in accordance with HKAS 8.**

130A An entity shall apply the amendments in paragraph 2 for annual periods beginning on or after 1 January 2006. If an entity applies HKFRS 6 for an earlier period, those amendments shall be applied for that earlier period.

130B HKAS 1 *Presentation of Financial Statements* (as revised in 2007) amended the terminology used throughout HKFRSs. In addition it amended paragraphs 85, 86 and 118(e)(iii). An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. If an entity applies HKAS 1 (revised 2007) for an earlier period, the amendments shall be applied for that earlier period.

130C HKFRS 3 (as revised in 2008) amended paragraphs 12, 33-35, 68, 69, 94 and 130, deleted paragraphs 38 and 129 and added paragraph 115A. *Improvements to HKFRSs* issued in May 2009 amended paragraphs 36 and 37. An entity shall apply those amendments prospectively for annual periods beginning on or after 1 July 2009. Therefore, amounts recognised for intangible assets and goodwill in prior business combinations shall not be adjusted. If an entity applies HKFRS 3 (revised 2008) for an earlier period, it shall apply the amendments for that earlier period and disclose the fact.

130D Paragraphs 69, 70 and 98 were amended and paragraph 69A was added by *Improvements to HKFRSs* issued in October 2008. An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. Earlier application is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact.

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

130E *Improvements to HKFRSs* issued in May 2009 amended paragraphs 40 and 41. An entity shall apply those amendments prospectively for annual periods beginning on or after 1 July 2009. Earlier application is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact.

Exchanges of similar assets

131 The requirement in paragraphs 129 and 130(b) to apply this Standard prospectively means that if an exchange of assets was measured before the effective date of this Standard on the basis of the carrying amount of the asset given up, the entity does not restate the carrying amount of the asset acquired to reflect its fair value at the acquisition date.

Early application

132 Entities to which paragraph 130 applies are encouraged to apply the requirements of this Standard before the effective dates specified in paragraph 130. However, if an entity applies this Standard before those effective dates, it also shall apply HKFRS 3 and HKAS 36 at the same time.

Withdrawal of SSAP 29

133 This Standard supersedes SSAP 29 *Intangible Assets* (issued in 2001).

Appendix

Comparison with International Accounting Standards

This comparison appendix, which was prepared as at August 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 38.

The International Accounting Standard comparable with HKAS 38 is IAS 38 *Intangible Assets.*

There are no major textual differences between HKAS 38 and IAS 38.

HKAS 38 BC
Revised ~~May 2009~~March 2010

Basis for Conclusions on
Hong Kong Accounting Standard 38

Intangible Assets

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

HKAS 38 is based on IAS 38 *Intangible Assets*. In approving HKAS 38, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IASB's Basis for Conclusions on IAS 38. Accordingly, there are no significant differences between HKAS 38 and IAS 38. The IASB's Basis for Conclusions is reproduced below for reference. The paragraph numbers of IAS 38 referred to below generally correspond with those in HKAS 38.

CONTENTS

paragraphs

BASIS FOR CONCLUSIONS ON IAS 38 *INTANGIBLE ASSETS*

Basis for Conclusions on IAS 38 *Intangible Assets*

The International Accounting Standards Board revised IAS 38 as part of its project on business combinations. It was not the Board's intention to reconsider as part of that project all of the requirements in IAS 38.

The previous version of IAS 38 was accompanied by a Basis for Conclusions summarising the former International Accounting Standards Committee's considerations in reaching some of its conclusions in that Standard. For convenience the Board has incorporated into its own Basis for Conclusions material from the previous Basis for Conclusions that discusses (a) matters the Board did not reconsider and (b) the history of the development of a standard on intangible assets. That material is contained in paragraphs denoted by numbers with the prefix BCZ. Paragraphs describing the Board's considerations in reaching its own conclusions are numbered with the prefix BC.

Introduction

BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching the conclusions in IAS 38 *Intangible Assets*. Individual Board members gave greater weight to some factors than to others.

BC2 The International Accounting Standards Committee (IASC) issued the previous version of IAS 38 in 1998. It has been revised by the Board as part of its project on business combinations. That project has two phases. The first has resulted in the Board issuing simultaneously IFRS 3 *Business Combinations* and revised versions of IAS 38 and IAS 36 *Impairment of Assets*. Therefore, the Board's intention in revising IAS 38 as part of the first phase of the project was not to reconsider all of the requirements in IAS 38. The changes to IAS 38 are primarily concerned with:

(a) the notion of 'identifiability' as it relates to intangible assets;

(b) the useful life and amortisation of intangible assets; and

(c) the accounting for in-process research and development projects acquired in business combinations.

BC3 With the exception of research and development projects acquired in business combinations, the Board did not reconsider the requirements in the previous version of IAS 38 on the recognition of internally generated intangible assets. The previous version of IAS 38 was accompanied by a Basis for Conclusions summarising IASC's considerations in reaching some of its conclusions in that Standard. For convenience, the Board has incorporated into this Basis for Conclusions material from the previous Basis for Conclusions that discusses the recognition of internally generated intangible assets (see paragraphs BCZ29-BCZ46) and the history of the development of a standard on intangible assets (see paragraphs BCZ104-BCZ110). The views expressed in paragraphs BCZ29-BCZ46 and BCZ104-BCZ110 are those of IASC.

Definition of an intangible asset (paragraph 8)

BC4 An intangible asset was defined in the previous version of IAS 38 as "an identifiable non-monetary asset without physical substance held for use in the production or supply of goods or services, for rental to others, or for administrative services". The definition in the revised Standard eliminates the requirement for the asset to be held for use in the production or supply of goods or services, for rental to others, or for administrative services.

BC5 The Board observed that the essential characteristics of intangible assets are that they:

(a) are resources controlled by the entity from which future economic benefits are expected to flow to the entity;

(b) lack physical substance; and

(c) are identifiable.

The Board concluded that the purpose for which an entity holds an item with these characteristics is not relevant to its classification as an intangible asset, and that all such items should be within the scope of the Standard.

Identifiability (paragraph 12)

BC6 Under the Standard, as under the previous version of IAS 38, a non-monetary asset without physical substance must be identifiable to meet the definition of an intangible asset. The previous version of IAS 38 did not define 'identifiability', but stated that an intangible asset could be distinguished from goodwill if the asset was separable, but that separability was not a necessary condition for identifiability. The revised Standard requires an asset to be treated as meeting the identifiability criterion in the definition of an intangible asset when it is separable, or when it arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

Background to the Board's deliberations

BC7 The Board was prompted to consider the issue of 'identifiability' as part of the first phase of its Business Combinations project as a result of changes during 2001 to the requirements in Canadian and United States standards on the separate recognition of intangible assets acquired in business combinations. The Board observed that intangible assets comprise an increasing proportion of the assets of many entities, and that intangible assets acquired in a business combination are often included in the amount recognised as goodwill, despite the requirements in IAS 22 *Business Combinations* and IAS 38 for them to be recognised separately from goodwill. The Board agreed with the conclusion reached by the Canadian and US standard-setters that the usefulness of financial statements would be enhanced if intangible assets acquired in a business combination were distinguished from goodwill. Therefore, the Board concluded that the IFRS arising from the first phase of the Business Combinations project should provide a definitive basis for identifying and recognising intangible assets acquired in a business combination separately from goodwill.

BC8 In revising IAS 38 and developing IFRS 3, the Board affirmed the view in the previous version of IAS 38 that identifiability is the characteristic that conceptually distinguishes other intangible assets from goodwill. The Board concluded that to provide a definitive basis for identifying and recognising intangible assets separately from goodwill, the concept of identifiability needed to be articulated more clearly.

Clarifying identifiability (paragraph 12)

BC9 Consistently with the guidance in the previous version of IAS 38, the Board concluded that an intangible asset can be distinguished from goodwill if it is separable, ie capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged. Therefore, in the context of intangible assets, separability signifies identifiability, and intangible assets with that characteristic that are acquired in a business combination should be recognised as assets separately from goodwill.

BC10 However, again consistently with the guidance in the previous version of IAS 38, the Board concluded that separability is not the only indication of identifiability. The Board observed that, in contrast to goodwill, the values of many intangible assets arise from rights conveyed legally by contract or statute. In the case of acquired goodwill, its value arises from the collection of assembled assets that make up an acquired entity or the value created by assembling a collection of assets through a business combination, such as the synergies that are expected to result from combining entities or businesses. The Board also observed that, although many intangible assets are both separable and arise from contractual-legal rights, some contractual-legal rights establish property interests that are not readily separable from the entity as a whole. For example, under the laws of some jurisdictions some licences granted to an entity are not transferable except by sale of the entity as a whole. The Board concluded that the fact that an intangible asset arises from contractual or other legal rights is a characteristic that distinguishes it from goodwill. Therefore, intangible assets with that characteristic that are acquired in a business combination should be recognised as assets separately from goodwill.

Non-contractual customer relationships (paragraph 16)

BC11 The previous version of IAS 38 and the Exposure Draft of Proposed Amendments to IAS 38 stated that ‘An entity controls an asset if the entity has the power to obtain the future economic benefits flowing from the underlying resource and also can restrict the access of others to those benefits.’ The documents then expanded on this by stating that ‘in the absence of legal rights to protect, or other ways to control, the relationships with customers or the loyalty of the customers to the entity, the entity usually has insufficient control over the economic benefits from customer relationships and loyalty to consider that such items meet the definition of intangible assets.’

BC12 However, the Draft Illustrative Examples accompanying ED 3 *Business Combinations* stated that “If a customer relationship acquired in a business combination does not arise from a contract, the relationship is recognised as an intangible asset separately from goodwill if it meets the separability criterion. Exchange transactions for the same asset or a similar asset provide evidence of separability of a non-contractual customer relationship and might also provide information about exchange prices that should be considered when estimating fair value.” Whilst respondents to the Exposure Draft generally agreed with the Board’s conclusions on the definition of identifiability, some were uncertain about the relationship between the separability criterion for establishing whether a non-contractual customer relationship is identifiable, and the control concept for establishing whether the relationship meets the definition of an asset. Additionally, some respondents suggested that non-contractual customer relationships would, under the proposal in the Exposure Draft, be separately recognised if acquired in a business combination, but not if acquired in a separate transaction.

BC13 The Board observed that exchange transactions for the same or similar non-contractual customer relationships provide evidence not only that the item is separable, but also that the entity is able to control the expected future economic benefits flowing from that relationship. Similarly, if an entity separately acquires a non-contractual customer relationship, the existence of an exchange transaction for that relationship provides evidence both that the item is separable, and that the entity is able to control the expected future economic benefits flowing from the relationship. Therefore, the relationship would meet the intangible asset definition and be recognised as such. However, in the absence of exchange transactions for the same or similar non-contractual customer relationships, such relationships acquired in a business combination would not normally meet the definition of an 'intangible asset'—they would not be separable, nor would the entity be able to demonstrate that it controls the expected future economic benefits flowing from that relationship.

BC14 Therefore, the Board decided to clarify in paragraph 16 of IAS 38 that in the absence of legal rights to protect customer relationships, exchange transactions for the same or similar non-contractual customer relationships (other than as part of a business combination) provide evidence that the entity is nonetheless able to control the future economic benefits flowing from the customer relationships. Because such exchange transactions also provide evidence that the customer relationships are separable, those customer relationships meet the definition of an intangible asset.

Criteria for initial recognition

BC15 In accordance with the Standard, as with the previous version of IAS 38, an intangible asset is recognised if, and only if:

(a) it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and

(b) the cost of the asset can be measured reliably.

In revising IAS 38 the Board considered the application of these recognition criteria to intangible assets acquired in business combinations. The Board's deliberations on this issue are set out in paragraphs BC16-BC25.

Acquisition as part of a business combination (paragraphs 33-38)

BC16 ~~The Exposure Draft of Proposed Amendments to IAS 38 proposed that the recognition criteria in paragraph BC15 would, with the exception of an assembled workforce, always be satisfied for an intangible asset acquired in a business combination. Therefore, those criteria were not included in ED 3~~ ~~*Business Combinations*~~~~. ED 3 proposed requiring an acquirer to recognise separately at the acquisition date all of the acquiree's intangible assets as defined in IAS 38, other than an assembled workforce. After considering respondents' comments, the Board decided:~~

~~(a) to proceed with the proposal that the probability recognition criterion is always considered to be satisfied for intangible assets acquired in a business combination; and~~

(b) ~~not to proceed with the proposal that, with the exception of an assembled workforce, sufficient information should always exist to measure reliably the fair value of an intangible asset acquired in a business combination.~~ [Deleted]

BC16A The Board observed that in a business combination both criteria, the probability criterion and the reliability of measurement criterion, will always be met.

Probability recognition criterion

BC17 In revising IAS 38, the Board observed that the fair value of an intangible asset reflects market expectations about the probability that the future economic benefits associated with the intangible asset will flow to the acquirer. In other words, the effect of probability is reflected in the fair value measurement of an intangible asset. Therefore, the probability recognition criterion is always considered to be satisfied for intangible assets acquired in business combinations.

BC18 The Board observed that this highlights a general inconsistency between the recognition criteria for assets and liabilities in the *Framework* (which states that an item meeting the definition of an element should be recognised only if it is probable that any future economic benefits associated with the item will flow to or from the entity, and the item can be measured reliably) and the fair value measurements required in, for example, a business combination. However, the Board concluded that the role of probability as a criterion for recognition in the *Framework* should be considered more generally as part of a forthcoming Concepts project.

Reliability of measurement recognition criterion

BC19 ~~In developing the Exposure Draft, the Board concluded that, except for an assembled workforce, sufficient information should exist to measure reliably the fair value of an asset that has an underlying contractual or legal basis or is capable of being separated from the entity. Respondents generally disagreed with this conclusion, arguing that:~~

~~(a) it might not always be possible to measure reliably the fair value of an asset that has an underlying contractual or legal basis or is capable of being separated from the entity.~~

~~(b) a similar presumption does not exist in IFRSs for identifiable tangible assets acquired in a business combination. Indeed, the Board decided when developing IFRS 3 *Business Combinations* to carry forward from IAS 22 *Business Combinations* the general principle that an acquirer should recognise separately from goodwill the acquiree's identifiable tangible assets, but only provided they can be measured reliably.~~ [Deleted]

BC19A In developing IFRS 3, the IASB noted that the fair values of identifiable intangible assets acquired in a business combination are normally measurable with sufficient reliability to be recognised separately from goodwill. The effects of uncertainty because of a range of possible outcomes with different probabilities are reflected in measuring the asset's fair value; the existence of such a range does not demonstrate an inability to measure fair value reliably. IAS 38 (as revised in 2004) included a rebuttable presumption that the fair value of an intangible asset with a finite useful life acquired in a business combination can be measured reliably. The Board had concluded that it might not always be possible to measure reliably the fair value of an asset that has an underlying contractual or legal basis. However, IAS 38 (revised 2004) provided that the only circumstances in which it might not be possible to measure reliably the fair value of an intangible asset acquired in a business combination that arises from legal or other contractual rights were if it either:

(a) is not separable; or

(b) is separable, but there is no history or evidence of exchange transactions for the same or similar assets, and otherwise estimating fair value would depend on immeasurable variables.

BC19B In developing the 2005 Business Combinations exposure draft, the Board concluded that separate recognition of intangible assets, on the basis of an estimate of fair value, rather than subsuming them in goodwill, provides better information to the users of financial statements even if a significant degree of judgment is required to estimate fair value. For this reason, the Board decided to propose consequential amendments to IAS 38 to remove the reliability of measurement criterion for intangible assets acquired in a business combination. In redeliberating the proposals in the 2005 Business Combinations exposure draft, the Board affirmed those amendments to IAS 38.

BC19C When the Board developed IFRS 3 (as revised in 2008), it decided that if an intangible asset acquired in a business combination is separable or arises from contractual or other legal rights, sufficient information exists to measure the fair value of the asset reliably. The Board made related amendments to IAS 38 to reflect that decision. However, the Board identified additional amendments that were needed to reflect clearly its decisions on the accounting for intangible assets acquired in a business combination. Consequently, in *Improvements to IFRSs* issued in April 2009, the Board amended paragraphs 36 and 37 of IAS 38 to clarify the Board's intentions.

BC19D Additionally, in *Improvements to IFRSs* issued in April 2009, the Board amended paragraphs 40 and 41 of IAS 38 to clarify the description of valuation techniques commonly used to measure intangible assets at fair value when assets are not traded in an active market. The Board also decided that the amendments should be applied prospectively because retrospective application might require some entities to remeasure fair values associated with previous transactions. The Board does not think this is appropriate because the remeasurement might involve the use of hindsight in those circumstances.

BC20-
BC25 [Deleted]

~~Additionally, as part of its consultative process, the Board conducted field visits and round-table discussions during the comment period for the Exposure Draft.[*] Field visit and round-table participants were asked a series of questions aimed at improving the Board's understanding of whether there might exist non-monetary assets without physical substance that are separable or arise from legal or other contractual rights, but for which there may *not* be sufficient information to measure fair value reliably.~~

[*] ~~The field visits were conducted from early December 2002 to early April 2003, and involved IASB members and staff in meetings with 41 companies in Australia, France, Germany, Japan, South Africa, Switzerland and the United Kingdom. IASB members and staff also took part in a series of round-table discussions with auditors, preparers, accounting standard-setters and regulators in Canada and the United States on implementation issues encountered by North American companies during first-time application of US Statements of Financial Accounting Standards 141 *Business Combinations* and 142 *Goodwill and Other Intangible Assets*, and the equivalent Canadian Handbook Sections, which were issued in June 2001.~~

~~BC21 The field visit and round-table participants provided numerous examples of intangible assets they had acquired in recent business combinations whose fair values might not be reliably measurable. For example, one participant acquired water acquisition rights as part of a business combination. The rights are extremely valuable to many manufacturers operating in the same jurisdiction as the participant – the manufacturers cannot acquire water and, in many cases, cannot operate their plants without them. Local authorities grant the rights at little or no cost, but in limited numbers, for fixed periods (normally ten years), and renewal is certain at little or no cost. The rights cannot be sold other than as part of the sale of a business as a whole, therefore there exists no secondary market in the rights. If a manufacturer hands the rights back to the local authority, it is prohibited from reapplying. The participant argued that it could not value these rights separately from its business (and therefore from goodwill), because the business would cease to exist without the rights.~~

~~BC22 After considering respondents' comments and the experiences of field visit and round-table participants, the Board concluded that, in some instances, there might not be sufficient information to measure reliably the fair value of an intangible asset separately from goodwill, notwithstanding that the asset is identifiable. The Board observed that, except as outlined in paragraph BC25, the intangible assets whose fair values respondents and field visit and round-table participants could not measure reliably arose either:~~

~~(a) from legal or other contractual rights and are not separable (ie could be transferred only as part of the sale of a business as a whole); or~~

~~(b) from legal or other contractual rights and are separable (ie capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability), but there is no history or evidence of exchange transactions for the same or similar assets, and otherwise estimating fair value would be dependent on immeasurable variables.~~

~~BC23 Nevertheless, the Board remained of the view that the usefulness of financial statements would be enhanced if intangible assets acquired in a business combination were distinguished from goodwill, particularly given the Board's decision to regard goodwill as an indefinite-lived asset that is not amortised. The Board also remained concerned that failing the recognition criterion of reliability of measurement might be inappropriately used by entities as a basis for not recognising intangible assets separately from goodwill. For example, IAS 22 and the previous version of IAS 38 required an acquirer to recognise an intangible asset of the acquiree separately from goodwill at the acquisition date if it was probable that any associated future economic benefits would flow to the acquirer and the asset's fair value could be measured reliably. The Board observed when developing the Exposure Draft that although intangible assets constitute an increasing proportion of the assets of many entities, those acquired in business combinations were often included in the amount recognised as goodwill, despite the requirements in IAS 22 and the previous version of IAS 38 that they be recognised separately from goodwill.~~

~~BC24 Therefore, although the Board decided not to proceed with the proposal that, with the exception of an assembled workforce, sufficient information should always exist to measure reliably the fair value of an intangible asset acquired in a business combination, the Board also decided:~~

~~(a) to clarify in paragraph 35 of the Standard that the fair value of an intangible asset acquired in a business combination can normally be measured with sufficient reliability for it to be recognised separately from goodwill. When, for the estimates used to~~

~~measure an intangible asset's fair value, there is a range of possible outcomes with different probabilities, that uncertainty enters into the measurement of the asset's fair value, rather than demonstrates an inability to measure fair value reliably.~~

~~(b) to include in paragraph 35 of the Standard a rebuttable presumption that the fair value of a finite-lived intangible asset acquired in a business combination can be measured reliably.~~

~~(c) to clarify in paragraph 38 of the Standard that the only circumstances in which it might not be possible to measure reliably the fair value of an intangible asset acquired in a business combination are when the intangible asset arises from legal or other contractual rights and it either (i) is not separable or (ii) is separable but there is no history or evidence of exchange transactions for the same or similar assets and otherwise estimating fair value would be dependent on immeasurable variables.~~

~~(d) to include in paragraph 67(h) of IFRS 3 a requirement for entities to disclose a description of each asset that meets the definition of an intangible asset and was acquired in a business combination during the period but was not recognised separately from goodwill, and an explanation of why its fair value could not be measured reliably.~~

~~BC25 Some respondents and field visit participants suggested that it might also not be possible to measure reliably the fair value of an intangible asset when it is separable, but only together with a related contract, asset or liability (ie it is not individually separable), there is no history of exchange transactions for the same or similar assets on a stand-alone basis, and, because the related items produce jointly the same cash flows, the fair value of each could be estimated only by arbitrarily allocating those cash flows between the two items. The Board disagreed that such circumstances provide a basis for subsuming the value of the intangible asset within the carrying amount of goodwill. Although some intangible assets are so closely related to other identifiable assets or liabilities that they are usually sold as a package, it would still be possible to measure reliably the fair value of that package. Therefore, the Board decided to include the following clarifications in paragraphs 36 and 37 of the Standard:~~

~~(a) when an intangible asset acquired in a business combination is separable but only together with a related tangible or intangible asset, the acquirer recognises the group of assets as a single asset separately from goodwill if the individual fair values of the assets in the group are not reliably measurable.~~

~~(b) similarly, an acquirer recognises as a single asset a group of complementary intangible assets constituting a brand if the individual fair values of the complementary assets are not reliably measurable. If the individual fair values of the complementary assets are reliably measurable, the acquirer may recognise them as a single asset separately from goodwill, provided the individual assets have similar useful lives.~~

Separate acquisition (paragraphs 25 and 26)

BC26 Having decided to include paragraphs 33-38 in IAS 38, the Board also decided that it needed to consider the role of the probability and reliability of measurement recognition criteria for separately acquired intangible assets.

BC27 Consistently with its conclusion about the role of probability in the recognition of intangible assets acquired in business combinations, the Board concluded that the probability recognition criterion is always considered to be satisfied for separately acquired intangible assets. This is because the price an entity pays to acquire separately an intangible asset normally reflects expectations about the probability that the expected future economic benefits associated with the intangible asset will flow to the entity. In other words, the effect of probability is reflected in the cost of the intangible asset.

BC28 The Board also concluded that when an intangible asset is separately acquired in exchange for cash or other monetary assets, sufficient information should exist to measure the cost of that asset reliably. However, this might not be the case when the purchase consideration comprises non-monetary assets. Therefore, the Board decided to carry forward from the previous version of IAS 38 guidance clarifying that the cost of a separately acquired intangible asset can usually be measured reliably, particularly when the purchase consideration is cash or other monetary assets.

Internally generated intangible assets (paragraphs 51-67)

BCZ29 The controversy relating to internally generated intangible assets surrounds whether there should be:

(a) a requirement to recognise internally generated intangible assets in the balance sheet whenever certain criteria are met;

(b) a requirement to recognise expenditure on all internally generated intangible assets as an expense;

(c) a requirement to recognise expenditure on all internally generated intangible assets as an expense, with certain specified exceptions; or

(d) an option to choose between the treatments described in (a) and (b) above.

Background on the requirements for internally generated intangible assets

BCZ30 Before IAS 38 was issued in 1998, some internally generated intangible assets (those that arose from development expenditure) were dealt with under IAS 9 *Research and Development Costs*. The development of, and revisions to, IAS 9 had always been controversial.

BCZ31 Proposed and approved requirements for the recognition of an asset arising from development expenditure and other internally generated intangible assets had been the following:

(a) in 1978, IASC approved IAS 9 *Accounting for Research and Development Activities*. It required expenditure on research and development to be recognised as an expense when incurred, except that an enterprise had the option to recognise an asset arising from development expenditure whenever certain criteria were met.

(b) in 1989, Exposure Draft E32 *Comparability of Financial Statements* proposed retaining IAS 9's option to recognise an asset arising from development expenditure if certain criteria were met and identifying:

   - (i) as a preferred treatment, recognising all expenditure on research and development as an expense when incurred; and
   - (ii) as an allowed alternative treatment, recognising an asset arising from development expenditure whenever certain criteria were met.

   The majority of commentators on E32 did not support maintaining an option or the proposed preferred treatment.

(c) in 1991, Exposure Draft E37 *Research and Development Costs* proposed requiring the recognition of an asset arising from development expenditure whenever certain criteria were met. In 1993, IASC approved IAS 9 *Research and Development Costs* based on E37.

(d) in 1995, consistently with IAS 9, Exposure Draft E50 *Intangible Assets* proposed requiring internally generated intangible assets—other than those arising from development expenditure, which would still have been covered by IAS 9—to be recognised as assets whenever certain criteria were met.

(e) in 1997, Exposure Draft E60 *Intangible Assets* proposed:

   - (i) retaining E50's proposals for the recognition of internally generated intangible assets; but
   - (ii) extending the scope of the Standard on intangible assets to deal with all internally generated intangible assets— including those arising from development expenditure.

(f) in 1998, IASC approved:

   - (i) IAS 38 *Intangible Assets* based on E60, with a few minor changes; and
   - (ii) the withdrawal of IAS 9.

BCZ32 From 1989, the majority view at IASC and from commentators was that there should be only one treatment that would require an internally generated intangible asset—whether arising from development expenditure or other expenditure—to be recognised as an asset whenever certain recognition criteria are met. Several minority views were strongly opposed to this treatment but there was no clear consensus on any other single treatment.

Combination of IAS 9 with the Standard on intangible assets

BCZ33 The reasons for not retaining IAS 9 as a separate Standard were that:

(a) IASC believed that an identifiable asset that results from research and development activities is an intangible asset because knowledge is the primary outcome of these activities. Therefore, IASC supported treating expenditure on research and development activities similarly to expenditure on activities intended to create any other internally generated intangible assets.

(b) some commentators on E50, which proposed to exclude research and development expenditures from its scope,

   - (i) argued that it was sometimes difficult to identify whether IAS 9 or the proposed Standard on intangible assets should apply, and

(ii) perceived differences in accounting treatments between IAS 9 and E50's proposals, whereas this was not IASC's intent.

BCZ34 A large majority of commentators on E60 supported including certain aspects of IAS 9 with the proposed Standard on intangible assets and the withdrawal of IAS 9. A minority of commentators on E60 supported maintaining two separate Standards. This minority supported the view that internally generated intangible assets should be dealt with on a case-by-case basis with separate requirements for different types of internally generated intangible assets. These commentators argued that E60's proposed recognition criteria were too general to be effective in practice for all internally generated intangible assets.

BCZ35 IASC rejected a proposal to develop separate standards (or detailed requirements within one standard) for specific types of internally generated intangible assets because, as explained above, IASC believed that the same recognition criteria should apply to all types of internally generated intangible assets.

Consequences of combining IAS 9 with IAS 38

BCZ36 The requirements in IAS 38 and IAS 9 differ in the following main respects:

(a) IAS 9 limited the amount of expenditure that could initially be recognised for an asset arising from development expenditure (ie the amount that formed the cost of such an asset) to the amount that was probable of being recovered from the asset. Instead, IAS 38 requires that:

(i) all expenditure incurred from when the recognition criteria are met until the asset is available for use should be accumulated to form the cost of the asset; and

(ii) an enterprise should test for impairment, at least annually, an intangible asset that is not yet available for use. If the cost recognised for the asset exceeds its recoverable amount, an enterprise recognises an impairment loss accordingly. This impairment loss should be reversed if the conditions for reversals of impairment losses under IAS 36 *Impairment of Assets* are met.

(b) IAS 38 permits an intangible asset to be measured after recognition at a revalued amount less subsequent amortisation and subsequent impairment losses. IAS 9 did not permit this treatment. However, it is highly unlikely that an active market (the condition required to revalue intangible assets) will exist for an asset that arises from development expenditure.

(c) IAS 38 requires consideration of residual values in determining the depreciable amount of an intangible asset. IAS 9 prohibited the consideration of residual values. However, IAS 38 sets criteria that make it highly unlikely that an asset that arises from development expenditure would have a residual value above zero.

BCZ37 IASC believed that, in practice, it would be unlikely that the application of IAS 38 would result in differences from the application of IAS 9.

Recognition of expenditure on all internally generated intangible assets as an expense

BCZ38 Those who favour the recognition of expenditure on all internally generated intangible assets (including development expenditure) as an expense argue that:

(a) internally generated intangible assets do not meet the *Framework's* requirements for recognition as an asset because:

(i) the future economic benefits that arise from internally generated intangible assets cannot be distinguished from future economic benefits that arise from internally generated goodwill; and/or

(ii) it is impossible to distinguish reliably the expenditure associated with internally generated intangible assets from the expenditure associated with enhancing internally generated goodwill.

(b) comparability of financial statements will not be achieved. This is because the judgement involved in determining whether it is probable that future economic benefits will flow from internally generated intangible assets is too subjective to result in similar accounting under similar circumstances.

(c) it is not possible to assess reliably the amount that can be recovered from an internally generated intangible asset, unless its fair value can be determined by reference to an active market. Therefore, recognising an internally generated intangible asset for which no active market exists at an amount other than zero may mislead investors.

(d) a requirement to recognise internally generated intangible assets at cost if certain criteria are met results in little, if any, decision useful or predictive information because:

(i) demonstration of technological feasibility or commercial success in order to meet the recognition criteria will generally not be achieved until substantial expenditure has been recognised as an expense. Therefore, the cost recognised for an internally generated intangible asset will not reflect the total expenditure on that asset.

(ii) the cost of an internally generated intangible asset may not have any relationship to the value of the asset.

(e) in some countries, users are suspicious about an enterprise that recognises internally generated intangible assets.

(f) the added costs of maintaining the records necessary to justify and support the recognition of internally generated intangible assets do not justify the benefits.

Recognition of internally generated intangible assets

BCZ39 Those who support the mandatory recognition of internally generated intangible assets (including those resulting from development expenditure) whenever certain criteria are met argue that:

(a) recognition of an internally generated intangible asset if it meets the definition of an asset and the recognition criteria is consistent with the *Framework*. An enterprise can, in some instances:

(i) determine the probability of receiving future economic benefits from an internally generated intangible asset; and

(ii) distinguish the expenditure on this asset from expenditure on internally generated goodwill.

(b) there has been massive investment in intangible assets in the last two decades. There have been complaints that:

(i) the non-recognition of investments in intangible assets in the financial statements distorts the measurement of an enterprise's performance and does not allow an accurate assessment of returns on investment in intangible assets; and

(ii) if enterprises do not track the returns on investment in intangible assets better, there is a risk of over- or under-investing in important assets. An accounting system that encourages such behaviour will become an increasingly inadequate signal, both for internal control purposes and for external purposes.

(c) certain research studies, particularly in the United States, have established a cost-value association for research and development expenditures. The studies establish that capitalisation of research and development expenditure yields value-relevant information to investors.

(d) the fact that some uncertainties exist about the value of an asset does not justify a requirement that no cost should be recognised for the asset.

(e) it should not matter for recognition purposes whether an asset is purchased externally or developed internally. Particularly, there should be no opportunity for accounting arbitrage depending on whether an enterprise decides to outsource the development of an intangible asset or develop it internally.

IASC's view in approving IAS 38

BCZ40 IASC's view—consistently reflected in previous proposals for intangible assets—was that there should be no difference between the requirements for:

(a) intangible assets that are acquired externally; and

(b) internally generated intangible assets, whether they arise from development activities or other types of activities.

Therefore, an internally generated intangible asset should be recognised whenever the definition of, and recognition criteria for, an intangible asset are met. This view was also supported by a majority of commentators on E60.

BCZ41 IASC rejected a proposal for an allowed alternative to recognise expenditure on internally generated intangible assets (including development expenditure) as an expense immediately, even if the expenditure results in an asset that meets the recognition criteria. IASC believed that a free choice would undermine the comparability of financial statements and the efforts of IASC to reduce the number of alternative treatments in International Accounting Standards.

Differences in recognition criteria for internally generated intangible assets and purchased intangible assets

BCZ42 IAS 38 includes specific recognition criteria for internally generated intangible assets that expand on the general recognition criteria for intangible assets. It is assumed that these criteria are met implicitly whenever an enterprise acquires an intangible asset. Therefore, IAS 38 requires an enterprise to demonstrate that these criteria are met for internally generated intangible assets only.

Initial recognition at cost

BCZ43 Some commentators on E50 and E60 argued that the proposed recognition criteria in E50 and E60 were too restrictive and that they would prevent the recognition of many intangible assets, particularly internally generated intangible assets. Specifically, they disagreed with the proposals (retained in IAS 38) that:

(a) an intangible asset should not be recognised at an amount other than its cost, even if its fair value can be determined reliably; and

(b) expenditure on an intangible asset that has been recognised as an expense in prior periods should not be reinstated.

They argued that these principles contradict the *Framework* and quoted paragraph 83 of the *Framework*, which specifies that an item that meets the definition of an asset should be recognised if, among other things, its "*cost or value* can be measured with reliability". These commentators supported recognising an intangible asset—an internally generated intangible asset—at its fair value, if, among other things, its fair value can be measured reliably.

BCZ44 IASC rejected a proposal to allow the initial recognition of an intangible asset at fair value (except if the asset is acquired in a business combination, in exchange for a dissimilar asset[*] or by way of a government grant) because:

(a) this is consistent with IAS 16 *Property, Plant and Equipment*. IAS 16 prohibits the initial recognition of an item of property, plant or equipment at fair value (except in the specific limited cases as those in IAS 38).

(b) it is difficult to determine the fair value of an intangible asset reliably if no active market exists for the asset. Since active markets with the characteristics set out in IAS 38 are highly unlikely to exist for internally generated intangible assets, IASC did not believe that it was necessary to make an exception to the principles generally applied for the initial recognition and measurement of non-financial assets.

[*] IAS 16 *Property, Plant and Equipment* (as revised in 2003) requires an entity to measure an item of property, plant and equipment acquired in exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets, at fair value unless the exchange transaction lacks commercial substance. Previously, an entity measured such an acquired asset at fair value unless the exchanged assets were similar. The IASB concluded that the same measurement criteria should apply to intangible assets acquired in exchange for a nonmonetary asset or assets, or a combination of monetary and non-monetary assets.

(c) the large majority of commentators on E50 supported the initial recognition of intangible assets at cost and the prohibition of the reinstatement of expenditure on an intangible item that was initially recognised as an expense.

Application of the recognition criteria for internally generated intangible assets

BCZ45 IAS 38 specifically prohibits the recognition as intangible assets of brands, mastheads, publishing titles, customer lists and items similar in substance that are internally generated. IASC believed that internally generated intangible items of this kind would rarely, and perhaps never, meet the recognition criteria in IAS 38. However, to avoid any misunderstanding, IASC decided to set out this conclusion in the form of an explicit prohibition.

BCZ46 IAS 38 also clarifies that expenditure on research, training, advertising and start-up activities will not result in the creation of an intangible asset that can be recognised in the financial statements. Whilst some view these requirements and guidance as being too restrictive and arbitrary, they are based on IASC's interpretation of the application of the recognition criteria in IAS 38. They also reflect the fact that it is sometimes difficult to determine whether there is an internally generated intangible asset distinguishable from internally generated goodwill.

2008 Amendments[*]

BC46A Paragraph 68 states that expenditure on an internally developed intangible item shall be recognised as an expense when it is incurred. The Board noted that it was unclear to some constituents how this should be interpreted. For example, some believed that an entity should recognise expenditure on advertising and promotional activities as an expense when it received the goods or services that it would use to develop or communicate the advertisement or promotion. Others believed that an entity should recognise an expense when the advertisement or promotion was delivered to its customers or potential customers. Therefore, the Board decided to amend paragraph 69 to clarify the meaning of 'incurred'.

BC46B The Board noted that advertising and promotional activities enhance or create brands or customer relationships, which in turn generate revenues. Goods or services that are acquired to be used to undertake advertising or promotional activities have no other purpose than to undertake those activities. In other words, the only benefit of those goods or services is to develop or create brands or customer relationships, which in turn generate revenues. Internally generated brands or customer relationships are not recognised as intangible assets.

BC46C The Board concluded that it would be inconsistent for an entity to recognise an asset in respect of an advertisement that it had not yet published if the economic benefits that might flow to the entity as a result of publishing the advertisement are the same as those that might flow to the entity as a result of the brand or customer relationship that it would enhance or create. Therefore, the Board concluded that an entity should not recognise as an asset goods or services that it had received in respect of its future advertising or promotional activities.

[*] This Heading and paragraphs BC46A-BC46I were added by *Improvements to IFRSs* issued in May 2008.

BC46D In reaching this conclusion the Board noted that, if an entity pays for advertising goods or services in advance and the other party has not yet provided those goods or services, the entity has a different asset. That asset is the right to receive those goods and services. Therefore, the Board decided to retain paragraph 70, which allows an entity to recognise as an asset the right to receive those goods or services. However, the Board did not believe that this paragraph should be used as a justification for recognising an asset beyond the point at which the entity gained a right to access the related goods or received the related services. Therefore, the Board decided to amend the paragraph to make clear that a prepayment may be recognised by an entity only until that entity has gained a right to access to the related goods or has received the related services.

BC46E The Board noted that when the entity has received the related goods or services, it ceases to have the right to receive them. Because the entity no longer has an asset that it can recognise, it recognises an expense. However, the Board was concerned that the timing of delivery of goods should not be the determinant of when an expense should be recognised. The date on which physical delivery is obtained could be altered without affecting the commercial substance of the arrangement with the supplier. Therefore, the Board decided that an entity should recognise an expense for goods when they have been completed by the supplier in accordance with a contract to supply them and the entity could ask for delivery in return for payment—in other words, when the entity had gained a right to access the related goods.

BC46F A number of commentators on the exposure draft of proposed *Improvements to IFRSs* published in 2007 thought that it was unclear when the Board intended an expense to be recognised. In response to those comments, the Board added paragraph 69A to clarify when entities would gain a right to access goods or receive services.

BC46G The Board also received a number of comments arguing that mail order catalogues are not a form of advertising and promotion but instead give rise to a distribution network. The Board rejected these arguments, believing that the primary objective of mail order catalogues is to advertise goods to customers. To avoid confusion, the Board decided to include mail order catalogues in the Standard as an example of advertising activities.

BC46H Some respondents who argued that the cost of mail order catalogues should be capitalised suggested that making an analogy to web site costs in SIC-32 *Intangible Assets—Web Site Costs* would be appropriate. The Board agreed and concluded that its proposed amendments would result in accounting that is almost identical to that resulting from the application of SIC-32. In particular, SIC-32 requires the cost of content (to the extent that it is developed to advertise and promote products and services) to be recognised as an expense as it is incurred. The Board concluded that in the case of a mail order catalogue, the majority of the content is intended to advertise and promote products and services. Therefore, permitting the cost of catalogues to be capitalised while at the same time requiring the cost of developing and uploading web site content used to advertise and promote an entity's products to be recognised as an expense would base the accounting on the nature of the media (paper or electronic) used to deliver the content rather than the nature of the expenditure.

BC46I The Board also noted that SIC-32 permits expenditure on an internally developed web site to be capitalised only in the 'application and infrastructure development stage'. It requires costs associated with developing the functionality and infrastructure that make a web site operate to be capitalised. In the Board's view, the electronic infrastructure capitalised in accordance with SIC-32 is analogous to the property, plant and equipment infrastructure—for example, a sign—that permits advertising to be displayed to the public not the content that is displayed on that sign.

Subsequent accounting for intangible assets

BC47 The Board initially decided that the scope of the first phase of its Business Combinations project should include a consideration of the subsequent accounting for intangible assets acquired in business combinations. To that end, the Board initially focused its attention on the following three issues:

(a) whether an intangible asset with a finite useful life and acquired in a business combination should continue to be accounted for after initial recognition in accordance with IAS 38.

(b) whether, and under what circumstances, an intangible asset acquired in a business combination could be regarded as having an indefinite useful life.

(c) how an intangible asset with an indefinite useful life (assuming such an asset exists) acquired in a business combination should be accounted for after initial recognition.

BC48 However, during its deliberations of the issues in (b) and (c) of paragraph BC47, the Board decided that any conclusions it reached on those issues would equally apply to recognised intangible assets obtained other than in a business combination. The Board observed that amending the requirements in the previous version of IAS 38 only for intangible assets acquired in business combinations would create inconsistencies in the accounting for intangible assets depending on how they are obtained. Thus, similar items would be accounted for in dissimilar ways. The Board concluded that creating such inconsistencies would impair the usefulness of the information provided to users about an entity's intangible assets, because both comparability and reliability (which rests on the notion of representational faithfulness, ie that similar transactions are accounted for in the same way) would be diminished. Therefore, the Board decided that any amendments to the requirements in the previous version of IAS 38 to address the issues in (b) and (c) of paragraph BC47 should apply to all recognised intangible assets, whether generated internally or acquired separately or as part of a business combination.

BC49 Before beginning its deliberations of the issues identified in paragraph BC47, the Board noted the concern expressed by some that, because of the subjectivity involved in distinguishing goodwill from other intangible assets as at the acquisition date, differences between the subsequent treatment of goodwill and other intangible assets increases the potential for intangible assets to be misclassified at the acquisition date. The Board concluded, however, that adopting the separability and contractual or other legal rights criteria provides a reasonably definitive basis for separately identifying and recognising intangible assets acquired in a business combination. Therefore, the Board decided that its analysis of the accounting for intangible assets after initial recognition should have regard only to the nature of those assets and not to the subsequent treatment of goodwill.

Accounting for intangible assets with finite useful lives acquired in business combinations

BC50 The Board observed that the previous version of IAS 38 required an intangible asset to be measured after initial recognition:

(a) at cost less any accumulated amortisation and any accumulated impairment losses; or

(b) at a revalued amount, being the asset's fair value, determined by reference to an active market, at the date of revaluation less any subsequent accumulated amortisation and any subsequent accumulated impairment losses. Under this approach, revaluations must be made with such regularity that at the balance sheet date the carrying amount of the asset does not differ materially from its fair value.

Whichever of the above methods was used, the previous version of IAS 38 required the depreciable amount of the asset to be amortised on a systematic basis over the best estimate of its useful life.

BC51 The Board observed that underpinning the requirement for all intangible assets to be amortised is the notion that they all have determinable and finite useful lives. Setting aside the question of whether, and under what circumstances, an intangible asset could be regarded as having an indefinite useful life, an important issue for the Board to consider was whether a departure from the above requirements would be warranted for intangible assets acquired in a business combination that have finite useful lives.

BC52 The Board observed that any departure from the above requirements for intangible assets with finite lives acquired in business combinations would create inconsistencies between the accounting for recognised intangible assets based wholly on the means by which they are obtained. In other words, similar items would be accounted for in dissimilar ways. The Board concluded that creating such inconsistencies would impair the usefulness of the information provided to users about an entity's intangible assets, because both comparability and reliability would be diminished.

BC53 Therefore, the Board decided that intangible assets with finite useful lives acquired in business combinations should continue to be accounted for in accordance with the above requirements after initial recognition.

Impairment testing intangible assets with finite useful lives (paragraph 111)

BC54 The previous version of IAS 38 required the recoverable amount of an intangible asset with a finite useful life that is being amortised over a period of more than 20 years, whether or not acquired in a business combination, to be measured at least at each financial year-end.

BC55 The Board observed that the recoverable amount of a long-lived tangible asset needs to be measured only when, in accordance with IAS 36 *Impairment of Assets*, there is an indication that the asset may be impaired. The Board could see no conceptual reason for requiring the recoverable amounts of some identifiable assets being amortised over very long periods to be determined more regularly than for other identifiable assets being amortised or depreciated over similar periods. Therefore, the Board concluded that the recoverable amount of an intangible asset with a finite useful life that is amortised over a period of more than 20 years should be determined only when, in accordance with IAS 36, there is an indication that the asset may be impaired. Consequently, the Board decided to remove the requirement in the previous version of IAS 38 for the recoverable amount of such an intangible asset to be measured at least at each financial year-end.

BC56 The Board also decided that all of the requirements relating to impairment testing intangible assets should be included in IAS 36 rather than in IAS 38. Therefore, the Board relocated to IAS 36 the requirement in the previous version of IAS 38 that an entity should estimate at the end of each annual reporting period the recoverable amount of an intangible asset not yet available for use, irrespective of whether there is any indication that it may be impaired.

Residual value of an intangible asset with a finite useful life (paragraph 100)

BC57 In revising IAS 38, the Board considered whether to retain for intangible assets with finite useful lives the requirement in the previous version of IAS 38 for the residual value of an intangible asset to be assumed to be zero unless:

(a) there is a commitment by a third party to purchase the asset at the end of its useful life; or

(b) there is an active market for the asset and:

  (i) the asset's residual value can be determined by reference to that market; and

  (ii) it is probable that such a market will exist at the end of the asset's useful life.

BC58 The Board observed that the definition in the previous version of IAS 38 (as amended by IAS 16 when revised in 2003) of residual value required it to be estimated as if the asset were already of the age and in the condition expected at the end of the asset's useful life. Therefore, if the useful life of an intangible asset was shorter than its economic life because the entity expected to sell the asset before the end of that economic life, the asset's residual value would not be zero, irrespective of whether the conditions in paragraph BC57(a) or (b) are met.

BC59 Nevertheless, the Board observed that the requirement for the residual value of an intangible asset to be assumed to be zero unless the specified criteria are met was included in the previous version of IAS 38 as a means of preventing entities from circumventing the requirement in that Standard to amortise all intangible assets. Excluding this requirement from the revised Standard for finite-lived intangible assets would similarly provide a means of circumventing the requirement to amortise such intangible assets—by claiming that the residual value of such an asset was equal to or greater than its carrying amount, an entity could avoid amortising the asset, even though its useful life is finite. The Board concluded that it should not, as part of the Business Combinations project, modify the criteria for permitting a finite-lived intangible asset's residual value to be other than zero. However, the Board decided that this issue should be addressed as part of a forthcoming project on intangible assets.

Useful lives of intangible assets (paragraphs 88-96)

BC60 Consistently with the proposals in the Exposure Draft of Proposed Amendments to IAS 38, the Standard requires an intangible asset to be regarded by an entity as having an indefinite useful life when, based on an analysis of all of the relevant factors, there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity.

BC61 In developing the Exposure Draft and the revised Standard, the Board observed that the useful life of an intangible asset is related to the expected cash inflows that are associated with that asset. The Board observed that, to be representationally faithful, the amortisation period for an intangible asset generally should reflect that useful life and, by extension, the cash flow streams associated with the asset. The Board concluded that it is possible for management to have the intention and the ability to maintain an intangible asset in such a way that there is no foreseeable limit on the period over which that particular asset is expected to generate net cash inflows for the entity. In other words, it is conceivable that an analysis of all the relevant factors (ie legal, regulatory, contractual, competitive, economic and other) could lead to a conclusion that there is no foreseeable limit to the period over which a particular intangible asset is expected to generate net cash inflows for the entity.

BC62 For example, the Board observed that some intangible assets are based on legal rights that are conveyed in perpetuity rather than for finite terms. As such, those assets may have cash flows associated with them that may be expected to continue for many years or even indefinitely. The Board concluded that if the cash flows are expected to continue for a finite period, the useful life of the asset is limited to that finite period. However, if the cash flows are expected to continue indefinitely, the useful life is indefinite.

BC63 The previous version of IAS 38 prescribed a presumptive maximum useful life for intangible assets of 20 years. In developing the Exposure Draft and the revised Standard, the Board concluded that such a presumption is inconsistent with the view that the amortisation period for an intangible asset should, to be representationally faithful, reflect its useful life and, by extension, the cash flow streams associated with the asset. Therefore, the Board decided not to include in the revised Standard a presumptive maximum useful life for intangible assets, even if they have finite useful lives.

BC64 Respondents to the Exposure Draft generally supported the Board's proposal to remove from IAS 38 the presumptive maximum useful life and instead to require useful life to be regarded as indefinite when, based on an analysis of all of the relevant factors, there is no foreseeable limit to the period of time over which the intangible asset is expected to generate net cash inflows for the entity. However, some respondents suggested that an inability to determine clearly the useful life of an asset applies equally to many items of property, plant and equipment. Nonetheless, entities are required to determine the useful lives of those items of property, plant and equipment, and allocate their depreciable amounts on a systematic basis over those useful lives. Those respondents suggested that there is no conceptual reason for treating intangible assets differently.

BC65 In considering these comments, the Board noted the following:

(a) an intangible asset's useful life would be regarded as indefinite in accordance with IAS 38 only when, based on an analysis of all of the relevant factors, there is no foreseeable limit to the period of time over which the asset is expected to generate net cash inflows for the entity. Difficulties in accurately determining an intangible asset's useful life do not provide a basis for regarding that useful life as indefinite.

(b) although the useful lives of both intangible and tangible assets are directly related to the period during which they are expected to generate net cash inflows for the entity, the expected physical utility to the entity of a tangible asset places an upper limit on the asset's useful life. In other words, the useful life of a tangible asset could never extend beyond the asset's expected physical utility to the entity.

The Board concluded that tangible assets (other than land) could not be regarded as having indefinite useful lives because there is always a foreseeable limit to the expected physical utility of the asset to the entity.

Useful life constrained by contractual or other legal rights (paragraphs 94-96)

BC66 The Board noted that the useful life of an intangible asset that arises from contractual or other legal rights is constrained by the duration of those rights. The useful life of such an asset cannot extend beyond the duration of those rights, and may be shorter. Accordingly, the Board concluded that in determining the useful life of an intangible asset, consideration should be given to the period that the entity expects to use the intangible asset, which is subject to the expiration of the contractual or other legal rights.

BC67 However, the Board also observed that such rights are often conveyed for limited terms that may be renewed. It therefore considered whether renewals should be assumed in determining the useful life of such an intangible asset. The Board noted that some types of licences are initially issued for finite periods but renewals are routinely granted at little cost, provided that licensees have complied with the applicable rules and regulations. Such licences are traded at prices that reflect more than the remaining term, thereby indicating that renewal at minimal cost is the general expectation. However, renewals are not assured for other types of licences and, even if they are renewed, substantial costs may be incurred to secure their renewal.

BC68 The Board concluded that because the useful lives of some intangible assets depend, in economic terms, on renewal and on the associated costs of renewal, the useful lives assigned to those assets should reflect renewal when there is evidence to support renewal without significant cost.

BC69 Respondents to the Exposure Draft generally supported this conclusion. Those that disagreed suggested that:

(a) when the renewal period depends on the decision of a third party and not merely on the fulfilment of specified conditions by the entity, it gives rise to a contingent asset because the third party decision affects not only the cost of renewal but also the probability of obtaining it. Therefore, useful life should reflect renewal only when renewal is not subject to third-party approval.

(b) such a requirement would be inconsistent with the basis used to measure intangible assets at the date of a business combination, particularly contractual customer relationships. For example, it is not clear whether the fair value of a contractual customer relationship includes an amount that reflects the probability that the contract will be renewed. The possibility of renewal would have a fair value regardless of the costs required to renew. This means the useful life of a contractual customer relationship could be inconsistent with the basis used to determine the fair value of the relationship.

BC70 In relation to (a) above, the Board observed that if renewal by the entity is subject to third-party (eg government) approval, the requirement that there be evidence to support the entity's ability to renew would compel the entity to make an assessment of the likely effect of the third-party approval process on the entity's ability to renew. The Board could see no conceptual basis for narrowing the requirement to situations in which the contractual or legal rights are not subject to the approval of third parties.

BC71 In relation to (b) above, the Board observed the following:

(a) the requirements relating to renewal periods address circumstances in which *the entity* is able to renew the contractual or other legal rights, notwithstanding that such renewal may, for example, be conditional on the entity satisfying specified conditions, or subject to third-party approval. Paragraph 94 of the Standard states that "… the useful life of the intangible asset shall include the renewal period(s) only if there is evidence to support renewal *by the entity* [emphasis added] without significant cost." The ability to renew a customer contract normally rests with the customer and not with the entity.

(b) the respondents seem to regard as a single intangible asset what is, in substance, two intangible assets—one being the customer contract and the other being the related customer relationship. Expected renewals by the customer would affect the fair value of the customer relationship intangible asset, rather than the fair value of the customer contract. Therefore, the useful life of the customer contract would not, under the Standard, extend beyond the term of the contract, nor would the fair value of that customer contract reflect expectations of renewal by the customer. In other words, the useful life of the customer contract would not be inconsistent with the basis used to determine its fair value.

BC72 However, in response to respondents' suggestions, the Board included paragraph 96 in the Standard to provide additional guidance on the circumstances in which an entity should be regarded as being able to renew the contractual or other legal rights without significant cost.

Intangible assets with finite useful lives (paragraph 98)*

BC72A The last sentence of paragraph 98 previously stated, 'There is rarely, if ever, persuasive evidence to support an amortisation method for intangible assets with finite useful lives that results in a lower amount of accumulated amortisation than under the straight line method.' In practice, this wording was perceived as preventing an entity from using the unit of production method to amortise assets if it resulted in a lower amount of accumulated amortisation than the straight-line method. However, using the straight-line method could be inconsistent with the general requirement of paragraph 38 that the amortisation method should reflect the expected pattern of consumption of the expected future economic benefits embodied in an intangible asset. Consequently, the Board decided to delete the last sentence of paragraph 38.

* This heading and paragraph BC72A were adder by *Improvements to IFRSs* issued in May 2008.

Accounting for intangible assets with indefinite useful lives (paragraphs 107-110)

BC73 Consistently with the proposals in the Exposure Draft, the Standard prohibits the amortisation of intangible assets with indefinite useful lives. Therefore, such assets are measured after initial recognition at:

(a) cost less any accumulated impairment losses; or

(b) a revalued amount, being fair value determined by reference to an active market less any accumulated impairment losses.

Non-amortisation

BC74 In developing the Exposure Draft and the revised Standard, the Board observed that many assets yield benefits to an entity over several periods. Amortisation is the systematic allocation of the cost (or revalued amount) of an asset, less any residual value, to reflect the consumption over time of the future economic benefits embodied in that asset. Thus, if there is no foreseeable limit on the period during which an entity expects to consume the future economic benefits embodied in an asset, amortisation of that asset over, for example, an arbitrarily determined maximum period would not be representationally faithful. Respondents to the Exposure Draft generally supported this conclusion.

BC75 Consequently, the Board decided that intangible assets with indefinite useful lives should not be amortised, but should be subject to regular impairment testing. The Board's deliberations on the form of the impairment test, including the frequency of impairment testing, are included in the Basis for Conclusions on IAS 36. The Board further decided that regular re-examinations should be required of the useful life of an intangible asset that is not being amortised to determine whether circumstances continue to support the assessment that the useful life is indefinite.

Revaluations

BC76 Having decided that intangible assets with indefinite useful lives should not be amortised, the Board considered whether an entity should be permitted to carry such assets at revalued amounts. The Board could see no conceptual justification for precluding some intangible assets from being carried at revalued amounts solely on the basis that there is no foreseeable limit to the period over which an entity expects to consume the future economic benefits embodied in those assets.

BC77 As a result, the Board decided that the Standard should permit intangible assets with indefinite useful lives to be carried at revalued amounts.

Research and development projects acquired in business combinations

BC78 The Board considered the following issues in relation to in-process research and development (IPR&D) projects acquired in a business combination:

(a) whether the proposed criteria for recognising intangible assets acquired in a business combination separately from goodwill should also be applied to IPR&D projects;

(b) the subsequent accounting for IPR&D projects recognised as assets separately from goodwill; and

(c) the treatment of subsequent expenditure on IPR&D projects recognised as assets separately from goodwill.

The Board's deliberations on issue (a), although included in the Basis for Conclusions on IFRS 3, are also, for the sake of completeness, outlined below.

BC79 The Board did not reconsider as part of the first phase of its Business Combinations project the requirements in the previous version of IAS 38 for internally generated intangibles and expenditure on the research or development phase of an internal project. The Board decided that a reconsideration of those requirements is outside the scope of this project.

Initial recognition separately from goodwill

BC80 The Board observed that the criteria in IAS 22 *Business Combinations* and the previous version of IAS 38 for recognising an intangible asset acquired in a business combination separately from goodwill applied to all intangible assets, including IPR&D projects. Therefore, in accordance with those Standards, any intangible item acquired in a business combination was recognised as an asset separately from goodwill when it was identifiable and could be measured reliably, and it was probable that any associated future economic benefits would flow to the acquirer. If these criteria were not satisfied, the expenditure on the cost or value of that item, which was included in the cost of the combination, was part of the amount attributed to goodwill.

BC81 The Board could see no conceptual justification for changing the approach in IAS 22 and the previous version of IAS 38 of using the same criteria for all intangible assets acquired in a business combination when assessing whether those assets should be recognised separately from goodwill. The Board concluded that adopting different criteria would impair the usefulness of the information provided to users about the assets acquired in a combination because both comparability and reliability would be diminished. Therefore, IAS 38 and IFRS 3 require an acquirer to recognise as an asset separately from goodwill any of the acquiree's IPR&D projects that meet the definition of an intangible asset. This will be the case when the IPR&D project meets the definition of an asset and is identifiable, ie is separable or arises from contractual or other legal rights.

BC82 Some respondents to the Exposure Draft of Proposed Amendments to IAS 38 expressed concern that applying the same criteria to all intangible assets acquired in a business combination to assess whether they should be recognised separately from goodwill results in treating some IPR&D projects acquired in business combinations differently from similar projects started internally. The Board acknowledged this point, but concluded that this does not provide a basis for subsuming those acquired intangible assets within goodwill. Rather, it highlights a need to reconsider the conclusion in the Standard that an intangible asset can never exist in respect of an in-process research project and can exist in respect of an in-process development project only once all of the Standard's criteria for deferral have been satisfied. The Board decided that such a reconsideration is outside the scope of its Business Combinations project.

Subsequent accounting for IPR&D projects acquired in a business combination and recognised as intangible assets

BC83 The Board observed that the previous version of IAS 38 required all recognised intangible assets to be accounted for after initial recognition at:

(a) cost less any accumulated amortisation and any accumulated impairment losses; or

(b) revalued amount, being the asset's fair value, determined by reference to an active market, at the date of revaluation less any subsequent accumulated amortisation and any subsequent accumulated impairment losses.

Such assets included: IPR&D projects acquired in a business combination that satisfied the criteria for recognition separately from goodwill; separately acquired IPR&D projects that satisfied the criteria for recognition as an intangible asset; and recognised internally developed intangible assets arising from development or the development phase of an internal project.

BC84 The Board could see no conceptual justification for changing the approach in the previous version of IAS 38 of applying the same requirements to the subsequent accounting for all recognised intangible assets. Therefore, the Board decided that IPR&D projects acquired in a business combination that satisfy the criteria for recognition as an asset separately from goodwill should be accounted for after initial recognition in accordance with the requirements applying to the subsequent accounting for other recognised intangible assets.

Subsequent expenditure on IPR&D projects acquired in a business combination and recognised as intangible assets (paragraphs 42 and 43)

BC85 The Standard requires subsequent expenditure on an IPR&D project acquired separately or in a business combination and recognised as an intangible asset to be:

(a) recognised as an expense when incurred if it is research expenditure;

(b) recognised as an expense when incurred if it is development expenditure that does not satisfy the criteria for recognition as an intangible asset in paragraph 57; and

(c) added to the carrying amount of the acquired IPR&D project if it is development expenditure that satisfies the recognition criteria in paragraph 57.

BC86 In developing this requirement the Board observed that the treatment required under the previous version of IAS 38 of subsequent expenditure on an IPR&D project acquired in a business combination and recognised as an asset separately from goodwill was unclear. Some suggested that the requirements in the previous version of IAS 38 relating to expenditure on research, development, or the research or development phase of an internal project should be applied. However, others argued that those requirements were ostensibly concerned with the initial recognition and measurement of internally generated intangible assets. Instead, the requirements in the previous version of IAS 38 dealing with subsequent expenditure should be applied. Under those requirements, subsequent expenditure on an intangible asset after its purchase or completion would have been recognised as an expense when incurred unless:

(a) it was probable that the expenditure would enable the asset to generate future economic benefits in excess of its originally assessed standard of performance; and

(b) the expenditure could be measured and attributed to the asset reliably.

If these conditions were satisfied, the subsequent expenditure would be added to the carrying amount of the intangible asset.

BC87 The Board observed that this uncertainty also existed for separately acquired IPR&D projects that satisfied the criteria in the previous version of IAS 38 for recognition as intangible assets.

BC88 The Board noted that applying the requirements in the Standard for expenditure on research, development, or the research or development phase of an internal project to subsequent expenditure on IPR&D projects acquired in a business combination and recognised as assets separately from goodwill would result in such subsequent expenditure being treated inconsistently with subsequent expenditure on other recognised intangible assets. However, applying the subsequent expenditure requirements in the previous version of IAS 38 to subsequent expenditure on IPR&D projects acquired in a business combination and recognised as assets separately from goodwill would result in research and development expenditure being accounted for differently depending on whether a project is acquired or started internally.

BC89 The Board concluded that until it has had the opportunity to review the requirements in IAS 38 for expenditure on research, development, or the research or development phase of an internal project, more useful information will be provided to users of an entity's financial statements if all such expenditure is accounted for consistently. This includes subsequent expenditure on a separately acquired IPR&D project that satisfies the Standard's criteria for recognition as an intangible asset.

Transitional provisions (paragraphs 129-132)

BC90 If an entity elects to apply IFRS 3 from any date before the effective dates outlined in IFRS 3, it is also required to apply IAS 38 prospectively from that same date. Otherwise, IAS 38 applies to the accounting for intangible assets acquired in business combinations for which the agreement date is on or after 31 March 2004, and to the accounting for all other intangible assets prospectively from the beginning of the first annual reporting period beginning on or after 31 March 2004. IAS 38 also requires an entity, on initial application, to reassess the useful lives of intangible assets. If, as a result of that reassessment, the entity changes its useful life assessment for an asset, that change is accounted for as a change in an accounting estimate in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

BC91 The Board's deliberations on the transitional issues relating to the initial recognition of intangible assets acquired in business combinations and the impairment testing of intangible assets are addressed in the Basis for Conclusions on IFRS 3 and the Basis for Conclusions on IAS 36, respectively.

BC92 In developing the requirements outlined in paragraph BC90, the Board considered the following three questions:

(a) should the useful lives of, and the accounting for, intangible assets already recognised at the effective date of the Standard continue to be determined in accordance with the requirements in the previous version of IAS 38 (ie by amortising over a presumptive maximum period of twenty years), or in accordance with the requirements in the revised Standard?

(b) if the revised Standard is applied to intangible assets already recognised at its effective date, should the effect of a reassessment of an intangible asset's useful life as a result of the initial application of the Standard be recognised retrospectively or prospectively?

(c) should entities be required to apply the requirements in the Standard for subsequent expenditure on an acquired IPR&D project recognised as an intangible asset retrospectively to expenditure incurred before the effective date of the revised Standard?

BC93 In relation to the first question above, the Board noted its previous conclusion that the most representationally faithful method of accounting for intangible assets is to amortise those with finite useful lives over their useful lives with no limit on the amortisation period, and not to amortise those with indefinite useful lives. Thus, the Board concluded that the reliability and comparability of financial statements would be diminished if the Standard was not applied to intangible assets recognised before its effective date.

BC94 On the second question, the Board observed that a reassessment of an asset's useful life is regarded throughout IFRSs as a change in an accounting estimate, rather than a change in an accounting policy. For example, in accordance with the Standard, as with the previous version of IAS 38, if a new estimate of the expected useful life of an intangible asset is significantly different from previous estimates, the change must be accounted for as a change in accounting estimate in accordance with IAS 8. IAS 8 requires a change in an accounting estimate to be accounted for prospectively by including the effect of the change in profit or loss in:

(a) the period of the change, if the change in estimate affects that period only; or

(b) the period of the change and future periods, if the change in estimate affects both.

BC95 Similarly, in accordance with IAS 16 *Property, Plant and Equipment*, if a new estimate of the expected useful life of an item of property, plant and equipment is significantly different from previous estimates, the change must be accounted for prospectively by adjusting the depreciation expense for the current and future periods.

BC96 Therefore, the Board decided that a reassessment of useful life resulting from the initial application of IAS 38, including a reassessment from a finite to an indefinite useful life, should be accounted for as a change in an accounting estimate. Consequently, the effect of such a change should be recognised prospectively.

BC97 The Board considered the view that because the previous version of IAS 38 required intangible assets to be treated as having a finite useful life, a change to an assessment of indefinite useful life for an intangible asset represents a change in an accounting policy, rather than a change in an accounting estimate. The Board concluded that, even if this were the case, the useful life reassessment should nonetheless be accounted for prospectively. This is because retrospective application would require an entity to determine whether, at the end of each reporting period before the effective date of the Standard, the useful life of an intangible asset was indefinite. Such an assessment requires an entity to make estimates that would have been made at a prior date, and therefore raises problems in relation to the role of hindsight, in particular, whether the benefit of hindsight should be included or excluded from those estimates and, if excluded, how the effect of hindsight can be separated from the other factors existing at the date for which the estimates are required.

BC98 On the third question, and as noted in paragraph BC86, it was not clear whether the previous version of IAS 38 required subsequent expenditure on acquired IPR&D projects recognised as intangible assets to be accounted for:

(a) in accordance with its requirements for expenditure on research, development, or the research or development phase of an internal project; or

(b) in accordance with its requirements for subsequent expenditure on an intangible asset after its purchase or completion.

The Board concluded that subsequent expenditure on an acquired IPR&D project that was capitalised under (b) above before the effective date of the Standard might not have been capitalised had the Standard applied when the subsequent expenditure was incurred. This is because the Standard requires such expenditure to be capitalised as an intangible asset only when it is development expenditure and all of the criteria for deferral are satisfied. In the Board's view, those criteria represent a higher recognition threshold than (b) above.

BC99 Thus, retrospective application of the revised Standard to subsequent expenditure on acquired IPR&D projects incurred before its effective date could result in previously capitalised expenditure being reversed. Such reversal would be required if the expenditure was research expenditure, or it was development expenditure and one or more of the criteria for deferral were not satisfied at the time the expenditure was incurred. The Board concluded that determining whether, at the time the subsequent expenditure was incurred, the criteria for deferral were satisfied raises the same hindsight issues discussed in paragraph BC97: it would require assessments to be made as of a prior date, and therefore raises problems in relation to how the effect of hindsight can be separated from factors existing at the date of the assessment. In addition, such assessments could, in many cases, be impossible: the information needed may not exist or no longer be obtainable.

BC100 Therefore, the Board decided that the Standard's requirements for subsequent expenditure on acquired IPR&D projects recognised as intangible assets should not be applied retrospectively to expenditure incurred before the revised Standard's effective date. The Board noted that any amounts previously included in the carrying amount of such an asset would, in any event, be subject to the requirements for impairment testing in IAS 36.

Early application (paragraph 132)

BC101 The Board noted that the issue of any Standard reflects its opinion that application of the Standard will result in more useful information being provided to users about an entity's financial position, performance or cash flows. On that basis, a case exists for permitting, and indeed encouraging, entities to apply the revised Standard before its effective date. However, the Board also considered the assertion that permitting a revised Standard to be applied before its effective date potentially diminishes comparability between entities in the period(s) leading up to that effective date, and has the effect of providing entities with an option.

BC102 The Board concluded that the benefit of providing users with more useful information about an entity's financial position and performance by permitting early application of the Standard outweighs the disadvantages of potentially diminished comparability. Therefore, entities are encouraged to apply the requirements of the revised Standard before its effective date, provided they also apply IFRS 3 and IAS 36 (as revised in 2004) at the same time.

Summary of main changes from the Exposure Draft

BC103 The following are the main changes from the Exposure Draft of Proposed Amendments to IAS 38:

(a) The Standard includes additional guidance clarifying the relationship between the separability criterion for establishing whether a non-contractual customer relationship is identifiable, and the control concept for establishing whether the relationship meets the definition of an asset. In particular, the Standard clarifies that in the absence of legal rights to protect customer relationships, exchange transactions for the same or similar non-contractual customer relationships (other than as part of a business combination) provide evidence that the entity is nonetheless able to control the future economic benefits flowing from the customer relationships. Because such exchange transactions also provide evidence that the customer relationships are separable, those customer relationships meet the definition of an intangible asset (see paragraphs BC11-BC14).

(b) The Exposure Draft proposed that, except for an assembled workforce, an intangible asset acquired in a business combination should always be recognised separately from goodwill; there was a presumption that sufficient information would always exist to measure reliably its fair value. The Standard states that the fair value of an intangible asset acquired in a business combination can *normally* be measured with sufficient reliability to qualify for recognition separately from goodwill. If an intangible asset acquired in a business combination has a finite useful life, there is a rebuttable presumption that its fair value can be measured reliably (see paragraphs BC16-BC25).

(c) The Exposure Draft proposed, and the Standard requires, that the useful life of an intangible asset arising from contractual or other legal rights should not exceed the period of those rights. However, if the rights are conveyed for a limited term that can be renewed, the useful life should include the renewal period(s) only if there is evidence to support renewal by the entity without significant cost. Additional guidance has been included in the Standard to clarify the circumstances in which an entity should be regarded as being able to renew the contractual or other legal rights without significant cost (see paragraphs BC66-BC72).

History of the development of a standard on intangible assets

BCZ104 IASC published a Draft Statement of Principles on Intangible Assets in January 1994 and an Exposure Draft E50 *Intangible Assets* in June 1995. Principles in both documents were consistent as far as possible with those in IAS 16 *Property, Plant and Equipment*. The principles were also greatly influenced by the decisions reached in 1993 during the revisions to the treatment of research and development costs and goodwill.

BCZ105 IASC received about 100 comment letters on E50 from over 20 countries. Comment letters on E50 showed that the proposal for the amortisation period for intangible assets—a 20-year ceiling for almost all intangible assets, as required for goodwill in IAS 22 (revised 1993)—raised significant controversy and created serious concerns about the overall acceptability of the proposed standard on intangible assets. IASC considered alternative solutions and concluded in March 1996 that, if an impairment test that is sufficiently robust and reliable could be developed, IASC would propose deleting the 20-year ceiling on the amortisation period for both intangible assets and goodwill.

BCZ106 In August 1997, IASC published proposals for revised treatments for intangible assets and goodwill in Exposure Drafts E60 *Intangible Assets* and E61 *Business Combinations*. This followed the publication of Exposure Draft E55 *Impairment of Assets* in May 1997, which set out detailed proposals for impairment testing.

BCZ107 E60 proposed two major changes to the proposals in E50:

(a) as explained above, revised proposals for the amortisation of intangible assets; and

(b) combining the requirements relating to all internally generated intangible assets in one standard. This meant including certain aspects of IAS 9 *Research and Development Costs* in the proposed standard on intangible assets and withdrawing IAS 9.

BCZ108 Among other proposed changes, E61 proposed revisions to IAS 22 to make the requirements for the amortisation of goodwill consistent with those proposed for intangible assets.

BCZ109 IASC received about 100 comment letters on E60 and E61 from over 20 countries. The majority of the commentators supported most of the proposals in E60 and E61, although some proposals still raised significant controversy. The proposals for impairment tests were also supported by most commentators on E55.

BCZ110 After considering the comments received on E55, E60 and E61, IASC approved:

(a) IAS 36 *Impairment of Assets* (April 1998);

(b) IAS 38 *Intangible Assets* (July 1998);

(c) a revised IAS 22 *Business Combinations* (July 1998); and

(d) withdrawal of IAS 9 *Research and Development Costs* (July 1998).

Dissenting opinions

Dissent of Geoffrey Whittington from IAS 38 issued in March 2004

DO1 Professor Whittington dissents from the issue of this Standard because it does not explicitly require the probability recognition criterion in paragraph 21(a) to be applied to intangible assets acquired in a business combination, notwithstanding that it applies to all other intangible assets.

DO2 The reason given for this (paragraphs 33 and BC17) is that fair value is the required measurement on acquisition of an intangible asset as part of a business combination, and fair value incorporates probability assessments. Professor Whittington does not believe that the *Framework* precludes having a prior recognition test based on probability, even when subsequent recognition is at fair value. Moreover, the application of probability may be different for recognition purposes: for example, it may be the 'more likely than not' criterion used in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, rather than the 'expected value' approach used in the measurement of fair value.

DO3 This inconsistency between the recognition criteria in the *Framework* and fair values is acknowledged in paragraph BC18. In Professor Whittington's view, the inconsistency should be resolved before changing the recognition criteria for intangible assets acquired in a business combination.

Dissent of James J Leisenring from amendments issued in May 2008

DO1 Mr Leisenring dissents from the amendments to IAS 38 *Intangible Assets* made by *Improvements to IFRSs* issued in May 2008.

DO2 Mr Leisenring believes that the Board's amendments introduce a logical flaw into IAS 38. Paragraph 68 states that 'expenditure on an intangible item shall be recognised as an expense when it is incurred unless' specific conditions apply. The amendments to paragraph 69 include guidance on the accounting for expenditure on a tangible rather than an intangible item and therefore the amendment to paragraph 69 is inconsistent with paragraph 68.

DO3 Extending the application of IAS 38 to tangible assets used for advertising also raises application concerns. Are signs constructed by a restaurant chain at their location an advertising expense in the period of construction? Would the costs of putting an entity's name on trucks, airplanes and buildings be an advertising expense in the year incurred? The logic of this amendment would suggest an affirmative answer to these questions even though the result of the expenditure benefits several periods.

DO4 Mr Leisenring believes that if an entity acquires goods, including items such as catalogues, film strips or other materials, the entity should determine whether those goods meet the definition of an asset. In his view, IAS 38 is not relevant for determining whether goods acquired by an entity and which may be used for advertising should be recognised as an asset.

DO5 Mr Leisenring agrees that the potential benefit that might result from having advertised should not be recognised as an intangible asset in accordance with IAS 38.

Illustrative Examples
Hong Kong Accounting Standard 38

Intangible Assets

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

HKAS 38 *Intangible Assets*
Illustrative examples

These examples accompany, but are not part of, IAS 38.

Assessing the useful lives of intangible assets

The following guidance provides examples on determining the useful life of an intangible asset in accordance with IAS 38.

Each of the following examples describes an acquired intangible asset, the facts and circumstances surrounding the determination of its useful life, and the subsequent accounting based on that determination.

Example 1—An acquired customer list

A direct-mail marketing company acquires a customer list and expects that it will be able to derive benefit from the information on the list for at least one year, but no more than three years.

The customer list would be amortised over management's best estimate of its useful life, say 18 months. Although the direct-mail marketing company may intend to add customer names and other information to the list in the future, the expected benefits of the acquired customer list relate only to the customers on that list at the date it was acquired. The customer list also would be reviewed for impairment in accordance with IAS 36 *Impairment of Assets* by assessing at the end of each reporting ~~date~~ period whether there is any indication that the customer list may be impaired.

Example 2—An acquired patent that expires in 15 years

The product protected by the patented technology is expected to be a source of net cash inflows for at least 15 years. The entity has a commitment from a third party to purchase that patent in five years for 60 per cent of the fair value of the patent at the date it was acquired, and the entity intends to sell the patent in five years.

The patent would be amortised over its five-year useful life to the entity, with a residual value equal to the present value of 60 per cent of the patent's fair value at the date it was acquired. The patent would also be reviewed for impairment in accordance with IAS 36 by assessing at the end of each reporting ~~date~~ period whether there is any indication that it may be impaired.

Example 3—An acquired copyright that has a remaining legal life of 50 years

An analysis of consumer habits and market trends provides evidence that the copyrighted material will generate net cash inflows for only 30 more years.

The copyright would be amortised over its 30-year estimated useful life. The copyright also would be reviewed for impairment in accordance with IAS 36 by assessing at the end of each reporting ~~date~~ period whether there is any indication that it may be impaired.

Example 4—An acquired broadcasting licence that expires in five years

The broadcasting licence is renewable every 10 years if the entity provides at least an average level of service to its customers and complies with the relevant legislative requirements. The licence may be renewed indefinitely at little cost and has been renewed twice before the most recent acquisition. The acquiring entity intends to renew the licence indefinitely and evidence supports its ability to do so. Historically, there has been no compelling challenge to the licence renewal. The technology used in broadcasting is not expected to be replaced by another technology at any time in the foreseeable future. Therefore, the licence is expected to contribute to the entity's net cash inflows indefinitely.

The broadcasting licence would be treated as having an indefinite useful life because it is expected to contribute to the entity's net cash inflows indefinitely. Therefore, the licence would not be amortised until its useful life is determined to be finite. The licence would be tested for impairment in accordance with IAS 36 annually and whenever there is an indication that it may be impaired.

Example 5—The broadcasting licence in Example 4

The licensing authority subsequently decides that it will no longer renew broadcasting licences, but rather will auction the licences. At the time the licensing authority's decision is made, the entity's broadcasting licence has three years until it expires. The entity expects that the licence will continue to contribute to net cash inflows until the licence expires.

Because the broadcasting licence can no longer be renewed, its useful life is no longer indefinite. Thus, the acquired licence would be amortised over its remaining three-year useful life and immediately tested for impairment in accordance with IAS 36.

Example 6—An acquired airline route authority between two European cities that expires in three years

The route authority may be renewed every five years, and the acquiring entity intends to comply with the applicable rules and regulations surrounding renewal. Route authority renewals are routinely granted at a minimal cost and historically have been renewed when the airline has complied with the applicable rules and regulations. The acquiring entity expects to provide service indefinitely between the two cities from its hub airports and expects that the related supporting infrastructure (airport gates, slots, and terminal facility leases) will remain in place at those airports for as long as it has the route authority. An analysis of demand and cash flows supports those assumptions.

Because the facts and circumstances support the acquiring entity's ability to continue providing air service indefinitely between the two cities, the intangible asset related to the route authority is treated as having an indefinite useful life. Therefore, the route authority would not be amortised until its useful life is determined to be finite. It would be tested for impairment in accordance with IAS 36 annually and whenever there is an indication that it may be impaired.

Example 7—An acquired trademark used to identify and distinguish a leading consumer product that has been a market-share leader for the past eight years

The trademark has a remaining legal life of five years but is renewable every 10 years at little cost. The acquiring entity intends to renew the trademark continuously and evidence supports its ability to do so. An analysis of (1) product life cycle studies, (2) market, competitive and environmental trends, and (3) brand extension opportunities provides evidence that the trademarked product will generate net cash inflows for the acquiring entity for an indefinite period.

The trademark would be treated as having an indefinite useful life because it is expected to contribute to net cash inflows indefinitely. Therefore, the trademark would not be amortised until its useful life is determined to be finite. It would be tested for impairment in accordance with IAS 36 annually and whenever there is an indication that it may be impaired.

Example 8—A trademark acquired 10 years ago that distinguishes a leading consumer product

The trademark was regarded as having an indefinite useful life when it was acquired because the trademarked product was expected to generate net cash inflows indefinitely. However, unexpected competition has recently entered the market and will reduce future sales of the product. Management estimates that net cash inflows generated by the product will be 20 per cent less for the foreseeable future. However, management expects that the product will continue to generate net cash inflows indefinitely at those reduced amounts.

As a result of the projected decrease in future net cash inflows, the entity determines that the estimated recoverable amount of the trademark is less than its carrying amount, and an impairment loss is recognised. Because it is still regarded as having an indefinite useful life, the trademark would continue not to be amortised but would be tested for impairment in accordance with IAS 36 annually and whenever there is an indication that it may be impaired.

Example 9—A trademark for a line of products that was acquired several years ago in a business combination

At the time of the business combination the acquiree had been producing the line of products for 35 years with many new models developed under the trademark. At the acquisition date the acquirer expected to continue producing the line, and an analysis of various economic factors indicated there was no limit to the period the trademark would contribute to net cash inflows. Consequently, the trademark was not amortised by the acquirer. However, management has recently decided that production of the product line will be discontinued over the next four years.

Because the useful life of the acquired trademark is no longer regarded as indefinite, the carrying amount of the trademark would be tested for impairment in accordance with IAS 36 and amortised over its remaining four-year useful life.

Table of Concordance

This table shows how the contents of the superseded SSAP 29 and the current version of HKAS 38 correspond. Paragraphs are treated as corresponding if they broadly address the same matter even though their guidance may differ.

Superseded paragraph	Current paragraph
Objective	1
1	2
2	3
3	4
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20	22
21	23, 25, 33
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23	26
24	27, 28
25	32

Superseded paragraph	Current paragraph
26	None*
27	33
28	35, 38,39
29	40
30	41
31	34
32	None
33	44
34	45-47
35	45-47
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* Now addressed in HKFRS 2 *Share-based Payment*

Superseded paragraph	Current paragraph
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60	18, 21
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63	72, 74
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70	72
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74	83
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77	86
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81	92
82	None

Superseded paragraph	Current paragraph
83	None
84	93
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94	104
95	105
96	106
97	111
98	None
99	None*
100	None†
101	None
102	None
103	112
104	113
105	None
106	None
107	118
108	119
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* Modified and relocated to HKAS 36 *Impairment of Assets*
† Relocated to HKAS 36

Superseded paragraph	**Current paragraph**
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Superseded paragraph	**Current paragraph**
None	42, 43
None	88, 89
None	91
None	103
None	107-110
None	114-117
None	132
None	Illustrative Examples