MEMBERS' HANDBOOK

Update No. 245

(Issued 31 August 2020)

The following Framework, Standards and Amendments are effective for annual reporting periods beginning on or after 1 January 2020:

- *Conceptual Framework for Financial Reporting 2018*
- *Definition of a Business* (Amendments to HKFRS 3)
- *Definition of Material* (Amendments to HKAS 1 and HKAS 8)
- *Interest Rate Benchmark Reform – Phase 1* (Amendments to HKFRS 9, HKAS 39 and HKFRS 7)

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

Document Reference and Title	***Instructions***
VOLUME II	
Contents of Volume II	Discard existing pages i-iv & replace with revised pages i-iv.
Preface and Framework	
Conceptual Framework for Financial Reporting 2010	Discard the full set of *Conceptual Framework for Financial Reporting 2010.*
Conceptual Framework for Financial Reporting 2018	Replace the cover page and pages 2, 5 and 14 with revised cover page and revised pages 2, 5 and 14.
Conceptual Framework for Financial Reporting 2018 (Basis for Conclusions)	Replace the cover page and pages 2 and 28 with revised cover page and revised pages 2 and 28.
Conceptual Framework for Financial Reporting 2018 (Amendments to References to the Conceptual Framework in HKFRS Standards)	Discard the full set of Amendments to References to the Conceptual Framework in HKFRS Standards.

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Conceptual Framework for Financial Reporting 2018 (Amendments to References to the Conceptual Framework in HKFRS Standards – Basis for Conclusions)	Discard the full set of Amendments to References to the Conceptual Framework in HKFRS Standards – Basis for Conclusions.
Conceptual Framework for Financial Reporting 2018 (Amendments to References to the Conceptual Framework in HKFRS Standards – Illustrative Examples and Implementation Guidance)	Discard the full set of Amendments to References to the Conceptual Framework in HKFRS Standards – Illustrative Examples and Implementation Guidance.

HONG KONG ACCOUNTING STANDARDS (HKAS)

HKAS 1 (Revised) *Presentation of Financial Statements*	Replace pages 4, 9, 10, 12-14, 27, 37, 40-42, 56-58, 63, 90, 91A-91D, 92 and 94 with revised pages 4, 9, 10, 12-14, 27, 37, 40-42, 56-58, 63, 90, 91A-91D, 92 and 94. Insert page 9A after page 9, pages 63A-63E after page 63 and page 90A after page 90. Discard pages 55A-55N and 91E-91J.
HKAS 7 *Statement of Cash Flows*	Replace the cover page and pages 2 and 20 with revised cover page and revised pages 2 and 20.
HKAS 8 *Accounting Polices, Changes in Accounting Estimates and Errors*	Replace the cover page and pages 2, 3, 4, 9-11, 19, 22, 24, 26, 29 and 29A with revised cover page and revised pages 2, 3, 4, 9-11, 19, 22, 24, 26, 29 and 29A. Insert page 19A after page 19 and discard page 22A.
HKAS 10 *Events after the Reporting Period*	Replace the cover page and pages 2, 10 and 11 with revised cover page and revised pages 2, 10 and 11.
HKAS 12 *Income Taxes*	Replace the cover page and pages 2 and 63 with revised cover page and revised pages 2 and 63.
HKAS 16 *Property, Plant and Equipment*	Replace the cover page and pages 8, 23 and 34 with revised cover page and revised pages 8, 23 and 34.
HKAS 19 (2011) *Employee Benefits*	Replace the cover page and pages 2, 68 and 77 with revised cover page and revised pages 2, 68 and 77.
HKAS 21 *The Effects of Changes in Foreign Exchange Rates*	Replace the cover page and pages 2 and 22 with revised cover page and revised pages 2 and 22.

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HKAS 28 (2011) *Investments in Associates and Joint Ventures*	Replace the cover page and pages 2, 15, 29 and 30 with revised cover page and revised pages 2, 15, 29 and 30.
HKAS 32 *Financial Instruments: Presentation* (Basis for Conclusions)	Replace the cover page and pages 10, 11, 20 and 21 with revised cover page and revised pages 10, 11, 20 and 21.
HKAS 34 *Interim Financial Reporting*	Replace the cover page and pages 2, 10-11, 13A, 14A and 19 with revised cover page and revised pages 2, 10-11, 13A, 14A and 19.
HKAS 36 *Impairment of Assets* (Basis for Conclusions)	Replace the cover page and pages 53 and 57 with revised cover page and revised pages 53 and 57.
HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*	Replace the cover page and pages 9, 17, 19A and 26 with revised cover page and revised pages 9, 17, 19A and 26.
HKAS 38 *Intangible Assets*	Replace the cover page and pages 2 and 11 with revised cover page and revised pages 2 and 11.
HKAS 38 *Intangible Assets* (Basis for Conclusions)	Replace the cover page and pages 8, 17 and 34 with revised cover page and revised pages 8, 17 and 34.
HKAS 39 *Financial Instruments: Recognition and Measurement*	Replace the full set of HKAS 39 (Revised November 2019) with HKAS 39 (Revised August 2020).
HKAS 39 *Financial Instruments: Recognition and Measurement* (Basis for Conclusions)	Replace the full set of Basis for Conclusions on HKAS 39 (Revised November 2019) with Basis for Conclusions on HKAS 39 (Revised August 2020).
HKAS 40 *Investment Property*	Replace the cover page and pages 2 and 34 with revised cover page and revised pages 2 and 34.
HKAS 41 *Agriculture* (Basis for Conclusions)	Replace the cover page and page 8 with revised cover page and revised page 8.

HONG KONG FINANCIAL REPORTING STANDARDS (HKFRS)

HKFRS 1 (Revised) *First-time Adoption of Hong Kong Financial Reporting Standards*	Replace the cover page and pages 2 and 28 with revised cover page and revised pages 2 and 28.
HKFRS 1 (Revised) *First-time Adoption of Hong Kong Financial Reporting Standards* (Basis for Conclusions)	Replace the cover page and pages 7 and 35 with revised cover page and revised pages 7 and 35.

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HKFRS 2 *Share-based Payment*	Replace the cover page and pages 2, 23A and 24 with revised cover page and revised pages 2, 23A and 24. Insert page 23B after page 23A.
HKFRS 2 *Share-based Payment* (Basis for Conclusions)	Replace the cover page and pages 14, 16, 18, 65 and 76 with revised cover page and revised pages 14, 16, 18, 65 and 76.
HKFRS 2 *Share-based Payment* (Implementation Guidance)	Replace the cover page and pages 23 and 26D with revised cover page and revised pages 23 and 26D.
HKFRS 3 (Revised) *Business Combinations*	Replace the cover page and pages 1A, 3, 4, 8, 9, 19A, 19B, 20, 23, 24 and 43-45 with revised cover page and revised pages 1A, 3, 4, 8, 9, 19A, 19B, 20, 23, 24 and 43-45. Insert pages 24A, 24B and 24C after page 24. Discard pages 46-50.
HKFRS 3 (Revised) *Business Combinations* (Basis for Conclusions)	Replace the cover page and pages 5, 11, 14, 28, 29, 35, 68 and 98-101 with revised cover page and pages 5, 11, 14, 28, 29, 35, 68 and 98-101. Insert pages 11A-11I after page 11 and page 28A after page 28. Discard pages 102-109.
HKFRS 3 (Revised) *Business Combinations* (Illustrative Examples)	Replace the cover page and pages 2, 20 and 21 with revised cover page and revised pages 2, 20 and 21. Insert pages 20A-20K after page 20. Discard pages 21A-21K.
HKFRS 4 *Insurance Contracts* (Basis for Conclusions)	Replace the cover page and pages 2, 7 and 80 with revised cover page and revised pages 2, 7 and 80.
HKFRS 4 *Insurance Contracts* (Implementation Guidance)	Replace the cover page and pages 2, 24 and 25 with revised cover page and revised pages 2, 24 and 25.
HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*	Replace the cover page and pages 2 and 18 with revised cover page and revised pages 2 and 18.
HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* (Basis for Conclusions)	Replace the cover page and page 15 with revised cover page and revised page 15.

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HKFRS 6 *Exploration for and Evaluation of Mineral Resources*	Replace the cover page and pages 2, 7 and 9 with revised cover page and revised pages 2, 7 and 9.
HKFRS 6 *Exploration for and Evaluation of Mineral Resources* (Basis for Conclusions)	Replace pages 2 and 12 with revised pages 2 and 12. Insert page 11A after page 11.
HKFRS 7 *Financial Instruments: Disclosures*	Replace the cover page and pages 2, 4, 21, 22 and 36 with revised cover page and revised pages 2, 4, 21, 22 and 36. Insert page 21A after page 21 and page 36A after page 36. Discard page 55.
HKFRS 7 *Financial Instruments: Disclosures* (Basis for Conclusions)	Replace the cover page and pages 3, 24 and 25 with revised cover page and revised pages 3, 24 and 25. Insert pages 24A and 24B after page 24. Discard pages 49-50.
HKFRS 8 *Operating Segments* (Basis for Conclusions)	Replace the cover page and page 15 with revised cover page and revised page 15.
HKFRS 9 (2014) *Financial Instruments*	Replace the cover page and pages 2, 3, 36, 36A, 40, 41, 41A, 45, 81 and 104 with revised cover page and revised pages 2, 3, 36, 36A, 40, 41, 41A, 45, 81 and 104. Insert pages 36B and 36C after page 36A. Discard pages 125-127.
HKFRS 9 (2014) *Financial Instruments* (Basis for Conclusions)	Replace the cover page and pages 2, 3, 19, 93, 207, 220 and 276 with revised cover page and revised pages 2, 3, 19, 93, 207, 220 and 276. Insert pages 207A-207K after page 207. Discard pages 288-299.
HKFRS 10 *Consolidated Financial Statements* (Basis for Conclusions)	Replace the cover page and pages 2, 32, 61 and 64 with revised cover page and revised pages 2, 32, 61 and 64.
HKFRS 12 *Disclosures of Interests In Other Entities* (Basis for Conclusions)	Replace the cover page and pages 2 and 12 with revised cover page and revised pages 2 and 12.
HKFRS 14 *Regulatory Deferral Accounts*	Replace the cover page and pages 2 and 9 with revised cover page and revised pages 2 and 9.
HKFRS 14 *Regulatory Deferral Accounts* (Basis for Conclusions)	Replace the cover page and pages 2, 4, 5 and 21 with revised cover page and revised pages 2, 4, 5, and 21.
HKFRS 15 *Revenue from Contracts with Customers* (Basis for Conclusions)	Replace the cover page and pages 2 and 14 with revised cover page and revised pages 2 and 14.

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HKFRS 17 *Insurance Contracts*	Replace the cover page and pages 2, 32, 66 and 75-76 with revised cover page and revised pages 2, 32, 66 and 75-76.
HKFRS 17 *Insurance Contracts* (Basis for Conclusions)	Replace the cover page and pages 2 and 23 with revised cover page and revised pages 2 and 23.
HKFRS 17 *Insurance Contracts* (Illustrative Examples)	Replace the cover page and pages 2, 18 and 26 with revised cover page and revised pages 2, 18 and 26.

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

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HK(IFRIC)-Int 12 *Service Concession Arrangements*	Replace the cover page and pages 2, 4, 21, 29 and 38 with revised cover page and revised pages 2, 4, 21, 29 and 38.
HK(IFRIC)-Int 14 *HKAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction*	Replace the cover page and pages 2 and 15 with revised cover page and revised pages 2 and 15.
HK(IFRIC)-Int 17 *Distributions of Non-cash Assets to Owners*	Replace the cover page and pages 2, 13 and 16 with revised cover page and revised pages 2, 13 and 16.
HK(IFRIC)-Int 19 *Extinguishing Financial Liabilities with Equity Instruments*	Replace the cover page and pages 2, 4 and 10-12 with revised cover page and revised pages 2, 4 and 10-12.
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HK(IFRIC)-Int 22 *Foreign Currency Transactions and Advance Consideration*	Replace the cover page and pages 2, 4, and 14 with revised cover page and revised pages 2, 4 and 14.

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HK(SIC)-Int 32 *Intangible Assets – Web Site Costs*	Replace the cover page and pages 2, 4 and 7 with revised cover page and revised pages 2, 4 and 7. Insert page 7A after page 7.

Hong Kong Institute of
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MEMBERS' HANDBOOK
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(Updated to August 2020)

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Conceptual Framework for Financial Reporting 2018

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~~**AMENDMENTS TO REFERENCES TO THE CONCEPTUAL FRAMEWORK IN HKFRS STANDARDS (ILLUSTRATIVE EXAMPLES AND IMPLEMENTATION GUIDANCE) [see separate booklet]**~~

2.10 The predictive value and confirmatory value of financial information are interrelated. Information that has predictive value often also has confirmatory value. For example, revenue information for the current year, which can be used as the basis for predicting revenues in future years, can also be compared with revenue predictions for the current year that were made in past years. The results of those comparisons can help a user to correct and improve the processes that were used to make those previous predictions.

Materiality

2.11 Information is material if omitting~~, it or~~ misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general purpose financial reports (see paragraph 1.5) make on the basis of those reports, which provide financial information about a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report. Consequently, the HKICPA cannot specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation.

Faithful representation

2.12 Financial reports represent economic phenomena in words and numbers. To be useful, financial information must not only represent relevant phenomena, but it must also faithfully represent the substance of the phenomena that it purports to represent. In many circumstances, the substance of an economic phenomenon and its legal form are the same. If they are not the same, providing information only about the legal form would not faithfully represent the economic phenomenon (see paragraphs 4.59–4.62).

2.13 To be a perfectly faithful representation, a depiction would have three characteristics. It would be complete, neutral and free from error. Of course, perfection is seldom, if ever, achievable. The 'HKICPA's objective is to maximise those qualities to the extent possible.

2.14 A complete depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations. For example, a complete depiction of a group of assets would include, at a minimum, a description of the nature of the assets in the group, a numerical depiction of all of the assets in the group, and a description of what the numerical depiction represents (for example, historical cost or fair value). For some items, a complete depiction may also entail explanations of significant facts about the quality and nature of the items, factors and circumstances that might affect their quality and nature, and the process used to determine the numerical depiction.

2.15 A neutral depiction is without bias in the selection or presentation of financial information. A neutral depiction is not slanted, weighted, emphasised, de-emphasised or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourably by users. Neutral information does not mean information with no purpose or no influence on behaviour. On the contrary, relevant financial information is, by definition, capable of making a difference in users' decisions.

2.16 Neutrality is supported by the exercise of prudence. Prudence is the exercise of caution when making judgements under conditions of uncertainty. The exercise of prudence means that assets and income are not overstated and liabilities and expenses are not understated.[6] Equally, the exercise of prudence does not allow for the understatement of assets or income or the overstatement of liabilities or expenses. Such misstatements can lead to the overstatement or understatement of income or expenses in future periods.

6 Assets, liabilities, income and expenses are defined in Table 4.1. They are the elements of financial statements.

Basis for Conclusions

Conceptual Framework for Financial Reporting 2018

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Materiality (2018)

BC2.20 In revising the *Conceptual Framework* in 2018, the Board concluded that the concept of materiality is described clearly in the 2010 *Conceptual Framework*. Hence, the Board did not amend that description of materiality, except to clarify that the users mentioned in the description are the primary users of general purpose financial reports, as described in paragraph 1.5 of the *Conceptual Framework*. This clarification emphasises that decisions about materiality are intended to reflect the needs of the primary users, not the needs of any other group.

BC2.20A The definition of material in the *Conceptual Framework* was amended to include a reference to 'obscuring information' and to replace the phrase 'could influence decisions' with 'could reasonably be expected to influence decisions'. Paragraphs BC13A–BC13T of the Basis for Conclusions on IAS 1 explains the reasons for those amendments.

Faithful representation (paragraphs 2.12–2.19)

BC2.21 The discussion of faithful representation in Chapter 3 of the 2010 *Conceptual Framework* differed from that in the previous frameworks in two significant ways. First, it used the term 'faithful representation' instead of the term 'reliability'. Second, substance over form, prudence (conservatism) and verifiability, which had been aspects of reliability in Concepts Statement 2 and the 1989 *Framework*, were not considered aspects of faithful representation in the 2010 *Conceptual Framework*. References to substance over form and prudence were removed in 2010 for the reasons described in paragraphs BC2.32 and BC2.34, but they were reinstated, with clarifications, in the 2018 *Conceptual Framework*. Since 2010, verifiability has been described as an enhancing qualitative characteristic rather than as part of this fundamental qualitative characteristic (see paragraphs 2.30–2.32).

Replacement of the term 'reliability' (2010)

BC2.22 Concepts Statement 2 and the 1989 *Framework* used the term 'reliability' to describe what is now called faithful representation.

BC2.23 Concepts Statement 2 listed representational faithfulness, verifiability and neutrality as aspects of reliability and discussed completeness as part of representational faithfulness.

BC2.24 The 1989 *Framework* said:

> Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

The 1989 *Framework* also discussed substance over form, neutrality, prudence and completeness as aspects of faithful representation.

BC2.25 Unfortunately, neither framework clearly conveyed the meaning of reliability. The comments of respondents to numerous proposed standards indicated a lack of a common understanding of the term 'reliability'. Some focused on verifiability or free from material error to the virtual exclusion of faithful representation. Others focused more on faithful representation, perhaps combined with neutrality. Some apparently think that reliability refers primarily to precision.

BC2.26 Because attempts to explain what reliability was intended to mean in this context have proved unsuccessful, the Board sought a different term that would more clearly convey the intended meaning. The term 'faithful representation', the faithful depiction in financial reports of economic phenomena, was the result of that search. That term encompasses the main characteristics that the previous frameworks included as aspects of reliability.

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

This revised Standard was issued in December 2007 and revised in August 2020. It supersedes HKAS 1, issued in 2004, as amended in 2005.

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

Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity.

Materiality depends on the nature or magnitude of information, or both. An entity assesses whether information, either individually or in combination with other information, is material in the context of its financial statements taken as a whole.

Information is obscured if it is communicated in a way that would have a similar effect for primary users of financial statements to omitting or misstating that information. The following are examples of circumstances that may result in material information being obscured:

(a) information regarding a material item, transaction or other event is disclosed in the financial statements but the language used is vague or unclear;

(b) information regarding a material item, transaction or other event is scattered throughout the financial statements;

(c) dissimilar items, transactions or other events are inappropriately aggregated;

(d) similar items, transactions or other events are inappropriately disaggregated; and

(e) the understandability of the financial statements is reduced as a result of material information being hidden by immaterial information to the extent that a primary user is unable to determine what information is material.

Assessing whether information ~~an omission or misstatement~~ could reasonably be expected to influence ~~economic~~ decisions ~~of~~ made by the primary users of a specific reporting entity's general purpose financial statements~~, and so be material,~~ requires an entity to consider ~~consideration of~~ the characteristics of those users while also considering the entity's own circumstances. ~~The *Framework for the Preparation and Presentation of Financial Statements* states in paragraph 25[*] that 'users are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence.' Therefore, the assessment needs to take into account how users with such attributes could reasonably be expected to be influenced in making economic decisions.~~

Many existing and potential investors, lenders and other creditors cannot require reporting entities to provide information directly to them and must rely on general purpose financial statements for much of the financial information they need. Consequently, they are the primary users to whom general purpose financial statements are directed. Financial statements are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently. At times, even well-informed and diligent users may need to seek the aid of an adviser to understand information about complex economic phenomena.

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

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

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

The components of other comprehensive income include:

(a) changes in revaluation surplus (see HKAS 16 *Property, Plant and Equipment* and HKAS 38 *Intangible Assets*);

(b) remeasurements of defined benefit plans (see HKAS 19 *Employee Benefits)*;

(c) gains and losses arising from translating the financial statements of a foreign operation (see HKAS 21 *The Effects of Changes in Foreign Exchange Rates*);

(d) gains and losses from investments in equity instruments designated at fair value through other comprehensive income in accordance with paragraph 5.7.5 of HKFRS 9 *Financial Instruments*;

(da) gains and losses on financial assets measured at fair value through other comprehensive income in accordance with paragraph 4.1.2A of HKFRS 9.

(e) the effective portion of gains and losses on hedging instruments in a cash flow hedge and the gains and losses on hedging instruments that hedge investments in equity instruments measured at fair value through other comprehensive income in accordance with paragraph 5.7.5 of HKFRS 9 (see Chapter 6 of HKFRS 9);

(f) for particular liabilities designated as at fair value through profit or loss, the amount of the change in fair value that is attributable to changes in the liability's credit risk (see paragraph 5.7.7 of HKFRS 9);

(g) changes in the value of the time value of options when separating the intrinsic value and time value of an option contract and designating as the hedging instrument only the changes in the intrinsic value (see Chapter 6 of HKFRS 9); and

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

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***Owners* are holders of instruments classified as equity.**

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

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

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

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

8 Although this Standard uses the terms 'other comprehensive income', 'profit or loss' and 'total comprehensive income', an entity may use other terms to describe the totals as long as the meaning is clear. For example, an entity may use the term 'net income' to describe profit or loss.

8A The following terms are described in HKAS 32 *Financial Instruments: Presentation* and are used in this Standard with the meaning specified in HKAS 32:

(a) puttable financial instrument classified as an equity instrument (described in paragraphs 16A and 16B of HKAS 32)

(b) an instrument that imposes on the entity an obligation to deliver to another party a pro_rata share of the net assets of the entity only on liquidation and is classified as an equity instrument (described in paragraphs 16C and 16D of HKAS 32).

Financial statements

Purpose of financial statements

9 Financial statements are a structured representation of the financial position and financial performance of an entity. The objective of financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions. Financial statements also show the results of the management's stewardship of the resources entrusted to it. To meet this objective, financial statements provide information about an entity's:

(a) assets;

(b) liabilities;

(c) equity;

(d) income and expenses, including gains and losses;

(c) the entity's resources not recognised in the statement of financial position in accordance with HKFRSs.

14 Many entities also present, outside the financial statements, reports and statements such as environmental reports and value added statements, particularly in industries in which environmental factors are significant and when employees are regarded as an important user group. Reports and statements presented outside financial statements are outside the scope of HKFRSs.

General features

True and fair view and compliance with HKFRSs

15 Financial statements shall present a true and fair view of the financial position, financial performance and cash flows of an entity. True and fair view requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the ~~*Framework*~~ *Conceptual Framework for Financial Reporting (Conceptual Framework)*.[*] The application of HKFRSs, with additional disclosure when necessary, is presumed to result in financial statements that achieve a true and fair view.

16 An entity whose financial statements comply with HKFRSs shall make an explicit and unreserved statement of such compliance in the notes. An entity shall not describe financial statements as complying with HKFRSs unless they comply with all the requirements of HKFRSs.

17 In virtually all circumstances, an entity achieves a true and fair view by compliance with applicable HKFRSs. A true and fair view also requires an entity:

(a) to select and apply accounting policies in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. HKAS 8 sets out a hierarchy of authoritative guidance that management considers in the absence of an HKFRS that specifically applies to an item.

(b) to present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information.

(c) to provide additional disclosures when compliance with the specific requirements in HKFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.

18 An entity cannot rectify inappropriate accounting policies either by disclosure of the accounting policies used or by notes or explanatory material.

19 In the extremely rare circumstances in which management concludes that compliance with a requirement in a HKFRS would be so misleading that it would conflict with the objective of financial statements set out in the ~~*Framework*~~ *Conceptual Framework*, the entity shall depart from that requirement in the manner set out in paragraph 20 if the relevant regulatory framework requires, or otherwise does not prohibit, such a departure.

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

20 When an entity departs from a requirement of a HKFRS in accordance with paragraph 19, it shall disclose:

(a) that management has concluded that the financial statements present fairly the entity's financial position, financial performance and cash flows;

(b) that it has complied with applicable HKFRSs, except that it has departed from a particular requirement to achieve a true and fair view;

(c) the title of the HKFRS from which the entity has departed, the nature of the departure, including the treatment that the HKFRS would require, the reason why that treatment would be so misleading in the circumstances that it would conflict with the objective of financial statements set out in the ~~*Framework*~~ *Conceptual Framework*, and the treatment adopted; and

(d) for each period presented, the financial effect of the departure on each item in the financial statements that would have been reported in complying with the requirement.

21 When an entity has departed from a requirement of a HKFRS in a prior period, and that departure affects the amounts recognised in the financial statements for the current period, it shall make the disclosures set out in paragraph 20(c) and (d).

22 Paragraph 21 applies, for example, when an entity departed in a prior period from a requirement in a HKFRS for the measurement of assets or liabilities and that departure affects the measurement of changes in assets and liabilities recognised in the current period's financial statements.

23 In the extremely rare circumstances in which management concludes that compliance with a requirement in a HKFRS would be so misleading that it would conflict with the objective of financial statements set out in the ~~*Framework*~~ *Conceptual Framework*, but the relevant regulatory framework prohibits departure from the requirement, the entity shall, to the maximum extent possible, reduce the perceived misleading aspects of compliance by disclosing:

(a) the title of the HKFRS in question, the nature of the requirement, and the reason why management has concluded that complying with that requirement is so misleading in the circumstances that it conflicts with the objective of financial statements set out in the ~~*Framework*~~ *Conceptual Framework*; and

(b) for each period presented, the adjustments to each item in the financial statements that management has concluded would be necessary to achieve a true and fair view.

24 For the purpose of paragraphs 19–23, an item of information would conflict with the objective of financial statements when it does not represent faithfully the transactions, other events and conditions that it either purports to represent or could reasonably be expected to represent and, consequently, it would be likely to influence economic decisions made by users of financial statements. When assessing whether complying with a specific requirement in a HKFRS would be so misleading that it would conflict with the objective of financial statements set out in the ~~*Framework*~~ *Conceptual Framework*, management considers:

(a) why the objective of financial statements is not achieved in the particular circumstances; and

(b) how the entity's circumstances differ from those of other entities that comply with the requirement. If other entities in similar circumstances comply with the requirement, there is a rebuttable presumption that the entity's compliance with the requirement would not be so misleading that it would conflict with the objective of financial statements set out in the ~~*Framework*~~ *Conceptual Framework*.

Going concern

25 When preparing financial statements, management shall make an assessment of an entity's ability to continue as a going concern. An entity shall prepare financial statements on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. When management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, the entity shall disclose those uncertainties. When an entity does not prepare financial statements on a going concern basis, it shall disclose that fact, together with the basis on which it prepared the financial statements and the reason why the entity is not regarded as a going concern.

26 In assessing whether the going concern assumption is appropriate, management takes into account all available information about the future, which is at least, but is not limited to, twelve months from the end of the reporting period. The degree of consideration depends on the facts in each case. When an entity has a history of profitable operations and ready access to financial resources, the entity may reach a conclusion that the going concern basis of accounting is appropriate without detailed analysis. In other cases, management may need to consider a wide range of factors relating to current and expected profitability, debt repayment schedules and potential sources of replacement financing before it can satisfy itself that the going concern basis is appropriate.

Accrual basis of accounting

27 An entity shall prepare its financial statements, except for cash flow information, using the accrual basis of accounting.

28 When the accrual basis of accounting is used, an entity recognises items as assets, liabilities, equity, income and expenses (the elements of financial statements) when they satisfy the definitions and recognition criteria for those elements in the ~~*Framework*~~ *Conceptual Framework*.~~[*]~~

Materiality and aggregation

29 An entity shall present separately each material class of similar items. An entity shall present separately items of a dissimilar nature or function unless they are immaterial.

30 Financial statements result from processing large numbers of transactions or other events that are aggregated into classes according to their nature or function. The final stage in the process of aggregation and classification is the presentation of condensed and classified data, which form line items in the financial statements. If a line item is not individually material, it is aggregated with other items either in those statements or in the notes. An item that is not sufficiently material to warrant separate presentation in those statements may warrant separate presentation in the notes.

30A When applying this and other HKFRSs an entity shall decide, taking into consideration all relevant facts and circumstances, how it aggregates information in the financial statements, which include the notes. An entity shall not reduce the understandability of its financial statements by obscuring material information with immaterial information or by aggregating material items that have different natures or functions.

31 Some HKFRSs specify information that is required to be included in the financial statements, which include the notes. An entity need not provide a specific disclosure required by a HKFRS if the information resulting from that disclosure is not material. This is the case even if the HKFRS contains a list of specific requirements or describes them as minimum requirements. An entity shall also consider whether to provide additional disclosures when compliance with the specific requirements in HKFRS is insufficient to

~~[*] replaced by the *Conceptual Framework* in October 2010.~~

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

Profit or loss for the period

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

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

Other comprehensive income for the period

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

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

(a) net of related tax effects, or

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

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

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

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

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

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

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

139M [Deleted]

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

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

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

139Q HKFRS 16 *Leases*, issued in May 2016, amended paragraph 123. An entity shall apply that amendment when it applies HKFRS 16.

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

139S *Amendments to References to the Conceptual Framework in HKFRS Standards*, issued in 2018, amended paragraphs 7, 15, 19–20, 23–24, 28 and 89. An entity shall apply those amendments for annual periods beginning on or after 1 January 2020. Earlier application is permitted if at the same time an entity also applies all other amendments made by *Amendments to References to the Conceptual Framework in HKFRS Standards*. An entity shall apply the amendments to HKAS 1 retrospectively in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. However, if an entity determines that retrospective application would be impracticable or would involve undue cost or effort, it shall apply the amendments to HKAS 1 by reference to paragraphs 23–28, 50–53 and 54F of HKAS 8.

139T *Definition of Material* (Amendments to HKAS 1 and HKAS 8), issued in January 2019, amended paragraph 7 of HKAS 1 and paragraph 5 of HKAS 8, and deleted paragraph 6 of HKAS 8. An entity shall apply those amendments prospectively for annual periods beginning on or after 1 January 2020. Earlier application is permitted. If an entity applies those amendments for an earlier period, it shall disclose that fact.

Withdrawal of HKAS 1 (issued 2004)

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

Appendix ~~D~~C

Amendments to Classification of Liabilities as Current or Non-current

The following sets out amendments required for this Standard resulting from amendments to HKAS 1 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.

Paragraphs 69, 73, 74 and 76 are amended. Paragraphs 72A, 75A, 76A, 76B and 139U are added. Paragraph 139D is deleted. Headings are added before paragraphs 70, 71, 72A and 76A. Paragraphs 70, 71, 72 and 75 are not amended, but are included for ease of reading. New text is underlined and deleted text is struck through.

Structure and content

...

Statement of financial position

...

Current liabilities

69 **An entity shall classify a liability as current when:**

(a) it expects to settle the liability in its normal operating cycle;

(b) it holds the liability primarily for the purpose of trading;

(c) the liability is due to be settled within twelve months after the reporting period; or

(d) it does not have ~~an unconditional~~ the right at the end of the reporting period to defer settlement of the liability for at least twelve months after the reporting period ~~(see paragraph 73). Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification~~.

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

Normal operating cycle (paragraph 69(a))

70 Some current liabilities, such as trade payables and some accruals for employee and other operating costs, are part of the working capital used in the entity's normal operating cycle. An entity classifies such operating items as current liabilities even if they are due to be settled more than twelve months after the reporting period. The same normal operating cycle applies to the classification of an entity's assets and liabilities. When the entity's normal operating cycle is not clearly identifiable, it is assumed to be twelve months.

Held primarily for the purpose of trading (paragraph 69(b)) or due to be settled within twelve months (paragraph 69(c))

71 Other current liabilities are not settled as part of the normal operating cycle, but are due for settlement within twelve months after the reporting period or held primarily for the purpose of trading. Examples are some financial liabilities that meet the definition of held for trading in HKFRS 9, bank overdrafts, and the current portion of non-current financial liabilities, dividends payable, income taxes and other non-trade payables. Financial liabilities that provide financing on a long-term basis (ie are not part of the working capital used in the entity's normal operating cycle) and are not due for settlement within twelve months after the reporting period are non-current liabilities, subject to paragraphs 74 and 75.

72 An entity classifies its financial liabilities as current when they are due to be settled within twelve months after the reporting period, even if:

(a) the original term was for a period longer than twelve months; and

(b) an agreement to refinance, or to reschedule payments, on a long-term basis is completed after the reporting period and before the financial statements are authorised for issue.

Right to defer settlement for at least twelve months (paragraph 69(d))

72A An entity's right to defer settlement of a liability for at least twelve months after the reporting period must have substance and, as illustrated in paragraphs 73–75, must exist at the end of the reporting period. If the right to defer settlement is subject to the entity complying with specified conditions, the right exists at the end of the reporting period only if the entity complies with those conditions at the end of the reporting period. The entity must comply with the conditions at the end of the reporting period even if the lender does not test compliance until a later date.

73 If an entity ~~expects, and~~ has the ~~discretion,~~ right, at the end of the reporting period, to ~~refinance or~~ roll over an obligation for at least twelve months after the reporting period under an existing loan facility, it classifies the obligation as non-current, even if it would otherwise be due within a shorter period. ~~However, when refinancing or rolling over the obligation is not at the discretion of the entity (for example, there is no arrangement for refinancing)~~ If the entity has no such right, the entity does not consider the potential to refinance the obligation and classifies the obligation as current.

74 When an entity breaches a ~~provision~~ condition of a long-term loan arrangement on or before the end of the reporting period with the effect that the liability becomes payable on demand, it classifies the liability as current, even if the lender agreed, after the reporting period and before the authorisation of the financial statements for issue, not to demand payment as a consequence of the breach. An entity classifies the liability as current because, at the end of the reporting period, it does not have ~~an unconditional~~ the right to defer its settlement for at least twelve months after that date.

75 However, an entity classifies the liability as non-current if the lender agreed by the end of the reporting period to provide a period of grace ending at least twelve months after the reporting period, within which the entity can rectify the breach and during which the lender cannot demand immediate repayment.

75A Classification of a liability is unaffected by the likelihood that the entity will exercise its right to defer settlement of the liability for at least twelve months after the reporting period. If a liability meets the criteria in paragraph 69 for classification as non-current, it is classified as non-current even if management intends or expects the entity to settle the liability within twelve months after the reporting period, or even if the entity settles the liability between the end of the reporting period and the date the financial statements are authorised for issue. However, in either of those circumstances, the entity may need to disclose information about the timing of settlement to enable users of its financial statements to understand the impact of the liability on the entity's financial position (see paragraphs 17(c) and 76(d)).

76 ~~In respect of loans classified as current liabilities, if~~ If the following events occur between the end of the reporting period and the date the financial statements are authorised for issue, those events are disclosed as non-adjusting events in accordance with HKAS 10 *Events after the Reporting Period*:

(a) refinancing on a long-term basis of a liability classified as current (see paragraph 72);

(b) rectification of a breach of a long-term loan arrangement classified as current (see paragraph 74); ~~and~~

(c) the granting by the lender of a period of grace to rectify a breach of a long-term loan arrangement ~~ending at least twelve months after the reporting period.~~ classified as current (see paragraph 75); and

(d) settlement of a liability classified as non-current (see paragraph 75A).

Settlement (paragraphs 69(a), 69(c) and 69(d))

76A For the purpose of classifying a liability as current or non-current, settlement refers to a transfer to the counterparty that results in the extinguishment of the liability. The transfer could be of:

(a) cash or other economic resources—for example, goods or services; or

(b) the entity's own equity instruments, unless paragraph 76B applies.

76B Terms of a liability that could, at the option of the counterparty, result in its settlement by the transfer of the entity's own equity instruments do not affect its classification as current or non-current if, applying HKAS 32 *Financial Instruments: Presentation*, the entity classifies the option as an equity instrument, recognising it separately from the liability as an equity component of a compound financial instrument.

...

Transition and effective date

...

139D [Deleted]

...

139U *Classification of Liabilities as Current or Non-current*, issued in August 2020 amended paragraphs 69, 73, 74 and 76 and added paragraphs 72A, 75A, 76A and 76B. An entity shall apply those amendments for annual reporting periods beginning on or after 1 January 2023 retrospectively in accordance with HKAS 8. Earlier application is permitted. If an entity applies those amendments for an earlier period, it shall disclose that fact.

BASIS FOR CONCLUSIONS ON IAS 1 *PRESENTATION OF FINANCIAL STATEMENTS*

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

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

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APPENDICES

Amendments to the Basis for Conclusions on other IFRSs

~~**Amendments to the Basis for Conclusions on Definition of Material**~~

Amendments to the Basis for Conclusions on Classification of Liabilities as Current or Non-current

DISSENTING OPINIONS

GUIDANCE ON IMPLEMENTING

IAS 1 *PRESENTATION OF FINANCIAL STATEMENTS*

BC12 Respondents expressed concern about the proposed change. They argued that it could be understood as defining as general purpose financial statements any financial statement or set of financial statements filed with a regulator and could capture documents other than annual reports and prospectuses. They saw this change as expanding the scope of IAS 1 to documents that previously would not have contained all of the disclosures required by IAS 1. Respondents pointed out that the change would particularly affect some entities (such as small private companies and subsidiaries of public companies with no external users of financial reports) that are required by law to place their financial statements on a public file.

BC13 The Board acknowledged that in some countries the law requires entities, whether public or private, to report to regulatory authorities and include information in those reports that could be beyond the scope of IAS 1. Because the Board did not intend to extend the definition of general purpose financial statements, it decided to eliminate the explanatory paragraph of what ‘general purpose financial statements’ include, while retaining the definition of ‘general purpose financial statements’.

Definition of Material (paragraph 7)

Background

BC13A The Board was informed at the *Discussion Forum on Financial Reporting Disclosure* it hosted in January 2013 [*] through feedback on the amendments to IAS 1 in the 2014 Exposure Draft *Disclosure Initiative*, the 2017 Discussion Paper *Disclosure Initiative—Principles of Disclosure*, and from other sources, that entities experience difficulties in making materiality judgements when preparing financial statements.

BC13B The feedback indicated that difficulties in making materiality judgements are generally behavioural rather than related to the definition of material. That feedback indicated that some entities apply the disclosure requirements in IFRS Standards mechanically, using them as a checklist for disclosures in their financial statements, rather than applying their judgement to determine what information is material. Some entities have said that it is easier to use a checklist approach than to apply judgement because of management resource constraints, and because following a mechanical approach means that their judgement is less likely to be challenged by auditors, regulators or users of their financial statements. Similarly, some entities say that they prefer to be cautious when deciding whether to omit disclosures to avoid the risk of being challenged by these parties.

BC13C The Board concluded that these behavioural difficulties could best be addressed by providing guidance to help entities make materiality judgements, rather than by making substantive changes to the definition of material. Consequently, in September 2017 the Board issued IFRS Practice Statement 2 *Making Materiality Judgements* (Materiality Practice Statement).

BC13D Although many stakeholders agreed that substantive changes to the definition of material were unnecessary, the Board received some feedback that the definition of material might encourage entities to disclose immaterial information in their financial statements. Feedback suggested that the Board should address the following points:

(a) the phrase ‘could influence decisions of users’, to describe the threshold for deciding whether information is material, may be understood as requiring too much information to be provided, because almost anything ‘could’ influence the decisions of some users of the financial statements, even if such a possibility were remote;

[*] A Feedback Statement summarising the feedback from that forum and from the Board’s related survey on financial reporting disclosure is available on the IFRS Foundation website at http://www.ifrs.org/-/media/project/disclosure-initative/feedback-statement-discussion-forum-financial-reporting-disclosure-may-2013.pdf.

(b) the phrase 'information is material if omitting it or misstating it' focuses only on information that cannot be omitted (material information) and does not also consider the effect of including immaterial information; and

(c) the definition refers to 'users' but does not specify their characteristics, which is interpreted by some as implying that an entity is required to consider all possible users of its financial statements when deciding what information to disclose.

BC13E The Board also observed that the wording of the definition of material in the *Conceptual Framework for Financial Reporting* (*Conceptual Framework*) differed from the wording used in IAS 1 *Presentation of Financial Statements* and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. The Board believes that the substance of the definitions is the same because these definitions all cover the omission or misstatement of information that could influence the decisions of users of financial statements. Nevertheless, the existence of more than one definition of material could be confusing and could imply that the Board intended these definitions to have different meanings and be applied differently in practice.

BC13F Consequently, the Board decided to propose refinements to the definition of material and to align the definition across IFRS Standards and other publications. The Board observed that these refinements were intended to make the definition easier to understand and were not intended to alter the concept of materiality in IFRS Standards.

Refinements to the definition of material

BC13G In September 2017 the Board published the Exposure Draft *Definition of Material* (Proposed amendments to IAS 1 and IAS 8) which proposed a revised definition.

BC13H The Board developed this definition by:

(a) replacing the description of the threshold 'could influence' with 'could reasonably be expected to influence' to incorporate the existing clarification in paragraph 7 of IAS 1 which states: 'Therefore, the assessment needs to take into account how users with such attributes *could reasonably be expected to be influenced* in making economic decisions' [emphasis added]. This wording helps to address concerns raised by some parties that the threshold 'could influence' in the existing definition of material is too low and might be applied too broadly (see paragraph BC13D(a)).

(b) using the wording of the definition of material in the *Conceptual Framework*.[*] The Board concluded that this wording was clearer than the definition in IAS 1 and IAS 8. However, the Board decided to refer to 'financial statements' rather than 'financial reports' in the amendments to IAS 1 to be consistent with the scope of that Standard.[**] The *Conceptual Framework* definition also clarifies that the users to whom the definition refers are the primary users of an entity's financial reports or statements. Referring to the primary users in the definition of material in IAS 1 helps to respond to concerns that the term 'users' may be interpreted too widely (see paragraph BC13D(c)).

[*] The wording in paragraph 2.11 of the *Conceptual Framework* is: 'Information is material if omitting it or misstating it could influence decisions that the primary users of general purpose financial reports make on the basis of those reports, which provide financial information about a specific reporting entity'.

[**] Financial statements are a type of financial report.

(c) including 'obscuring' in the definition of material to incorporate the existing concept in paragraph 30A of IAS 1 which states: 'An entity shall not reduce the understandability of its financial statements by obscuring material information with immaterial information or by aggregating items that have different natures or functions.' Referring to 'obscuring' in the definition of material is intended to respond to concerns that the effect of including immaterial information should also be considered in addition to 'misstating' and 'omitting' (see paragraphs BC13D(a) and (b)).

(d) relocating wording that explains rather than defines material from the definition itself to its explanatory paragraphs. This reorganisation clarifies which requirements are part of the definition and which paragraphs explain the definition.

BC13I Some parties said that the Board should raise the threshold at which information becomes material by replacing 'could' with 'would' in the definition. However, the Board did not do this because it concluded that using 'would' would be a substantive change that might have unintended consequences. For example, 'would influence decisions' might be interpreted as a presumption that information is not material unless it can be proved otherwise, ie for information to be seen as material it would be necessary to prove that the information would influence the decisions of users of the financial statements.

Obscuring information

BC13J Responses to the Exposure Draft *Definition of Material* (Proposed amendments to IAS 1 and IAS 8) indicated strong support for the definition of material to be aligned across the *Conceptual Framework* and IFRS Standards. However, many respondents had some concerns—in particular about including the existing concept of 'obscuring' (as set out in paragraph 30A of IAS 1) in the definition of material in the way proposed in the Exposure Draft. Many respondents thought that if the Board were to include this concept in the definition, then 'obscuring information' would need to be more precisely defined or explained than it was in the Exposure Draft.

BC13K The Board agreed with respondents that the concept of 'obscuring information' is inherently more judgemental than 'omitting' or 'misstating' information and considered removing the concept from the definition of material and its explanatory paragraphs altogether. However, the Board decided that the benefit of including 'obscuring' in the definition of material outweighed these concerns. Including this concept emphasises that obscuring information can affect the decisions of primary users just as omitting or misstating that information can. In particular, including 'obscuring' in the definition of material addresses concerns that the former definition could be perceived by stakeholders as focusing only on information that cannot be omitted (material information) and not also on why it may be unhelpful to include immaterial information.

BC13L The Board did not intend to be prescriptive by including the word 'obscuring' in the definition of material and by further clarifying it—the Board is not prohibiting entities from disclosing immaterial information or introducing a required quality of explanations and information included in the financial statements. For example, the Board did not intend the addition of the word 'obscure' to prevent entities from providing information required by local regulators or prescribe how an entity organises and communicates information in the financial statements. Rather, the Board's intention is to:

(a) support the existing requirements in paragraph 30A of IAS 1 which state that 'An entity shall not reduce the understandability of its financial statements by obscuring material information with immaterial information or by aggregating material items that have different natures or functions'; and

(b) help entities and other stakeholders avoid instances in which material information may be obscured by immaterial information to the extent that it has a similar effect on the primary users of financial statements to omitting or misstating that information.

Other amendments

BC13M While the revised definition of material in IAS 1 has been based on the definition of material in the *Conceptual Framework*, some adjustments were made to the *Conceptual Framework* definition to improve clarity and consistency between the *Conceptual Framework* and the IFRS Standards. The definition in the *Conceptual Framework*, however, continues to refer to 'financial reports' rather than 'financial statements'.

BC13N The Board also made amendments to the Materiality Practice Statement to align it with the revised definition of material. The Materiality Practice Statement continues to refer to both 'immaterial' and 'not material' as the Board concluded that these terms have the same meaning.

BC13O As explained in paragraph BC13H, the amendments incorporate existing guidance from the *Conceptual Framework* and IAS 1 and are not substantive changes to the existing requirements in IFRS Standards. For this reason, the Board concluded that the guidance in the Materiality Practice Statement and the *Conceptual Framework* would not be affected by these amendments.

BC13P Because the amendments are based on existing guidance, they are not considered to be substantive changes. The Board consequently concluded that amendments to other requirements in IFRS Standards are unnecessary, other than to update the definition of material where it is quoted or referred to directly.

BC13Q The Board also decided that it was unnecessary to change all instances of 'economic decisions' to 'decisions', and all instances of 'users' to 'the primary users of financial statements' in IFRS Standards. In its Conceptual Framework project, the Board clarified that:

(a) the terms 'primary users' and 'users' are intended to be interpreted the same way and both refer to existing and potential investors, lenders and other creditors who must rely on general purpose financial reports for much of the financial information they need (see the footnote to paragraph 1.5 of the *Conceptual Framework*); and

(b) the terms 'decisions' and 'economic decisions' are intended to be interpreted the same way.

Likely effects of the amendments to IFRS Standards

BC13R In the Board's view, the amendments will improve understanding of the definition of material by:

(a) aligning the wording of the definition in IFRS Standards and the *Conceptual Framework* to avoid the potential for confusion arising from different definitions;

(b) incorporating supporting requirements in IAS 1 into the definition to give them more prominence and clarify their applicability; and

(c) providing existing guidance on the definition of material in one place, together with the definition.

BC13S The Board concluded that the amendments do not change existing requirements substantively because:

(a) the refinements to the definition of material:

(i) are based on wording in the *Conceptual Framework* that is similar to but clearer than the existing definition in IAS 1 and IAS 8 (see paragraphs BC13E and BC13H(b)); and

(ii) incorporate wording that already exists in IAS 1 (see paragraphs BC13H(a), (c) and (d)).

(b) the clarification that 'users' are the primary users and the description of their characteristics have been taken from the *Conceptual Framework*.

(c) the inclusion of 'obscuring information' reflects the existing requirement, as set out in paragraph 30A of IAS 1, that an entity shall not reduce the understandability of its financial statements by obscuring material information. This amendment is not expected to substantively change an entity's decisions about whether information is material—in no circumstances would obscuring information influence the decisions of users, if omitting or misstating the same information would have no influence on those decisions.

Consequently, the Board expects that the effect of the revised definition will be to help entities to make better materiality judgements.

Effective date of the amendments

BC13T Because the amendments do not substantively change existing requirements, the Board decided that:

(a) prospective application is appropriate;

(b) a long implementation period is unnecessary; and

(c) early adoption of the amendments should be permitted.

Financial statements

Complete set of financial statements

Titles of financial statements (paragraph 10)

BC14 The exposure draft of 2006 proposed changes to the titles of some of the financial statements—from 'balance sheet' to 'statement of financial position', from 'income statement' to 'statement of profit or loss' and from 'cash flow statement' to 'statement of cash flows'. In addition, the exposure draft proposed a 'statement of recognised income and expense' and that all owner changes in equity should be included in a 'statement of changes in equity'. The Board did not propose to make any of these changes of nomenclature mandatory.

BC15 Many respondents opposed the proposed changes, pointing out that the existing titles had a long tradition and were well understood. However, the Board reaffirmed its view that the proposed new titles better reflect the function of each financial statement, and pointed out that an entity could choose to use other titles in its financial report.

BC16 The Board reaffirmed its conclusion that the title 'statement of financial position' not only better reflects the function of the statement but is consistent with the *Framework for the Preparation and Presentation of Financial Statements*, which contains several references to 'financial position'. Paragraph 12 of the *Framework*[*] states that the objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity; paragraph 19 of the *Framework* states that information about financial position is primarily provided in a balance sheet. In the Board's view, the title 'balance sheet' simply reflects that double entry bookkeeping requires debits to equal credits. It does not identify the content or purpose of the statement. The Board also noted that 'financial position' is a well-known and accepted term, as it has been used in auditors' opinions internationally for more than 20 years to describe what the 'balance sheet' presents. The Board decided that aligning the statement's title with its content and the opinion rendered by the auditor would help the users of financial statements.

[*] References to the *Framework* in this Basis for Conclusions are to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the ~~IASB~~Board in 2001 and in effect when the Standard was revised and amended. ~~In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.~~

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

Amended references to the *Conceptual Framework*

BC105G Following the issue of the revised *Conceptual Framework for Financial Reporting* in 2018 (2018 *Conceptual Framework*), the Board issued *Amendments to References to the Conceptual Framework in IFRS Standards*. In IAS 1, that document replaced references in paragraphs 15, 19–20, 23–24, 28 and 89 to the *Framework* with references to the 2018 *Conceptual Framework*.

BC105H The Board does not expect the replacement of the references to the *Framework* to have a significant effect on the application of the Standard for the following reasons:

(a) In paragraph 15, replacing the reference to the *Framework* should not change the assessment of whether the financial statements present fairly the financial position, financial performance and cash flows of an entity. Paragraph 15 explains that the application of IFRS Standards, with additional disclosure when necessary, is presumed to result in financial statements that achieve fair presentation. Revisions of the *Conceptual Framework* will not automatically lead to changes in IFRS Standards. Hence, entities are expected to continue applying IFRS Standards in preparing their financial statements even in cases in which the requirements of a particular Standard depart from aspects of the *Conceptual Framework*.

(b) In paragraphs 19–20 and 23–24, replacing the reference to the *Framework* means referring to the revised description of the objective of financial statements in the 2018 *Conceptual Framework* instead of the description provided by the *Framework*. The objective did not change substantively—it is an adapted and updated version of the objective of financial statements from the *Framework* and paragraph 9 of IAS 1. Hence, applying the revised objective is not expected to lead to changes in the application of the requirements in paragraphs 19–20 and 23–24.

(c) In paragraph 28, replacing the reference to the *Framework* in the discussion of the accrual basis of accounting is not expected to result in any changes because no changes were made to the discussion of the accrual basis of accounting in the 2018 *Conceptual Framework*.

(d) In paragraph 89, replacing the reference to the *Framework* means referring to the revised definitions of income and expenses in the 2018 *Conceptual Framework*. The Board concluded that this is unlikely to lead to changes in applying the requirements of IAS 1 because the definitions of income and expenses in the 2018 *Conceptual Framework* were updated only to align them with the revised definitions of an asset and a liability. Moreover, the main purpose of paragraph 89 is to indicate that particular items of income or expenses can be recognised outside profit or loss only if required by other IFRS Standards.

BC105I IAS 1 referred to the *Framework* in paragraph 7 and quoted the description of users of financial statements from the *Framework*. To retain the requirements of this paragraph, the Board decided to embed that description in the Standard itself instead of updating the reference and the related quotation.

BC105J In developing the 2018 *Conceptual Framework* the Board retained the term 'faithful representation' as a label for the qualitative characteristic previously called 'reliability' (see paragraphs BC2.22–BC2.31 of the Basis for Conclusions on the 2018 *Conceptual Framework*). In order to avoid possible unintended consequences, the Board decided against replacing the term 'reliability' with the term 'faithful representation' in the Standards at this time.

Differences from SFAS 130

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

(a) **Reporting and display of comprehensive income** Paragraph 22 of SFAS 130 permits a choice of displaying comprehensive income and its components, in one or two statements of financial performance or in a statement of changes in equity. IAS 1 (as revised in 2007) does not permit display in a statement of changes in equity.

(b) **Reporting other comprehensive income in the equity section of a statement of financial position** Paragraph 26 of SFAS 130 specifically states that the *total of other comprehensive income* is reported separately from retained earnings and additional paid-in capital in a statement of financial position at the end of the period. A descriptive title such as *accumulated other comprehensive income* is used for that component of equity. An entity discloses accumulated balances for each classification in that separate component of equity in a statement of financial position, in a statement of changes in equity, or in notes to the financial statements. IAS 1 (as revised in 2007) does not specifically require the display of a total of accumulated other comprehensive income in the statement of financial position.

(c) **Display of the share of other comprehensive income items of associates and joint ventures accounted for using the equity method** Paragraph 82 of IAS 1 (as revised in 2007) requires the display in the statement of comprehensive income of the investor's share of the investee's other comprehensive income. Paragraph 122 of SFAS 130 does not specify how that information should be displayed. An investor is permitted to combine its proportionate share of other comprehensive income amounts with its own other comprehensive income items and display the aggregate of those amounts in an income statement type format or in a statement of changes in equity.

Appendix

Amendments to the Basis for Conclusions on Classification of Liabilities as Current or Non-current

This appendix contains amendments to the Basis for Conclusions on IAS 1 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.

Paragraphs BC38L–BC38P and the heading above paragraph BC38L are deleted. The heading above paragraph BC39 is replaced by a new heading and sub-heading. Paragraphs BC48A–BC48H are added and headings are added above paragraphs BC48A and BC48F. After paragraph BC105F, a new heading and paragraphs BC105FA–BC105FC are added. New text is underlined and deleted text is struck through.

Statement of financial position

...

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

BC38L–BC38P [Deleted]

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

Current liabilities (paragraphs 69–76B)

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

BC39 ...

Right to defer settlement for at least twelve months (paragraphs 69(d) and 72A–76)

BC48A Paragraph 69(d) specifies that, to classify a liability as non-current, an entity must have the right to defer settlement of the liability for at least twelve months after the reporting period. In January 2020, the Board amended aspects of this classification principle and related application requirements in paragraphs 73–76. The Board made the amendments in response to a request to reconcile apparent contradictions between paragraph 69(d)—which required an 'unconditional right' to defer settlement—and paragraph 73—which referred to an entity that 'expects, and has the discretion, to' refinance or roll over an obligation.

BC48B The Board added to the classification principle in paragraph 69(d) and the example in paragraph 73 clarification that an entity's right to defer settlement must exist 'at the end of the reporting period'. The need for the right to exist at the end of the reporting period was already illustrated in the examples in paragraphs 74 and 75 but was not stated explicitly in the classification principle.

BC48C The Board also observed that the classification principle requires an assessment of whether an entity has the right to defer settlement of a liability and not whether the entity will exercise that right. Accordingly:

(a) the Board amended paragraph 73, which discusses liabilities an entity has a right to roll over for at least twelve months after the reporting period. The Board deleted from paragraph 73 a suggestion that to classify such a liability as non-current, an entity must not only have the right to roll over the liability but also expect to exercise that right. The Board also aligned the terminology by replacing 'discretion' with 'right' in paragraph 73.

(b) the Board added paragraph 75A, which explicitly clarifies that classification is unaffected by management intentions or expectations, or by settlement of the liability within twelve months after the reporting period.

BC48D The Board considered whether an entity's right to defer settlement needs to be unconditional. The Board noted that rights to defer settlement of a loan are rarely unconditional—they are often conditional on compliance with covenants. The Board decided that if an entity's right to defer settlement of a liability is subject to the entity complying with specified conditions, the entity has a right to defer settlement of the liability at the end of the reporting period if it complies with those conditions at that date. Accordingly, the Board:

(a) deleted the word 'unconditional' from the classification principle in paragraph 69(d); and

(b) added paragraph 72A to clarify that if an entity's right to defer settlement is subject to compliance with specified conditions:

   (i) the right exists at the end of the reporting period only if the entity complies with those conditions at the end of the reporting period; and

   (ii) the entity must comply with the conditions at the end of the reporting period even if the lender does not test compliance until a later date.

BC48E The Board considered whether to specify how management assesses an entity's compliance with a condition relating to the entity's cumulative financial performance (for example, profit) for a period extending beyond the reporting period. The Board concluded that comparing the entity's actual performance up to the end of the reporting period with the performance required over a longer period would not provide useful information—one of these measures would have to be adjusted to make the two comparable. However, the Board decided not to specify a method of adjustment because any single method could be inappropriate in some situations.

Settlement (paragraphs 76A–76B)

BC48F While developing the amendments discussed in paragraphs BC48A–BC48E, the Board considered whether a liability is 'settled' when it is rolled over under an existing loan facility. The Board concluded that rolling over a liability does not constitute settlement because it is the extension of an existing liability, which does not involve any transfer of economic resources. The Board also observed that a liability is defined as an obligation 'to transfer an economic resource' and that some types of liabilities are settled by transferring economic resources other than cash. For example, performance obligations within the scope of IFRS 15 *Revenue from Contracts with Customers* are settled by transferring promised goods or services. The Board decided it would be helpful to clarify those aspects of the meaning of the term 'settlement' and so added paragraph 76A.

BC48G While considering the meaning of the term settlement, the Board also considered liabilities an entity will or may settle by issuing its own equity instruments or, in other words, by converting the liability to equity. In *Improvements to IFRSs* issued in 2009, the Board had added to paragraph 69(d) a statement that 'terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification'. The effect of this statement is that a bond that the holder may convert to equity before maturity is classified as current or non-current according to the terms of the bond, without considering the possibility of earlier settlement by conversion to equity.

BC48H The Board concluded that, when it had added the statement about counterparty conversion options in 2009, it had intended the statement to apply only to liabilities that include a counterparty conversion option that meets the definition of an equity instrument and, applying IAS 32 *Financial Instruments: Presentation*, is recognised separately from the host liability as the equity component of a compound financial instrument. The Board further concluded that, in other cases—that is, if an obligation to transfer equity instruments is classified applying IAS 32 as a liability or part of a liability—the transfer of equity instruments would constitute settlement of the liability for the purpose of classifying it as current or non-current. To reflect those conclusions, the Board moved the statement about counterparty conversion options from paragraph 69(d) to new paragraph 76B and clarified its scope.

Transition and effective date

Classification of Liabilities as Current or Non-current (Amendments to IAS 1)

BC105FA In January 2020 the Board issued *Classification of Liabilities as Current or Non-current* for the reasons described in paragraphs BC48A–BC48H. When issued, those amendments had an effective date of annual reporting periods beginning on or after 1 January 2022. Subsequently, the Board noted that the covid-19 pandemic has created pressures that could make it more challenging to implement any changes in classification of liabilities as current or non-current resulting from the application of these amendments. The pressures caused by the covid-19 pandemic could also delay the start and extend the duration of any renegotiation of loan covenants resulting from those changes. Consequently, the Board decided to provide entities with operational relief by deferring the effective date of the amendments by one year to annual reporting periods beginning on or after 1 January 2023. Earlier application of the amendments continues to be permitted.

BC105FB The Board noted that deferring the effective date would delay the implementation of the improvements to the classification of liabilities that the amendments intend to bring about. However, the amendments clarify the requirements for presentation of liabilities instead of fundamentally changing the required accounting; recognition and measurement requirements are unaffected by the amendments. Consequently, the Board concluded that the advantages of a deferral during a time of significant disruption would outweigh the disadvantages.

BC105FC The Board considered whether to introduce disclosure requirements as part of the amendment but concluded that this was unnecessary because an entity is required to comply with paragraph 30 of IAS 8. Application of that paragraph requires disclosure of known or reasonably estimable information relevant to assessing the possible impact of the application of the amendments issued in January 2020 on an entity's financial statements.

Dissenting opinions

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

DO1 Professor Barth and Messrs Cope, Garnett and Leisenring voted against the issue of IAS 1 *Presentation of Financial Statements* in 2007. The reasons for their dissent are set out below.

DO2 Those Board members agree with the requirement to report all items of income and expense separately from changes in net assets that arise from transactions with owners in their capacity as owners. Making that distinction clearly is a significant improvement in financial reporting.

DO3 However, they believe that the decision to permit entities to divide the statement of comprehensive income into two separate statements is both conceptually unsound and unwise.

DO4 As noted in paragraph BC51, the *Framework*[*] does not define profit or loss, or net income. It also does not indicate what criteria should be used to distinguish between those items of recognised income and expense that should be included in profit or loss and those items that should not. In some cases, it is even possible for identical transactions to be reported inside or outside profit or loss. Indeed, in that same paragraph, the Board acknowledges these facts, and indicates that it had a preference for reporting all items of income and expense in a single statement, believing that a single statement is the conceptually correct approach. Those Board members believe that some items of income and expense that will potentially bypass the statement of profit and loss can be as significant to the assessment of an entity's performance as items that will be included. Until a conceptual distinction can be developed to determine whether any items should be reported in profit or loss or elsewhere, financial statements will lack neutrality and comparability unless all items are reported in a single statement. In such a statement, profit or loss can be shown as a subtotal, reflecting current conventions.

DO5 In the light of those considerations, it is puzzling that most respondents to the exposure draft that proposed these amendments favoured permitting a two-statement approach, reasoning that it 'distinguishes between profit and loss and total comprehensive income' (paragraph BC50). Distinguishing between those items reported in profit or loss and those reported elsewhere is accomplished by the requirement for relevant subtotals to be included in a statement of comprehensive income. Respondents also stated that a two-statement approach gives primacy to the 'income statement'; that conflicts with the Board's requirement in paragraph 11 of IAS 1 to give equal prominence to all financial statements within a set of financial statements.

DO6 Those Board members also believe that the amendments are flawed by offering entities a choice of presentation methods. The Board has expressed a desire to reduce alternatives in IFRSs. The *Preface to International Financial Reporting Standards*, in paragraph 13[†], states: 'the IASB intends not to permit choices in accounting treatment … and will continue to reconsider … those transactions and events for which IASs permit a choice of accounting treatment, with the objective of reducing the number of those choices.' The *Preface* extends this objective to both accounting and reporting. The same paragraph states: 'The IASB's objective is to require like transactions and events to be accounted for *and reported* in a like way and unlike transactions and events to be accounted for *and reported* differently' (emphasis added). By permitting a choice in this instance, the IASB has abandoned that principle.

[*] The reference to the *Framework* is to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the ~~IASB~~Board in 2001 and in effect when the Standard was revised. ~~In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.~~

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

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

DO1 Mr Pacter voted against issuing the amendments to IAS 1 *Presentation of Financial Statements* set out in *Presentation of Items of Other Comprehensive Income* in June 2011. Mr Pacter believes that the Board has missed a golden opportunity to align the performance statement with the Board's *Conceptual Framework*[*] and, thereby, improve information for users of IFRS financial statements.

DO2 Mr Pacter believes that ideally this project should have provided guidance, to the Board and to those who use IFRSs, on which items of income and expense (if any) should be presented as items of other comprehensive income (OCI) and which of those (if any) should subsequently be recycled through profit or loss. Mr Pacter acknowledges and accepts that this project has a more short-term goal – 'to improve the consistency and clarity of the presentation of items of OCI'. He believes that this project fails to deliver on that objective, for the following reasons:

(a) Consistency is not achieved because the standard allows choice between presenting performance in a single performance statement or two performance statements. Users of financial statements—and the Board itself—have often said that accounting options are not helpful for understandability and comparability of financial statements.

(b) Clarity is not achieved because allowing two performance statements is inconsistent with the *Conceptual Framework*. The *Conceptual Framework* defines two types of items that measure an entity's performance—income and expenses. Mr Pacter believes that all items of income and expense should be presented in a single performance statement with appropriate subtotals (including profit or loss, if that can be defined) and supporting disclosures. This is consistent with reporting all assets and liabilities in a single statement of financial position, rather than multiple statements. Unfortunately, neither IAS 1 nor any other IFRS addresses criteria for which items are presented in OCI. And the recent history of which items are presented in OCI suggests that the decisions are based more on expediency than conceptual merit. In Mr Pacter's judgement, that is all the more reason to have all items of income and expense reported in a single performance statement.

DO3 Mr Pacter believes that the Board should breathe new life into its former project on performance reporting as a matter of urgency.

[*] References to the *Conceptual Framework* in this Dissent are to the *Conceptual Framework for Financial Reporting*, issued in 2010 and in effect when the Standard was amended.

HKAS 7

Revised ~~July 2019~~August 2020

Hong Kong Accounting Standard 7

Statement of Cash Flows

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

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Appendix B

Statement of cash flows for a financial institution

This appendix accompanies, but is not part of, IAS 7.

1 The example shows only current period amounts. Comparative amounts for the preceding period are required to be presented in accordance with IAS 1 *Presentation of Financial Statements.*

2 The example is presented using the direct method.

		20X2
Cash flows from operating activities		
Interest and commission receipts	28,447	
Interest payments	(23,463)	
Recoveries on loans previously written off	237	
Cash payments to employees and suppliers	(997)	
	4,224	
(Increase) decrease in operating assets:		
Short-term funds	(650)	
Deposits held for regulatory or monetary control purposes	234	
Funds advanced to customers	(288)	
Net increase in credit card receivables	(360)	
Other short-term negotiable securities	(120)	
Increase (decrease) in operating liabilities:		
Deposits from customers	600	
Negotiable certificates of deposit	(200)	
Net cash from operating activities before income tax	3,440	
Income taxes paid	(100)	
Net cash from operating activities		3,340
Cash flows from investing activities		
Disposal of subsidiary Y	50	
Dividends received	200	
Interest received	300	
Proceeds from sales of non-dealing securities	1,200	
Purchase of non-dealing securities	(600)	
Purchase of property, plant and equipment	(500)	
Net cash from investing activities		650

continued …

HKAS 8
Revised ~~January 2019~~August 2020

Effective for annual periods
beginning on or after 1 January 2005

Hong Kong Accounting Standard 8

Accounting Policies, Changes in Accounting Estimates and Errors

Hong Kong Institute of
Certified Public Accountants
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A Comparison with International Accounting Standards

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BASIS FOR CONCLUSIONS

~~**APPENDIX:**~~

~~**Amendments to the Basis for Conclusions on Definition of Material**~~

IMPLEMENTATION GUIDANCE

TABLE OF CONCORDANCE

Hong Kong Accounting Standard 8 *Accounting Policies, Changes in Accounting Estimates and Errors* (HKAS 8) is set out in paragraphs 1-56 and the Appendix ~~C~~. All the paragraphs have equal authority. HKAS 8 should be read in the context of its objective and the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Conceptual Framework for Financial Reporting*.

Material ~~**Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.**~~**is defined in paragraph 7 of HKAS 1 and is used in this Standard with the same meaning.**

Prior period errors **are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:**

(a) **was available when financial statements for those periods were authorised for issue; and**

(b) **could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.**

Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.

Retrospective application **is applying a new accounting policy to transactions, other events and conditions as if that policy had always been applied.**

Retrospective restatement **is correcting the recognition, measurement and disclosure of amounts of elements of financial statements as if a prior period error had never occurred.**

Impracticable **Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so. For a particular prior period, it is impracticable to apply a change in an accounting policy retrospectively or to make a retrospective restatement to correct an error if:**

(a) **the effects of the retrospective application or retrospective restatement are not determinable;**

(b) **the retrospective application or retrospective restatement requires assumptions about what management's intent would have been in that period; or**

(c) **the retrospective application or retrospective restatement requires significant estimates of amounts and it is impossible to distinguish objectively information about those estimates that:**

> **(i)** **provides evidence of circumstances that existed on the date(s) as at which those amounts are to be recognised, measured or disclosed; and**
>
> **(ii)** **would have been available when the financial statements for that prior period were authorised for issue from other information.**

Prospective application **of a change in accounting policy and of recognising the effect of a change in an accounting estimate, respectively, are:**

(a) **applying the new accounting policy to transactions, other events and conditions occurring after the date as at which the policy is changed; and**

(b) **recognising the effect of the change in the accounting estimate in the current and future periods affected by the change.**

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

Accounting policies

Selection and application of accounting policies

7 **When a HKFRS specifically applies to a transaction, other event or condition, the accounting policy or policies applied to that item shall be determined by applying the HKFRS.**

8 HKFRSs set out accounting policies that the HKICPA has concluded result in financial statements containing relevant and reliable information about the transactions, other events and conditions to which they apply. Those policies need not be applied when the effect of applying them is immaterial. However, it is inappropriate to make, or leave uncorrected, immaterial departures from HKFRSs to achieve a particular presentation of an entity's financial position, financial performance or cash flows.

9 HKFRSs are accompanied by guidance to assist entities in applying their requirements. All such guidance states whether it is an integral part of HKFRSs. Guidance that is an integral part of HKFRSs is mandatory. Guidance that is not an integral part of HKFRSs does not contain requirements for financial statements.

10 **In the absence of a HKFRS that specifically applies to a transaction, other event or condition, management shall use its judgement in developing and applying an accounting policy that results in information that is:**

(a) **relevant to the economic decision-making needs of users; and**

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

(b) reliable, in that the financial statements:

(i) represent faithfully the financial position, financial performance and cash flows of the entity;

(ii) reflect the economic substance of transactions, other events and conditions, and not merely the legal form;

(iii) are neutral, ie free from bias;

(iv) are prudent; and

(v) are complete in all material respects.

11 In making the judgement described in paragraph 10, management shall refer to, and consider the applicability of, the following sources in descending order:

(a) the requirements in HKFRSs dealing with similar and related issues; and

(b) the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the ~~*Framework*~~[+]*Conceptual Framework for Financial Reporting (Conceptual Framework*[#].

12 In making the judgement described in paragraph 10, management may also consider the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards, other accounting literature[*] and accepted industry practices, to the extent that these do not conflict with the sources in paragraph 11.

Consistency of accounting policies

13 An entity shall select and apply its accounting policies consistently for similar transactions, other events and conditions, unless a HKFRS specifically requires or permits categorisation of items for which different policies may be appropriate. If a HKFRS requires or permits such categorisation, an appropriate accounting policy shall be selected and applied consistently to each category.

Changes in accounting policies

14 An entity shall change an accounting policy only if the change:

(a) is required by a HKFRS; or

(b) results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows.

[+] ~~In October 2010 the HKICPA replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.~~

[#] Paragraph 54G explains how this requirement is amended for regulatory account balances.

[*] In the context of Hong Kong, other accounting literature includes Accounting Guidelines and Accounting Bulletins.

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

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

53 Hindsight should not be used when applying a new accounting policy to, or correcting amounts for, a prior period, either in making assumptions about what management's intentions would have been in a prior period or estimating the amounts recognised, measured or disclosed in a prior period. For example, when an entity corrects a prior period error in calculating its liability for employees' accumulated sick leave in accordance with HKAS 19 *Employee Benefits*, it disregards information about an unusually severe influenza season during the next period that became available after the financial statements for the prior period were authorised for issue. The fact that significant estimates are frequently required when amending comparative information presented for prior periods does not prevent reliable adjustment or correction of the comparative information.

Effective date and transition

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

54a If an entity decides to apply this Standard for an earlier period, it is not required to apply all the HKASs with the same effective date for that same period. However, it is required to apply the amendments set out in the appendix on amendments to other pronouncements for that earlier period.

54A [Deleted]

54B [Deleted]

54C HKFRS 13 *Fair Value Measurement*, issued in June 2011, amended paragraph 52. An entity shall apply that amendment when it applies HKFRS 13.

54D [Deleted]

54E HKFRS 9 *Financial Instruments*, as issued in September 2014, amended paragraph 53 and deleted paragraphs 54A, 54B and 54D. An entity shall apply those amendments when it applies HKFRS 9.

54F Amendments *to References to the Conceptual Framework in HKFRS Standards*, issued in 2018, amended paragraphs 6 and 11(b). An entity shall apply those amendments for annual periods beginning on or after 1 January 2020. Earlier application is permitted if at the same time an entity also applies all other amendments made by *Amendments to References to the Conceptual Framework in HKFRS Standards*. An entity shall apply the amendments to paragraphs 6 and 11(b) retrospectively in accordance with this Standard. However, if an entity determines that retrospective application would be impracticable or would involve undue cost or effort, it shall apply the amendments to paragraphs 6 and 11(b) by reference to paragraphs 23–28 of this Standard. If retrospective application of any amendment in *Amendments to References to the Conceptual Framework in HKFRS Standards* would involve undue cost or effort, an entity shall, in applying paragraphs 23–28 of this Standard, read any reference except in the last sentence of paragraph 27 to 'is impracticable' as 'involves undue cost or effort' and any reference to 'practicable' as 'possible without undue cost or effort'.

54G If an entity does not apply HKFRS 14 *Regulatory Deferral Accounts*, the entity shall, in applying paragraph 11(b) to regulatory account balances, continue to refer to, and consider the applicability of, the definitions, recognition criteria, and measurement concepts in the *Framework for the Preparation and Presentation of Financial Statements*[*] instead of those in the *Conceptual Framework*. A regulatory account balance is the balance of any expense (or income) account that is not recognised as an asset or a liability in accordance with other applicable HKFRS Standards but is included, or is expected to be included, by the rate regulator in establishing the rate(s) that can be charged to customers. A rate regulator is an authorised body that is empowered by statute or regulation to establish the rate or a range of rates that bind an entity. The rate regulator may be a third-party body or a related party of the entity, including the entity's own governing board, if that body is required by statute or regulation to set rates both in the interest of the customers and to ensure the overall financial viability of the entity.

54H *Definition of Material* (Amendments to HKAS 1 and HKAS 8), issued in January 2019, amended paragraph 7 of HKAS 1 and paragraph 5 of HKAS 8, and deleted paragraph 6 of HKAS 8. An entity shall apply those amendments prospectively for annual periods beginning on or after 1 January 2020. Earlier application is permitted. If an entity applies those amendments for an earlier period, it shall disclose that fact.

Withdrawal of other pronouncements

55 This Standard supersedes SSAP 2 *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies*, revised in 2001.

56 [Not used]

[*] The reference is to the *Framework for the Preparation and Presentation of Financial Statements.*

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BC6 The Board identified the removal of optional treatments for changes in accounting policies and corrections of errors as an important improvement to the previous version of IAS 8. The Standard removes the allowed alternative treatments and requires changes in accounting policies and corrections of prior period errors to be accounted for retrospectively.

BC7 The Board concluded that retrospective application made by amending the comparative information presented for prior periods is preferable to the previously allowed alternative treatments because, under the now required method of retrospective application:

(a) profit or loss for the period of the change does not include the effects of changes in accounting policies or errors relating to prior periods.

(b) information presented about prior periods is prepared on the same basis as information about the current period, and is therefore comparable. This information possesses a qualitative characteristic identified in the *Framework for the Preparation and Presentation of Financial Statements (Framework)*[*], and provides the most useful information for trend analysis of income and expenses.

(c) prior period errors are not repeated in comparative information presented for prior periods.

BC8 Some respondents to the Exposure Draft argued that the previously allowed alternative treatments are preferable because:

(a) correcting prior period errors by restating prior period information involves an unjustifiable use of hindsight;

(b) recognising the effects of changes in accounting policies and corrections of errors in current period profit or loss makes them more prominent to users of financial statements; and

(c) each amount credited or debited to retained earnings as a result of an entity’s activities has been recognised in profit or loss in some period.

BC9 The Board concluded that restating prior period information to correct a prior period error does not involve an unjustifiable use of hindsight because prior period errors are defined in terms of a failure to use, or misuse of, reliable information that was available when the prior period financial statements were authorised for issue and could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

BC10 The Board also concluded that the disclosures about changes in accounting policies and corrections of prior period errors in paragraphs 28, 29 and 49 of the Standard should ensure that their effects are sufficiently prominent to users of financial statements.

BC11 The Board further concluded that it is less important for each amount credited or debited to retained earnings as a result of an entity’s activities to be recognised in profit or loss in some period than for the profit or loss for each period presented to represent faithfully the effects of transactions and other events occurring in that period.

[*] References to the *Framework* in this Basis for Conclusions are to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, ~~was~~ adopted by the ~~IASB~~ Board in 2001 and in effect when the Standard was revised. ~~In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.~~

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BC17 As proposed in the Exposure Draft, the Standard states that pronouncements of other standard-setting bodies are used only if they do not conflict with:

(a) the requirements and guidance in IFRSs dealing with similar and related issues; and

(b) the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the *Framework*[*].

BC18 The Standard refers to the most recent pronouncements of other standard-setting bodies because if pronouncements are withdrawn or superseded, the relevant standard-setting body no longer thinks they include the best accounting policies to apply.

BC19 Comments received indicated that it was unclear from the Exposure Draft whether a change in accounting policy following a change in a pronouncement of another standard-setting body should be accounted for under the transitional provisions in that pronouncement. As noted above, the Standard does not mandate using pronouncements of other standard-setting bodies in any circumstances. Accordingly, the Board decided to clarify that such a change in accounting policy is accounted for and disclosed as a voluntary change in accounting policy (see paragraph 21 of the Standard). Thus, an entity is precluded from applying transitional provisions specified by the other standard-setting body if they are inconsistent with the treatment of voluntary changes in accounting policies specified by the Standard.

Materiality

BC20 The Standard states that accounting policies specified by IFRSs need not be applied when the effect of applying them is immaterial. It also states that financial statements do not comply with IFRSs if they contain material errors, and that material prior period errors are to be corrected in the first set of financial statements authorised for issue after their discovery. The Standard includes a definition of material omissions or misstatements, which is based on the description of materiality in IAS 1 *Presentation of Financial Statements* (as issued in 1997) and in the *Framework*.

BC21 The former *Preface to Statements of International Accounting Standards* stated that International Accounting Standards were not intended to apply to immaterial items. There is no equivalent statement in the *Preface to International Financial Reporting Standards*. The Board received comments that the absence of such a statement from the *Preface* could be interpreted as requiring an entity to apply accounting policies (including measurement requirements) specified by IFRSs to immaterial items. However, the Board decided that the application of the concept of materiality should be in Standards rather than in the *Preface*.

BC21A As a consequence of the *Definition of Material* (Amendments to IAS 1 and IAS 8), issued in October 2018, the definition of material and the accompanying explanatory paragraphs have been replaced with a reference to the definition of material and explanatory paragraphs in IAS 1.[#] The Board made this change to avoid the duplication of the definition of material in the Standards.

BC22 The application of the concept of materiality is set out in two Standards. IAS 1 (as revised in 2007) continues to specify its application to disclosures. IAS 8 specifies the application of materiality in applying accounting policies and correcting errors (including errors in measuring items).

[*] ~~In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.~~ In 2018 the Board issued a revised *Conceptual Framework for Financial Reporting* (*Conceptual Framework*). The Board also issued *Amendments to References to the Conceptual Framework in IFRS Standards*. That document replaced the reference to the *Framework* in paragraph 11(b) of IAS 8 with a reference to the *Conceptual Framework*, except in the case of some regulatory account balances, as explained in paragraphs 54G of IAS 8 and BC38–BC40.

[#] Refer to paragraphs BC13A-BC13T of the Basis for Conclusions on IAS 1.

Recognising the effects of changes in accounting estimates

BC32 The Exposure Draft proposed to retain without exception the requirement in the previous version of IAS 8 that the effect of a change in accounting estimate is *recognised in profit or loss* in:

(a) the period of the change, if the change affects that period only; or

(b) the period of the change and future periods, if the change affects both.

BC33 Some respondents to the Exposure Draft disagreed with requiring the effects of all changes in accounting estimates to be recognised in profit or loss. They argued that this is inappropriate to the extent that a change in an accounting estimate gives rise to changes in assets and liabilities, because the entity's equity does not change as a result. These commentators also argued that it is inappropriate to preclude recognising the effects of changes in accounting estimates directly in equity when that is required or permitted by a Standard or an Interpretation. The Board concurs, and decided to provide an exception to the requirement described in paragraph BC32 for these circumstances.

Amended references to the *Conceptual Framework*

BC34 Following the issue of the revised *Conceptual Framework for Financial Reporting* in 2018 (2018 *Conceptual Framework*), the Board issued *Amendments to References to Conceptual Framework in IFRS Standards*. In IAS 8, that document amended paragraphs 6 and 11(b).

BC35 Paragraph 6 of IAS 8 quoted the description of users of financial statements from the *Framework*. To retain the requirements of this paragraph, the Board decided to embed that description of users in the Standard itself instead of updating the reference and the related quotation.

BC36 *Amendments to References to the Conceptual Framework in IFRS Standards* replaced the reference in paragraph 11(b) to the *Framework* with a reference to the 2018 *Conceptual Framework*. Following this replacement, if management developed accounting policies in accordance with paragraph 11(b), management will need to review whether those policies are still consistent with the 2018 *Conceptual Framework*.

BC37 The Board analysed the effects on preparers of financial statements of replacing the reference to the *Framework* in paragraph 11(b) of IAS 8 and discussed the results of the analysis at the November 2016 Board meeting (see November 2016 AP10G *Effects of the proposed changes to the Conceptual Framework on preparers*). The analysis suggested that the scope of any changes to preparers' accounting policies is likely to be limited because:

(a) most preparers of financial statements do not develop accounting policies by reference to the *Framework* because most transactions are:

(i) covered by IFRS Standards;

(ii) accounted for by applying accounting policies developed using other sources referred to in paragraphs 11–12 of IAS 8; or

(iii) exempt from the requirement to apply paragraph 11 of IAS 8; for example, IFRS 6 *Exploration for and Evaluation of Mineral Resources* exempts entities from applying paragraph 11 of IAS 8 to the recognition and measurement of exploration and evaluation assets; and

(b) in most of the few remaining areas, application of the revised concepts in the 2018 *Conceptual Framework* would be expected to result in similar accounting outcomes to application of the concepts in the *Framework*.

Application by rate-regulated entities

BC38 While assessing possible effects of updating the reference to the *Framework* in IAS 8, the Board identified a potential disadvantage for entities that conduct rate-regulated activities and develop their accounting policies for regulatory account balances by reference to the *Framework* rather than by applying IFRS 14 *Regulatory Deferral Accounts*. If the reference to the *Framework* had been updated, such entities might have needed to revise those accounting policies twice within a short period of time—first, when the 2018 *Conceptual Framework* comes into effect; and, later, when a new IFRS Standard on rate-regulated activities is issued. In the absence of specific guidance, there might have been uncertainty about what would be acceptable if the 2018 *Conceptual Framework* was applied. Establishing what would be acceptable might have been costly and the outcome might have been diversity in practice and a loss of trend information for users.

BC39 To prevent unhelpful and unnecessary disruption for users of the financial statements of entities that conduct rate-regulated activities and for the entities themselves, the Board provided a temporary exception: paragraph 54G prohibits entities from applying the 2018 *Conceptual Framework* to accounting policies relating to regulatory account balances. Instead, entities are required to continue to apply the *Framework* when developing or revising those accounting policies. Once the Board issues a new IFRS Standard on rate-regulated activities, that prohibition is likely to become unnecessary.

BC40 The Board based the definition of 'a regulatory account balance' on the definition of 'a regulatory deferral account balance' in IFRS 14, with one difference: the definition of a regulatory account balance does not mention qualifying for deferral. The reference to deferral in IFRS 14 reflects the fact that IFRS 14 permits continued recognition of some regulatory deferral account balances that an entity previously recognised as assets or liabilities immediately before it adopted IFRS Standards for the first time. In contrast, paragraph 54G of IAS 8 applies only when an entity is not applying IFRS 14 but is instead developing an accounting policy after considering paragraph 11 of IAS 8. Paragraph 54G applies regardless of whether that accounting policy results in recognition of any assets or liabilities, and regardless of whether such recognition could be viewed as deferral.

Transition relief

BC41 The Board concluded that the retrospective application of revised accounting policies in accordance with IAS 8 would provide the most useful information to users of financial statements. However, in order to keep disruption for users and preparers of financial statements to a minimum, the Board decided not to require retrospective application of any amendment in *Amendments to References to the Conceptual Framework in IFRS Standards* if doing so would either be impracticable or involve undue cost or effort.

HKAS 10
Revised ~~September 2018~~August 2020

Hong Kong Accounting Standard 10

Events after the Reporting Period

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

Updating disclosure about conditions at the end of the reporting period

19 If an entity receives information after the reporting period about conditions that existed at the end of the reporting period, it shall update disclosures that relate to those conditions, in the light of the new information.

20 In some cases, an entity needs to update the disclosures in its financial statements to reflect information received after the reporting period, even when the information does not affect the amounts that it recognises in its financial statements. One example of the need to update disclosures is when evidence becomes available after the reporting period about a contingent liability that existed at the end of the reporting period. In addition to considering whether it should recognise or change a provision under HKAS 37, an entity updates its disclosures about the contingent liability in the light of that evidence.

Non-adjusting events after the reporting period

21 If non-adjusting events after the reporting period are material, non-disclosure could reasonably be expected to influence ~~the economic~~ decisions that the primary users of general purpose financial statements make on the basis of ~~the~~ those financial statements, which provide financial information about a specific reporting entity. Accordingly, an entity shall disclose the following for each material category of non-adjusting event after the reporting period:

(a) the nature of the event; and

(b) an estimate of its financial effect, or a statement that such an estimate cannot be made.

22 The following are examples of non-adjusting events after the reporting period that would generally result in disclosure:

(a) a major business combination after the reporting period (HKFRS 3 *Business Combinations* requires specific disclosures in such cases) or disposing of a major subsidiary;

(b) announcing a plan to discontinue an operation;

(c) major purchases of assets, classification of assets as held for sale in accordance with HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations,* other disposals of assets, or expropriation of major assets by government;

(d) the destruction of a major production plant by a fire after the reporting period;

(e) announcing, or commencing the implementation of, a major restructuring (see HKAS 37);

(f) major ordinary share transactions and potential ordinary share transactions after the reporting period (HKAS 33 *Earnings per Share* requires an entity to disclose a description of such transactions, other than when such transactions involve capitalisation or bonus issues, share splits or reverse share splits all of which are required to be adjusted under HKAS 33);

(g) abnormally large changes after the reporting period in asset prices or foreign exchange rates;

(h) changes in tax rates or tax laws enacted or announced after the reporting period that have a significant effect on current and deferred tax assets and liabilities (see HKAS 12 *Income Taxes*);

(i) entering into significant commitments or contingent liabilities, for example, by issuing significant guarantees; and

(j) commencing major litigation arising solely out of events that occurred after the reporting period.

Effective date

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

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

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

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

23C *Definition of Material* (Amendments to HKAS 1 and HKAS 8), issued in January 2019, amended paragraph 21. An entity shall apply those amendments prospectively for annual periods beginning on or after 1 January 2020. Earlier application is permitted. If an entity applies those amendments for an earlier period, it shall disclose that fact. An entity shall apply those amendments when it applies the amendments to the definition of material in paragraph 7 of HKAS 1 and paragraphs 5 and 6 of HKAS 8.

Withdrawal of SSAP 9 (revised 2001)

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

HKAS 12
Revised ~~July 2019~~August 2020

Hong Kong Accounting Standard 12

Income Taxes

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Basis for Conclusions on IAS 12 *Income Taxes*

This Basis for Conclusions accompanies, but is not part of, IAS 12.

HKAS 12 is based on IAS 12 *Income Taxes*. In approving HKAS 12, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IASB's Basis for Conclusions on IAS 12. Accordingly, there are no significant differences between HKAS 12 and IAS 12. The IASB's Basis for Conclusions is reproduced below. The paragraph numbers of IAS 12 referred to below generally correspond with those in HKAS 12.

Introduction

BC1 When IAS 12 *Income Taxes* was issued by the International Accounting Standards Committee in 1996 to replace the previous IAS 12 *Accounting for Taxes on Income* (issued in July 1979), the Standard was not accompanied by a Basis for Conclusions. This Basis for Conclusions is not comprehensive. It summarises only the International Accounting Standards Board's considerations in making the amendments to IAS 12 contained in *Deferred Tax: Recovery of Underlying Assets* issued in December 2010. Individual Board members gave greater weight to some factors than to others.

BC1A In August 2014 the Board published an Exposure Draft of proposed amendments to IAS 12 to clarify the requirements on recognition of deferred tax assets for unrealised losses on debt instruments measured at fair value. The Board subsequently modified and confirmed the proposals and in January 2016 issued *Recognition of Deferred Tax Assets for Unrealised Losses* (Amendments to IAS 12). The Board's considerations and reasons for its conclusions are discussed in paragraphs BC37–BC62.

BC2 The Board amended IAS 12 to address an issue that arises when entities apply the measurement principle in IAS 12 to temporary differences relating to investment properties that are measured using the fair value model in IAS 40 *Investment Property*.

BC3 In March 2009 the Board published an exposure draft, *Income Tax* (the 2009 exposure draft), proposing a new IFRS to replace IAS 12. In the 2009 exposure draft, the Board addressed this issue as part of a broad proposal relating to the determination of tax basis. In October 2009 the Board decided not to proceed with the proposals in the 2009 exposure draft and announced that, together with the US Financial Accounting Standards Board, it aimed to conduct a fundamental review of the accounting for income tax in the future. In the meantime, the Board would address specific significant current practice issues.

BC4 In September 2010 the Board published proposals for addressing one of those practice issues in an exposure draft *Deferred Tax: Recovery of Underlying Assets* with a 60-day comment period. Although that is shorter than the Board's normal 120-day comment period, the Board concluded that this was justified because the amendments were straightforward and the exposure draft was short. In addition, the amendments were addressing a problem that existed in practice and needed to be solved as soon as possible. The Board considered the comments it received on the exposure draft and in December 2010 issued the amendments to IAS 12. The Board intends to address other practice issues arising from IAS 12 in due course, when other priorities on its agenda permit this.

Recovery of revalued non-depreciable assets

BC5 In December 2010, the Board incorporated in paragraph 51B of IAS 12 the consensus previously contained in SIC Interpretation 21 *Income Taxes—Recovery of Revalued Non-Depreciable Assets*. However, because paragraph 51C addresses investment property carried at fair value, the Board excluded such assets from the scope of paragraph 51B. Paragraphs BC6 and BC7 set out the basis that the Standing Interpretations Committee (SIC) gave for the conclusions it reached in developing the consensus expressed in SIC-21.

BC6 The SIC noted that the *Framework for the Preparation and Presentation of Financial Statements** stated that an entity recognises an asset if it is probable that the future economic benefits associated with the asset will flow to the entity. Generally, those future economic benefits will be derived (and therefore the carrying amount of an asset will be recovered)

* The reference is to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, ~~was~~ adopted by the ~~IASB~~Board in 2001 and in effect when the SIC discussed this matter. ~~In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.~~

HKAS 16
Revised ~~June 2020~~August 2020

Hong Kong Accounting Standard 16

Property, Plant and Equipment

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

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 fair value less costs ~~to sell~~ of disposal 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. Items such as spare parts, stand-by equipment and servicing equipment are recognised in accordance with this HKFRS when they meet the definition of property, plant and equipment. Otherwise, such items are classified as inventory.

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.

BC2A *Agriculture: Bearer Plants* (Amendments to IAS 16 and IAS 41), issued in June 2014, amended the scope of IAS 16 to include bearer plants. IAS 41 *Agriculture* applies to the produce growing on those bearer plants. The amendments define a bearer plant and require bearer plants to be accounted for as property, plant and equipment in accordance with IAS 16. These amendments are discussed in paragraphs BC38–BC117.

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.

[*] References to the *Framework* in this Basis for Conclusions are to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the ~~IASB~~ Board in 2001 and in effect when the Standard was revised. ~~In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting.*~~

produce over several periods. After this time they are usually scrapped. Consequently, the only significant future economic benefits from bearer plants arise from selling the agricultural produce that they create.

BC65 The Board noted that while fair value measurement may provide an indication of the quality and productive capacity of the bearer plants at a point in time, it is less important to users of financial statements than it is for biological assets whose value may be realised through sale as agricultural produce.

BC66 Bearer plants meet the definition of property, plant and equipment. The use of mature bearer plants to produce agricultural produce is similar to the use of machinery to manufacture goods. The manner in which an entity derives economic benefits from bearer plants and a production plant is similar and that manner differs from biological assets that are harvested for sale. The progressive decline in the future earning potential of a bearer plant over its life is also similar to other depreciable assets, for example, plant and machinery.

BC67 There is an assumption inherent in the *Conceptual Framework*[*] that accounting for similar assets in similar ways enhances the decision-usefulness of the reported information. The land upon which bearer plants are growing, the structures used to support their growth and the agricultural machinery are measured in accordance with IAS 16. Although bearer plants are dissimilar in form to plant and machinery, similarities in how they are used supports accounting for them in the same way.

Cost-benefit considerations

BC68 The Board noted that, on the basis of the responses to the 2011 Agenda Consultation and the outreach performed by the staff, the costs of measuring bearer plants at fair value are perceived by many preparers to exceed the benefits to users of financial statements. The Board also observed that nearly all investors and analysts consulted during the outreach performed by the staff said that the IAS 41 fair value information about bearer plants has limited use to them. The main reasons given by the investors and analysts were:

(a) information about operating performance and cash flows is more relevant to their forecasting and analysis. Consequently, they eliminate changes in the fair value less costs to sell of bearer plants from the figures used for their analysis.

(b) there are concerns about relying on the fair value measurements because valuations involve significant management judgement, have the potential for manipulation, and assumptions vary significantly between companies.

(c) fair value information about bearer plants is not very useful without fair value information about the related land, land improvements, agricultural machinery, etc.

Biological transformation

BC69 The IAS 41 fair value model is based on the principle that biological transformation is best reflected by fair value measurement. Once bearer plants mature, they are held by an entity solely to grow produce and so, apart from bearing produce, their biological transformation is no longer significant in generating future economic benefits. Consequently, the Board decided bearer plants should be accounted for under IAS 16 instead of IAS 41 (see paragraphs BC63–BC68). However, the Board noted that the same argument is not true for bearer plants before they reach maturity and bear produce. Until they reach maturity, bearer plants are in a growth phase and so undergo significant biological transformation. Furthermore, the Board noted that the produce growing on the bearer plants is undergoing biological transformation until it is harvested (for example, grapes growing on a grape vine). Paragraphs BC70–BC79 explain the reasons supporting the Board's conclusions regarding bearer plants before they reach maturity and the produce growing on the bearer plants.

Accounting for bearer plants before they mature

BC70 The Board considered whether a fair value approach or a cost accumulation approach should be applied to bearer plants before they reach maturity.

[*] References to the *Conceptual Framework* in this Basis for Conclusions are to the *Conceptual Framework for Financial Reporting*, issued in 2010 and in effect when the Standard was amended.

HKAS 19 (2011)
Revised ~~July 2019~~August 2020

Effective for annual periods
beginning on or after 1 January 2013

Hong Kong Accounting Standard 19 (2011)

Employee Benefits

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State plan and group plan disclosures: amendments issued in 2011

BC51 The amendments made in 2011 updated, without reconsideration, the disclosure requirements for entities that participate in state plans or defined benefit plans that share risks between various entities under common control, to be consistent with the disclosure requirements for multi-employer plans and defined benefit plans. However, those amendments permit an entity to include those disclosures by cross-reference to the required disclosures in another group entity's financial statements, if specified conditions are met.

Defined benefit plans: recognition and measurement

BC52 Although IAS 19 before its revision in 1998 did not deal explicitly with the recognition of retirement benefit obligations as a liability, it is likely that most entities recognised a liability for retirement benefit obligations at the same time under the requirements in IAS 19 before and after its revision in 1998. However, the requirements in IAS 19 before and after its revision in 1998 differed in the measurement of the resulting liability.

BC53 Paragraph 63 of IAS 19 is based on the definition of, and recognition criteria for, a liability in the IASC's *Framework for the Preparation and Presentation of Financial Statements (Framework)*.* The *Framework* defined a liability as 'a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits'. The *Framework* stated that an item which meets the definition of a liability should be recognised if:

(a) it is probable that any future economic benefit associated with the item will flow from the entity; and

(b) the item has a cost or value that can be measured with reliability.

BC54 IASC believed that:

(a) an entity has an obligation under a defined benefit plan when an employee has rendered service in return for the benefits promised under the plan. Paragraphs 70–74 deal with the attribution of benefit to individual periods of service in order to determine whether an obligation exists.

(b) an entity should use actuarial assumptions to determine whether the entity will pay those benefits in future reporting periods (see paragraphs 75–98).

(c) actuarial techniques allow an entity to measure the obligation with sufficient reliability to justify recognition of a liability.

* ~~In September 2010 the Board replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.~~References to the *Framework* in this Basis for Conclusions are to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the Board in 2001 and in effect when the Standard was revised.

BC90 In finalising the amendments made in 2011, the Board confirmed the proposal made in the 2010 ED that an entity should recognise remeasurements in other comprehensive income. The Board acknowledged that the *Conceptual Framework*[*] and IAS 1 do not describe a principle that would identify the items an entity should recognise in other comprehensive income rather than in profit or loss. However, the Board concluded that the most informative way to disaggregate the components of defined benefit cost with different predictive values is to recognise the remeasurements component in other comprehensive income.

BC91 The Board considered and rejected alternative approaches that would address some of the concerns expressed in paragraph BC89(a) and (b) for the reasons discussed in paragraphs BC92–BC98. Subsequent reclassification of amounts recognised in other comprehensive income to profit or loss is discussed in paragraph BC99.

Components of defined benefit cost: other approaches to recognising remeasurements

BC92 The Board considered the following alternatives for recognising the remeasurements component:

(a) previous options in IAS 19 for immediate recognition (paragraph BC93).

(b) recognition of all components in profit or loss (paragraphs BC94–BC96).

(c) a hybrid approach requiring recognition of the remeasurements component in other comprehensive income or profit or loss in different circumstances (paragraphs BC97 and BC98).

BC93 Before its amendment in 2011, IAS 19 permitted two methods for recognising actuarial gains and losses immediately: in profit or loss or in other comprehensive income. Many respondents to the 2010 ED suggested that the Board should permit an entity to recognise remeasurements either in profit or loss or in other comprehensive income. Retaining those options would have allowed entities with small plans to keep the accounting simple and would have allowed entities to eliminate the accounting mismatches noted in paragraph BC89(b). However, the Board concluded that eliminating options would improve financial reporting.

BC94 Some respondents to the 2010 ED expressed the view that entities should recognise all components of defined benefit cost within profit or loss, rather than using other comprehensive income for some items. They offered the following reasons for their position:

(a) Some indicated that the *Framework* and IAS 1 do not describe a principle that would identify the items an entity should recognise in other comprehensive income rather than in profit or loss.

(b) Some believe that an entity should show amounts relating to defined benefit plans in aggregate, as a single net amount arising from personnel or employment expense, in conformity with the presentation of a single net amount in the statement of financial position.

[*] The reference to the *Conceptual Framework* is to the *Conceptual Framework for Financial Reporting*, issued in 2010 and in effect when the Standard was amended.

HKAS 21
Revised ~~July 2019~~August 2020

Hong Kong Accounting Standard 21

The Effects of Changes in Foreign Exchange Rates

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BC21 With respect to translation of comparative amounts, the Board adopted the approach required by SIC-30 for:

(a) an entity whose functional currency is not the currency of the hyperinflationary economy (assets and liabilities in the comparative balance sheet are translated at the closing rate at the date of that balance sheet and income and expenses in the comparative income statement are translated at exchange rates at the dates of the transactions); and

(b) an entity whose functional currency is the currency of a hyperinflationary economy, and for which the comparative amounts are being translated into the currency of a hyperinflationary economy (both balance sheet and income statement items are translated at the closing rate of the most recent balance sheet presented).

BC22 However, the Board decided not to adopt the SIC-30 approach for the translation of comparatives for an entity whose functional currency is the currency of a hyperinflationary economy, and for which the comparative amounts are being translated into a presentation currency of a non-hyperinflationary economy. The Board noted that in such a case, the SIC-30 approach requires restating the comparative amounts from those shown in last year's financial statements for both the effects of inflation and for changes in exchange rates. If exchange rates fully reflect differing price levels between the two economies to which they relate, the SIC-30 approach will result in the same amounts for the comparatives as were reported as current year amounts in the prior year financial statements. Furthermore, the Board noted that in the prior year, the relevant amounts had been already expressed in the non-hyperinflationary presentation currency, and there was no reason to change them. For these reasons the Board decided to require that all comparative amounts are those presented in the prior year financial statements (ie there is no adjustment for either subsequent changes in the price level or subsequent changes in exchange rates).

BC23 The Board decided to incorporate into the Standard most of the disclosure requirements of SIC-30 *Reporting Currency–Translation from Measurement Currency to Presentation Currency* that apply when a different translation method is used or other supplementary information, such as an extract from the full financial statements, is displayed in a currency other than the functional currency (see paragraph 57 of the Standard). These disclosures enable users to distinguish information prepared in accordance with IFRSs from information that may be useful to users but is not the subject of IFRSs, and also tell users how the latter information has been prepared.

Capitalisation of exchange differences

BC24 The previous version of IAS 21 allowed a limited choice of accounting for exchange differences that arise 'from a severe devaluation or depreciation of a currency against which there is no practical means of hedging and that affects liabilities which cannot be settled and which arise directly on the recent acquisition of an asset'[*]. The benchmark treatment was to recognise such exchange differences in profit or loss. The allowed alternative was to recognise them as an asset.

BC25 The Board noted that the allowed alternative (of recognition as an asset) was not in accordance with the *Framework for the Preparation and Presentation of Financial Statements*[#] because exchange losses do not meet the definition of an asset. Moreover, recognition of exchange losses as an asset is neither allowed nor required by any liaison standard-setter, so its deletion would improve convergence. Finally, in many cases when the conditions for recognition as an asset are met, the asset would be restated in accordance with IAS 29 *Financial Reporting in Hyperinflationary Economies*. Thus, to the extent that an exchange loss reflects hyperinflation, this effect is taken into account by IAS 29. For all of these reasons, the Board removed the allowed alternative treatment and the related SIC Interpretation is superseded.

[*] IAS 21 (revised 1993), paragraph 21

[#] ~~In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.~~The reference is to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the Board in 2001 and in effect when the Standard was revised.

HKAS 28 (2011)
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Hong Kong Accounting Standard 28 (2011)

Investments in Associates and Joint Ventures

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

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

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

Using appropriate assumptions, both methods give the same result.

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

Separate financial statements

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

Effective date and transition

45 An entity shall apply this Standard for annual periods beginning on or after 1 January 2013. Earlier application is permitted. If an entity applies this Standard earlier, it shall disclose that fact and apply HKFRS 10, HKFRS 11 *Joint Arrangements*, HKFRS 12 *Disclosure of Interests in Other Entities* and HKAS 27 (as amended in 2011) at the same time.

45A HKFRS 9, as issued in September 2014, amended paragraphs 40-42 and added paragraphs 41A-41C. An entity shall apply those amendments when it applies HKFRS 9.

45B *Equity Method in Separate Financial Statements* (Amendments to HKAS 27), issued in September 2014, amended paragraph 25. An entity shall apply that amendment for annual periods beginning on or after 1 January 2016 retrospectively in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Earlier application is permitted. If an entity applies that amendment for an earlier period, it shall disclose that fact.

45C *[This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]*

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

BC29 The Board also noted that retaining the characterisation of significant economic event in the case of loss of joint control or significant influence when the retained interest is a financial asset is unnecessary. IFRS 9 already requires that in such cases the retained interest (ie a financial asset) must be measured at fair value.

BC30 In the case of loss of joint control when significant influence is maintained, the Board acknowledged that the investor-investee relationship changes and, consequently, so does the nature of the investment. However, in this instance, both investments (ie the joint venture and the associate) continue to be measured using the equity method. Considering that there is neither a change in the group boundaries nor a change in the measurement requirements, the Board concluded that losing joint control and retaining significant influence is not an event that warrants remeasurement of the retained interest at fair value.

BC31 Consequently, the Board removed all descriptions that characterise loss of joint control or significant influence as a significant economic event as introduced in the second phase of the Board's project on business combinations.

Incorporation of SIC-13

BC32 In the joint ventures project, the Board decided to extend the requirements and guidance in IAS 28 for the accounting for 'downstream' and 'upstream' transactions between an entity and its associate to the accounting for transactions between an entity and its joint venture.

BC33 In ED 9, the Board proposed to incorporate into the standard on joint arrangements the consensus of SIC-13 *Jointly Controlled Entities—Non-Monetary Contributions by Venturers*. Because the Board relocated all the requirements for the accounting for joint ventures into IAS 28, the Board incorporated the consensus of SIC-13 into IAS 28 and extended it to associates.

BC34 The Board noted that the consensus of SIC-13 regarding non-monetary contributions made by a venturer[3] to a joint venture is consistent with IAS 28, except for the following aspect. SIC-13 established three exceptions for the recognition of gains or losses attributable to the equity interests of the other parties. In response to comments raised by some respondents to ED 9, the Board redeliberated the need to incorporate into IAS 28 the exceptions included in SIC-13 for the recognition by an entity of the portion of a gain or loss attributable to the interests of other unrelated investors in the investee.

BC35 The Board concluded that only when the transaction lacks commercial substance should there be an exception for the recognition of gains or losses to be carried forward from the consensus of SIC-13 into IAS 28, because the other two exceptions in SIC-13 (ie 'the significant risks and rewards of ownership of the contributed non-monetary asset(s) have not been transferred to the jointly controlled entity' and 'the gain or loss on the non-monetary contribution cannot be measured reliably') either relate to requirements that are not aligned with the principles and requirements of IFRS 11 or relate to a criterion for the recognition of gain or losses (ie 'reliability of measurement') that is already included in the *Conceptual Framework for Financial Reporting*[4].

BCZ36 To the extent that the entity also receives monetary or non-monetary assets dissimilar to the assets contributed in addition to equity interests in the investee, the realisation of which is not dependent on the future cash flows of the investee, the earnings process is complete. Accordingly, an entity should recognise in full in profit or loss the portion of the gain or loss on the non-monetary contribution relating to the monetary or non-monetary assets received.

BC37 Additionally, the Board considered whether the requirements in IAS 31 for recognition of losses when downstream or upstream transactions provide evidence of a reduction in the net

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

[4] The reference is to the *Conceptual Framework for Financial Reporting*, issued in 2010 and in effect when the Standard was amended.

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

Recognition of losses (2003 revision)

BCZ38 The 2000 version of IAS 28 and SIC-20 *Equity Accounting Method—Recognition of Losses* restricted application of the equity method when, in accounting for the entity's share of losses, the carrying amount of the investment is reduced to zero.

BCZ39 The Board decided that the base to be reduced to zero should be broader than residual equity interests and should also include other non-equity interests that are in substance part of the net investment in the associate or joint venture, such as long-term receivables. Therefore, the Board decided to withdraw SIC-20.

BCZ40 The Board also noted that if non-equity investments are not included in the base to be reduced to zero, an entity could restructure its investment to fund the majority in non-equity investments to avoid recognising the losses of the associate or joint venture under the equity method.

BCZ41 In widening the base against which losses are to be recognised, the Board also clarified the application of the impairment provisions of IAS 39 *Financial Instruments: Recognition and Measurement*[5] to the financial assets that form part of the net investment.

Impairment losses (2008 amendment)

BCZ42 In 2008 the Board identified unclear guidance in IAS 28 regarding the extent to which an impairment reversal should be recognised as an adjustment to the carrying amount of an investment in an associate or in a joint venture.

BCZ43 The Board noted that applying the equity method involves adjusting the entity's share of the impairment loss recognised by the associate or joint venture on assets such as goodwill or property, plant and equipment to take account of the acquisition date fair values of those assets. The Board proposed in the exposure draft *Improvements to International Financial Reporting Standards* published in October 2007 that an additional impairment recognised by the entity, after applying the equity method, should not be allocated to any asset, including goodwill, that forms part of the carrying amount of the investment. Therefore, such an impairment should be reversed in a subsequent period to the extent that the recoverable amount of the investment increases.

BCZ44 Some respondents to the exposure draft expressed the view that the proposed amendment was not consistent with IAS 39 (regarding reversal of an impairment loss on an available-for-sale equity instrument[6]), or with IAS 36 *Impairment of Assets* (regarding the allocation of an impairment loss to goodwill and any reversal of an impairment loss relating to goodwill).

BCZ45 In its redeliberations, the Board affirmed its previous decisions but, in response to the comments made, decided to clarify the reasons for the amendments. The Board decided that an entity should not allocate an impairment loss to any asset that forms part of the carrying amount of the investment in the associate or joint venture because the investment is the only asset that the entity controls and recognises.

BCZ46 The Board also decided that any reversal of this impairment loss should be recognised as an adjustment to the investment in the associate or joint venture to the extent that the recoverable amount of the investment increases. This requirement is consistent with IAS 36, which permits the reversal of impairment losses for assets other than goodwill. The Board did not propose to align the requirements for the reversal of an impairment loss with those in IAS 39[7] relating to equity instruments, because an entity recognises an impairment loss on an investment in an associate or joint venture in accordance with IAS 36, rather than in accordance with IAS 39.

[5] IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that previously were within the scope of IAS 39.
[6] IFRS 9 *Financial Instruments* eliminated the category of available-for-sale financial assets.
[7] IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applied to all items that previously were within the scope of IAS 39.

HKAS 32
Revised ~~September 2018~~July 2019

Effective for annual periods
beginning on or after 1 January 2005

Hong Kong Accounting Standard 32

Financial Instruments: Presentation

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

Definitions (see also paragraphs AG3-AG23)

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

A *financial instrument* is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

A *financial asset* is any asset that is:

(a) cash;

(b) an equity instrument of another entity;

(c) a contractual right:

(i) to receive cash or another financial asset from another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or

(d) a contract that will or may be settled in the entity's own equity instruments and is:

(i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or

(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include puttable financial instruments classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.

A *financial liability* is any liability that is:

(a) a contractual obligation:

(i) to deliver cash or another financial asset to another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or

(b) a contract that will or may be settled in the entity's own equity instruments and is:

(i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or

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(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Also, for these purposes the entity's own equity instruments do not include puttable financial instruments that are classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.

As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D.

An *equity instrument* is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

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

A *puttable instrument* is a financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset or is automatically put back to the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder.

12 The following terms are defined in Appendix A of HKFRS 9 or paragraph 9 of HKAS 39 *Financial Instruments: Recognition and Measurement* and are used in this Standard with the meaning specified in HKAS 39 and HKFRS 9.

- amortised cost of a financial asset or financial liability
- ~~available-for-sale financial assets~~
- derecognition
- derivative
- effective interest method
- ~~financial asset or financial liability at fair value through profit or loss~~
- financial guarantee contract
- financial liability at fair value through profit or loss
- firm commitment
- forecast transaction
- hedge effectiveness
- hedged item
- hedging instrument
- held for trading~~held-to-maturity investments~~
- ~~loans and receivables~~
- regular way purchase or sale
- transaction costs.

13 In this Standard, 'contract' and 'contractual' refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing.

14 In this Standard, 'entity' includes individuals, partnerships, incorporated bodies, trusts and government agencies.

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Treasury shares (see also paragraph AG36)

33 **If an entity reacquires its own equity instruments, those instruments ('treasury shares') shall be deducted from equity. No gain or loss shall be recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments. Such treasury shares may be acquired and held by the entity or by other members of the consolidated group. Consideration paid or received shall be recognised directly in equity.**

34 The amount of treasury shares held is disclosed separately either in the statement of financial position or in the notes, in accordance with HKAS 1 *Presentation of Financial Statements*. An entity provides disclosure in accordance with HKAS 24 *Related Party Disclosures* if the entity reacquires its own equity instruments from related parties.

Interest, dividends, losses and gains (see also paragraph AG37)

35 **Interest, dividends, losses and gains relating to a financial instrument or a component that is a financial liability shall be recognised as income or expense in profit or loss. Distributions to holders of an equity instrument shall be recognised~~debited~~ by the entity directly in~~to~~ equity~~, net of any related income tax benefit~~. Transaction costs of an equity transaction shall be accounted for as a deduction from equity~~, net of any related income tax benefit~~.**

35A Income tax relating to distributions to holders of an equity instrument and to transaction costs of an equity transaction shall be accounted for in accordance with HKAS 12 *Income Taxes.*

36 The classification of a financial instrument as a financial liability or an equity instrument determines whether interest, dividends, losses and gains relating to that instrument are recognised as income or expense in profit or loss. Thus, dividend payments on shares wholly recognised as liabilities are recognised as expenses in the same way as interest on a bond. Similarly, gains and losses associated with redemptions or refinancings of financial liabilities are recognised in profit or loss, whereas redemptions or refinancings of equity instruments are recognised as changes in equity. Changes in the fair value of an equity instrument are not recognised in the financial statements.

37 An entity typically incurs various costs in issuing or acquiring its own equity instruments. Those costs might include registration and other regulatory fees, amounts paid to legal, accounting and other professional advisers, printing costs and stamp duties. The transaction costs of an equity transaction are accounted for as a deduction from equity~~ (net of any related income tax benefit)~~ to the extent they are incremental costs directly attributable to the equity transaction that otherwise would have been avoided. The costs of an equity transaction that is abandoned are recognised as an expense.

38 Transaction costs that relate to the issue of a compound financial instrument are allocated to the liability and equity components of the instrument in proportion to the allocation of proceeds. Transaction costs that relate jointly to more than one transaction (for example, costs of a concurrent offering of some shares and a stock exchange listing of other shares) are allocated to those transactions using a basis of allocation that is rational and consistent with similar transactions.

39 The amount of transaction costs accounted for as a deduction from equity in the period is disclosed separately ~~under~~in accordance with HKAS 1. ~~The related amount of income taxes recognised directly in equity is included in the aggregate amount of current and deferred income tax credited or charged to equity that is disclosed under HKAS 12 *Income Taxes*.~~

40 Dividends classified as an expense may be presented in the statement(s) of profit or loss and other comprehensive income either with interest on other liabilities or as a separate item. In addition to the requirements of this Standard, disclosure of interest and dividends is subject to the requirements of HKAS 1 and HKFRS 7. In some circumstances, because of the differences between interest and dividends with respect to matters such as tax deductibility, it is desirable to disclose them separately in the statement(s) of profit or loss and other comprehensive income. Disclosures of the tax effects are made in accordance with HKAS 12.

41 Gains and losses related to changes in the carrying amount of a financial liability are recognised as income or expense in profit or loss even when they relate to an instrument that includes a right to the residual interest in the assets of the entity in exchange for cash or another financial asset (see paragraph 18(b)). Under HKAS 1 the entity presents any gain or loss arising from remeasurement of such an instrument separately in the statement of comprehensive income when it is relevant in explaining the entity's performance.

Offsetting a financial asset and a financial liability (see also paragraphs AG38A-AG38F and AG39)

42 A financial asset and a financial liability shall be offset and the net amount presented in the statement of financial position when, and only when, an entity:

(a) currently has a legally enforceable right to set off the recognised amounts; and

(b) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

In accounting for a transfer of a financial asset that does not qualify for derecognition, the entity shall not offset the transferred asset and the associated liability (see HKFRS 9 ~~HKAS 39~~, paragraph 3.2.22~~36~~).

43 This Standard requires the presentation of financial assets and financial liabilities on a net basis when doing so reflects an entity's expected future cash flows from settling two or more separate financial instruments. When an entity has the right to receive or pay a single net amount and intends to do so, it has, in effect, only a single financial asset or financial liability. In other circumstances, financial assets and financial liabilities are presented separately from each other consistently with their characteristics as resources or obligations of the entity. An entity shall disclose the information required in paragraphs 13B-13E of HKFRS 7 for recognised financial instruments that are within the scope of paragraph 13A of HKFRS 7.

44 Offsetting a recognised financial asset and a recognised financial liability and presenting the net amount differs from the derecognition of a financial asset or a financial liability. Although offsetting does not give rise to recognition of a gain or loss, the derecognition of a financial instrument not only results in the removal of the previously recognised item from the statement of financial position but also may result in recognition of a gain or loss.

45 A right of set-off is a debtor's legal right, by contract or otherwise, to settle or otherwise eliminate all or a portion of an amount due to a creditor by applying against that amount an amount due from the creditor. In unusual circumstances, a debtor may have a legal right to apply an amount due from a third party against the amount due to a creditor provided that there is an agreement between the three parties that clearly establishes the debtor's right of set-off. Because the right of set-off is a legal right, the conditions supporting the right may vary from one legal jurisdiction to another and the laws applicable to the relationships between the parties need to be considered.

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Revised ~~July 2019~~August 2020

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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(d) 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 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 Part A of the illustrative examples accompanying this Standard 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~~ defines material ~~if its omission or misstatement could influence the economic decisions of users of the financial statements. HKAS 1~~ information and requires separate disclosure of material items, including (for example) discontinued operations, and HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* 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 16A(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.

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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 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*),[*]~~ *Conceptual Framework for Financial Reporting* (*Conceptual Framework*), recognition is the ~~'~~process of ~~incorporating in the balance sheet or income statement~~ capturing, for inclusion in the statement of financial position or the statement(s) of financial performance, an item that meets the definition of one of the elements of the financial statements ~~an element and satisfies the criteria for recognition'~~. The definitions of assets, liabilities, income, and expenses are fundamental to recognition, 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 the end of an interim reporting period must represent an existing obligation at that date, just as it must 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*~~ *Conceptual Framework* does not allow the recognition of items in the ~~balance sheet~~ statement of financial position 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 16A(d) and 26 require, however, that the nature and amount of any significant changes in estimates be disclosed.

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

56 *Annual Improvements to HKFRSs 2012–2014 Cycle*, issued in October 2014, amended paragraph 16A. An entity shall apply that amendment retrospectively in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* for annual periods beginning on or after 1 January 2016. Earlier application is permitted. If an entity applies the amendment for an earlier period it shall disclose that fact.

57 *Disclosure Initiative* (Amendments to HKAS 1), issued in January 2015, amended paragraph 5. An entity shall apply that amendment for annual periods beginning on or after 1 January 2016. Earlier application of that amendment is permitted.

58 *Amendments to References to the Conceptual Framework in HKFRS Standards*, issued in 2018, amended paragraphs 31 and 33. An entity shall apply those amendments for annual periods beginning on or after 1 January 2020. Earlier application is permitted if at the same time an entity also applies all other amendments made by *Amendments to References to the Conceptual Framework in HKFRS Standards*. An entity shall apply the amendments to HKAS 34 retrospectively in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. However, if an entity determines that retrospective application would be impracticable or would involve undue cost or effort, it shall apply the amendments to HKAS 34 by reference to paragraphs 43–45 of this Standard and paragraphs 23–28, 50–53 and 54F of HKAS 8.

59 *Definition of Material* (Amendments to HKAS 1 and HKAS 8), issued in January 2019, amended paragraph 24. An entity shall apply those amendments prospectively for annual periods beginning on or after 1 January 2020. Earlier application is permitted. If an entity applies those amendments for an earlier period, it shall disclose that fact. An entity shall apply those amendments when it applies the amendments to the definition of material in paragraph 7 of HKAS 1 and paragraphs 5 and 6 of HKAS 8.

Other disclosures incorporated by cross-reference to information outside the interim financial statements

BC7 The Board received a request to clarify the meaning of disclosure of information ‘elsewhere in the interim financial report’ as used in IAS 34. The submitter noted that the definition of ‘interim financial report’ in paragraph 4 of IAS 34 was not sufficiently clear with respect to whether the interim financial report covers only the information reported under IFRS (meaning the IFRS interim financial statements) or whether it also includes management reports or other elements in addition to IFRS interim financial statements.

BC8 The Board observed that presenting information ‘elsewhere in the interim financial report’ in accordance with paragraph 16A of IAS 34 is unclear. In the Exposure Draft *Annual Improvements to IFRSs 2012–2014 Cycle* (the ‘2013 Annual Improvements Exposure Draft’), published in December 2013, the Board proposed to clarify that an entity discloses information elsewhere in the interim financial report when it incorporates disclosures by cross-reference to information in another statement. This information should be available to users of the interim financial statements on the same terms as the interim financial statements and at the same time.

BC9 Some respondents to the 2013 Annual Improvements Exposure Draft observed that the proposed amendment seemed to suggest that the interim financial report was not a single report and that, instead, it included multiple documents. In response to these comments, the Board observed that in accordance with paragraphs 4 and 8 of IAS 34, an interim financial report is a single report that includes a set of condensed financial statements and selected explanatory notes. The Board further clarified that the amendment is not extending the scope of the interim financial report, because the disclosures required in paragraph 16A(a)–(k) of IAS 34 are part of the selected explanatory notes (and therefore part of the interim financial report), even if they are presented in another statement, such as a management commentary or risk report. If they are not presented, the interim financial report would be incomplete.

BC10 In response to the comments received on the 2013 Annual Improvements Exposure Draft the Board decided to clarify what was meant by the requirement that disclosures incorporated by cross-reference should be made available ‘on the same terms’ as the financial statements. This means that users of the financial statements should have access to the referenced material on the same basis as they have for accessing the financial statements from where the reference is made.

Amended references to the *Conceptual Framework*

BC11 Following the issue of the revised *Conceptual Framework for Financial Reporting* in 2018 (2018 *Conceptual Framework*), the Board issued *Amendments to References to the Conceptual Framework in IFRS Standards*. In IAS 34, that document replaced references in paragraphs 31 and 33 to the *Framework for the Preparation and Presentation of Financial Statements* adopted by the Board in 2001 (*Framework*) with references to the 2018 *Conceptual Framework*, and updated a related quotation. The Board does not expect that replacement to have a significant effect on the application of the Standard because the Board made no significant changes to the aspects of recognition that those paragraphs refer to—that is, the importance of definitions for recognition.

BC12 *Amendments to References to the Conceptual Framework in IFRS Standards* also replaced the term ‘balance sheet’ with the term ‘statement of financial position’ in paragraphs 31 and 33 of IAS 34. The term ‘balance sheet’ had been replaced in IFRS Standards following the revision of IAS 1 *Presentation of Financial Statements* in 2007. However, paragraphs 31 and 33 of IAS 34 had not been amended then because the term was part of direct quotations from the *Framework*. Upon issuing the 2018 *Conceptual Framework*, the Board replaced the term ‘balance sheet’ in those paragraphs so that the terminology used in the 2018 *Conceptual Framework* and in IFRS Standards is consistent.

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 tax 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 *Conceptual 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 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 the end of 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.

[*] The reference to the *Conceptual Framework* is to the *Conceptual Framework for Financial Reporting*, issued in 2010.

HKAS 36 BC
Revised ~~September 2018~~August 2020

Basis for Conclusions on
Hong Kong Accounting Standard 36

Impairment of Assets

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BCZ183 Opponents of reversals of impairment losses argue that:

(a) reversals of impairment losses are contrary to the historical cost accounting system. When the carrying amount is reduced, recoverable amount becomes the new cost basis for an asset. Consequently, reversing an impairment loss is no different from revaluing an asset upward. Indeed, in many cases, recoverable amount is similar to the measurement basis used for the revaluation of an asset. Hence, reversals of impairment losses should be either prohibited or recognised directly in equity as a revaluation.

(b) reversals of impairment losses introduce volatility in reported earnings. Periodic, short-term income measurements should not be affected by unrealised changes in the measurement of a long-lived asset.

(c) the result of reversals of impairment losses would not be useful to users of financial statements since the amount of a reversal under IAS 36 is limited to an amount that does not increase the carrying amount of an asset above its depreciated historical cost. Neither the amount reversed nor the revised carrying amount have any information content.

(d) in many cases, reversals of impairment losses will result in the implicit recognition of internally generated goodwill.

(e) reversals of impairment losses open the door to abuse and income ‘smoothing’ in practice.

(f) follow-up to verify whether an impairment loss needs to be reversed is costly.

BCZ184 IASC’s reasons for requiring reversals of impairment losses were the following:

(a) it is consistent with the *Framework*[#] and the view that future economic benefits that were not previously expected to flow from an asset have been reassessed as probable.

(b) a reversal of an impairment loss is not a revaluation and is consistent with the historical cost accounting system as long as the reversal does not result in the carrying amount of an asset exceeding its original cost less amortisation/depreciation, had the impairment loss not been recognised. Accordingly, the reversal of an impairment loss should be recognised in the income statement and any amount in excess of the depreciated historical cost should be accounted for as a revaluation.

(c) impairment losses are recognised and measured based on estimates. Any change in the measurement of an impairment loss is similar to a change in estimate. IAS 8 *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies*[*] requires that a change in accounting estimate should be included in the determination of the net profit or loss in (a) the period of the change, if the change affects the period only, or (b) the period of the change and future periods, if the change affects both.

[#] ~~The reference~~ References to the *Framework* in this Basis for Conclusions ~~is~~are to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the ~~IASB~~Board in 2001 and in effect when the Standard was developed and revised. ~~In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.~~

[*] IAS 8 *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies* was superseded in 2003 by IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

(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.

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

HKAS 37
Revised ~~June 2020~~August 2020

Effective for annual periods
beginning on or after 1 January 2005

Hong Kong Accounting Standard 37

Provisions, Contingent Liabilities and Contingent Assets

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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

[*] The definition of a liability in this Standard was not revised following the revision of the definition of a liability in the *Conceptual Framework for Financial Reporting* issued in 2018.

(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 end of the reporting period 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) 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 reporting period, disclosure is required under HKAS 10 *Events after the Reporting Period*, if the restructuring is material and non-disclosure could reasonably be expected to influence ~~the economic~~ decisions that the primary users of general purpose financial statements make on the basis of ~~the~~those financial statements, which provide financial information about a specific reporting entity.

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.

97 [Not used]

98 [Not used]

99 *Annual Improvements to HKFRSs 2010–2012 Cycle*, issued in January 2014, amended paragraph 5 as a consequential amendment derived from the amendment to HKFRS 3. An entity shall apply that amendment prospectively to business combinations to which the amendment to HKFRS 3 applies.

100 HKFRS 15 *Revenue from Contracts with Customers*, issued in July 2014, amended paragraph 5 and deleted paragraph 6. An entity shall apply those amendments when it applies HKFRS 15.

101 HKFRS 9, as issued in September 2014, amended paragraph 2 and deleted paragraphs 97 and 98. An entity shall apply those amendments when it applies HKFRS 9.

102 HKFRS 16, issued in May 2016, amended paragraph 5. An entity shall apply that amendment when it applies HKFRS 16.

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

104 *Definition of Material* (Amendments to HKAS 1 and HKAS 8), issued in January 2019, amended paragraph 75. An entity shall apply those amendments prospectively for annual periods beginning on or after 1 January 2020. Earlier application is permitted. If an entity applies those amendments for an earlier period, it shall disclose that fact. An entity shall apply those amendments when it applies the amendments to the definition of material in paragraph 7 of HKAS 1 and paragraphs 5 and 6 of HKAS 8.

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Example 8 An onerous contract

[Deleted]

Example 8A - An onerous contract

[Deleted]~~Same facts as example 8 except that the old factory can be used as a temporary godown generating a low level of income.~~

~~**Conclusion** - A provision is recognised for the best estimate of the net amount of the unavoidable lease costs i.e. the gross unavoidable lease costs less the probable net revenue expected from the godown operations (see paragraph 5(c), 14 and 66).~~

Example 9 A single guarantee

[Deleted]

HKAS 38
Revised ~~July 2019~~August 2020

Effective for annual periods
beginning on or after 1 January 2005

Hong Kong Accounting Standard 38

Intangible Assets

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

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.

* The definition of an asset in this Standard was not revised following the revision of the definition of an asset in the *Conceptual Framework for Financial Reporting* issued in 2018.

HKAS 38 BC
Revised ~~July 2019~~August 2020

Basis for Conclusions on
Hong Kong Accounting Standard 38

Intangible Assets

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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 [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.

---

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

References to the *Framework* in this Basis for Conclusions are to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the ~~IASB~~Board in 2001 and in effect when the Standard was developed and revised.~~ In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.~~

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

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*[ƛ], 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.

[ƛ] ~~now paragraph 4.38 of the *Conceptual Framework*~~

[*] 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.

[#] IFRS 13, issued in May 2011, defines an active market.

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*[ε] 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.

ε ~~The references~~ References to the *Framework* in this Dissent are to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the ~~IASB~~Board in 2001 and in effect when the Standard was revised. ~~In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.~~

HKAS 39
Revised ~~November 2019~~August 2020

Hong Kong Accounting Standard 39

Financial Instruments: Recognition and Measurement

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Appendix B: Amendments to other pronouncements

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BASIS FOR CONCLUSIONS

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IMPLEMENTATION GUIDANCE

Hong Kong Accounting Standard 39 *Financial Instruments: Recognition and Measurement* (HKAS 39) is set out in paragraphs 2-109 and Appendices A -and ~~C~~B. All the paragraphs have equal authority. HKAS 39 should be read in the context of its objective and the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Conceptual Framework for Financial Reporting*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Introduction

The HKICPA decided to replace HKAS 39 *Financial Instruments: Recognition and Measurement* over a period of time. The first instalment, dealing with classification and measurement of financial assets, was issued as HKFRS 9 *Financial Instruments* in November 2009. The requirements for classification and measurement of financial liabilities and derecognition of financial assets and liabilities were added to HKFRS 9 in November 2010. Requirements for hedge accounting were added to HKFRS 9 in December 2013. The requirements for classification and measurement of financial assets were amended and the requirements for amortised cost measurement and impairment were added in September 2014. The International Accounting Standards Board is deliberating proposals on accounting for macro hedging and in April 2014 published a Discussion Paper *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging*.

HKFRS 9 permits an entity to choose as its accounting policy either to apply the hedge accounting requirements of HKFRS 9 or to continue to apply the hedge accounting requirements in HKAS 39. Consequently, although HKFRS 9 is effective (with limited exceptions for entities that issue insurance contracts and entities applying the HKFRS for Private Entities), HKAS 39, which now contains only its requirements for hedge accounting, also remains effective.

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Hong Kong Accounting Standard 39
Financial Instruments: Recognition and Measurement

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Scope

2 This Standard shall be applied by all entities to all financial instruments within the scope of HKFRS 9 *Financial Instruments* if, and to the extent that:

(a) HKFRS 9 permits the hedge accounting requirements of this Standard to be applied; and

(b) the financial instrument is part of a hedging relationship that qualifies for hedge accounting in accordance with this Standard.

2A-7 [Deleted]

Definitions

8 The terms defined in HKFRS 13, HKFRS 9 and HKAS 32 are used in this Standard with the meanings specified in Appendix A of HKFRS 13, Appendix A of HKFRS 9 and paragraph 11 of HKAS 32. HKFRS 13, HKFRS 9 and HKAS 32 define the following terms:

- amortised cost of a financial asset or financial liability
- derecognition
- derivative
- effective interest method
- effective interest rate
- equity instrument
- fair value
- financial asset
- financial instrument
- financial liability

and provides guidance on applying those definitions.

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

Definitions relating to hedge accounting

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

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

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

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

***Hedge effectiveness* is the degree to which changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument (see Appendix A paragraphs AG105-AG113A).**

10-70 [Deleted]

Hedging

71 If an entity applies HKFRS 9 and has not chosen as its accounting policy to continue to apply the hedge accounting requirements of this Standard (see paragraph 7.2.21 of HKFRS 9), it shall apply the hedge accounting requirements in Chapter 6 of HKFRS 9. However, for a fair value hedge of the interest rate exposure of a portion of a portfolio of financial assets or financial liabilities, an entity may, in accordance with paragraph 6.1.3 of HKFRS 9, apply the hedge accounting requirements in this Standard instead of those in HKFRS 9. In that case the entity must also apply the specific requirements for fair value hedge accounting for a portfolio hedge of interest rate risk (see paragraphs 81A, 89A and AG114-AG132).

Hedging instruments

Qualifying instruments

72 This Standard does not restrict the circumstances in which a derivative may be designated as a hedging instrument provided the conditions in paragraph 88 are met, except for some written options (see Appendix A paragraph AG94). However, a non-derivative financial asset or non-derivative financial liability may be designated as a hedging instrument only for a hedge of a foreign currency risk.

73 For hedge accounting purposes, only instruments that involve a party external to the reporting entity (ie external to the group or individual entity that is being reported on) can be designated as hedging instruments. Although individual entities within a consolidated group or divisions within an entity may enter into hedging transactions with other entities within the group or divisions within the entity, any such intragroup transactions are eliminated on consolidation. Therefore, such hedging transactions do not qualify for hedge accounting in the consolidated financial statements of the group. However, they may qualify for hedge accounting in the individual or separate financial statements of individual entities within the group provided that they are external to the individual entity that is being reported on.

Designation of hedging instruments

74 There is normally a single fair value measure for a hedging instrument in its entirety, and the factors that cause changes in fair value are co-dependent. Thus, a hedging relationship is designated by an entity for a hedging instrument in its entirety. The only exceptions permitted are:

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(a) separating the intrinsic value and time value of an option contract and designating as the hedging instrument only the change in intrinsic value of an option and excluding change in its time value; and

(b) separating the interest element and the spot price of a forward contract.

These exceptions are permitted because the intrinsic value of the option and the premium on the forward can generally be measured separately. A dynamic hedging strategy that assesses both the intrinsic value and time value of an option contract can qualify for hedge accounting.

75 A proportion of the entire hedging instrument, such as 50 per cent of the notional amount, may be designated as the hedging instrument in a hedging relationship. However, a hedging relationship may not be designated for only a portion of the time period during which a hedging instrument remains outstanding.

76 A single hedging instrument may be designated as a hedge of more than one type of risk provided that (a) the risks hedged can be identified clearly; (b) the effectiveness of the hedge can be demonstrated; and (c) it is possible to ensure that there is specific designation of the hedging instrument and different risk positions.

77 Two or more derivatives, or proportions of them, (or, in the case of a hedge of currency risk, two or more non-derivatives or proportions of them, or a combination of derivatives and non-derivatives or proportions of them), may be viewed in combination and jointly designated as the hedging instrument, including when the risk(s) arising from some derivatives offset(s) those arising from others. However, an interest rate collar or other derivative instrument that combines a written option and a purchased option does not qualify as a hedging instrument if it is, in effect, a net written option (for which a net premium is received). Similarly, two or more instruments (or proportions of them) may be designated as the hedging instrument only if none of them is a written option or a net written option.

Hedged items

Qualifying items

78 A hedged item can be a recognised asset or liability, an unrecognised firm commitment, a highly probable forecast transaction or a net investment in a foreign operation. The hedged item can be (a) a single asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation, (b) a group of assets, liabilities, firm commitments, highly probable forecast transactions or net investments in foreign operations with similar risk characteristics or (c) in a portfolio hedge of interest rate risk only, a portion of the portfolio of financial assets or financial liabilities that share the risk being hedged.

79 [Deleted]

80 For hedge accounting purposes, only assets, liabilities, firm commitments or highly probable forecast transactions that involve a party external to the entity can be designated as hedged items. It follows that hedge accounting can be applied to transactions between entities in the same group only in the individual or separate financial statements of those entities and not in the consolidated financial statements of the group, except for the consolidated financial statements of an investment entity, as defined in HKFRS 10, where transactions between an investment entity and its subsidiaries measured at fair value through profit or loss will not be eliminated in the consolidated financial statements. As an exception, the foreign currency risk of an intragroup monetary item (eg a payable/receivable between two subsidiaries) may qualify as a hedged item in the consolidated financial statements if it results in an exposure to foreign exchange rate gains or losses that are not fully eliminated on consolidation in accordance with HKAS 21 *The Effects of Changes in Foreign Exchange Rates*. In accordance with HKAS 21, foreign exchange rate gains and losses on intragroup monetary items are not fully eliminated on consolidation when the intragroup monetary item is transacted between two group entities that have different functional currencies. In addition, the foreign currency risk of a highly probable forecast intragroup transaction may qualify as a hedged item in consolidated financial statements provided that the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction and the foreign currency risk will affect consolidated profit or loss.

Designation of financial items as hedged items

81 If the hedged item is a financial asset or financial liability, it may be a hedged item with respect to the risks associated with only a portion of its cash flows or fair value (such as one or more selected contractual cash flows or portions of them or a percentage of the fair value) provided that effectiveness can be measured. For example, an identifiable and separately measurable portion of the interest rate exposure of an interest-bearing asset or interest-bearing liability may be designated as the hedged risk (such as a risk-free interest rate or benchmark interest rate component of the total interest rate exposure of a hedged financial instrument).

81A In a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities (and only in such a hedge), the portion hedged may be designated in terms of an amount of a currency (eg an amount of dollars, euro, pounds or rand) rather than as individual assets (or liabilities). Although the portfolio may, for risk management purposes, include assets and liabilities, the amount designated is an amount of assets or an amount of liabilities. Designation of a net amount including assets and liabilities is not permitted. The entity may hedge a portion of the interest rate risk associated with this designated amount. For example, in the case of a hedge of a portfolio containing prepayable assets, the entity may hedge the change in fair value that is attributable to a change in the hedged interest rate on the basis of expected, rather than contractual, repricing dates. When the portion hedged is based on expected repricing dates, the effect that changes in the hedged interest rate have on those expected repricing dates shall be included when determining the change in the fair value of the hedged item. Consequently, if a portfolio that contains prepayable items is hedged with a non-prepayable derivative, ineffectiveness arises if the dates on which items in the hedged portfolio are expected to prepay are revised, or actual prepayment dates differ from those expected.

Designation of non-financial items as hedged items

82 If the hedged item is a non-financial asset or non-financial liability, it shall be designated as a hedged item (a) for foreign currency risks, or (b) in its entirety for all risks, because of the difficulty of isolating and measuring the appropriate portion of the cash flows or fair value changes attributable to specific risks other than foreign currency risks.

Designation of groups of items as hedged items

83 Similar assets or similar liabilities shall be aggregated and hedged as a group only if the individual assets or individual liabilities in the group share the risk exposure that is designated as being hedged. Furthermore, the change in fair value attributable to the hedged risk for each individual item in the group shall be expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group of items.

84 Because an entity assesses hedge effectiveness by comparing the change in the fair value or cash flow of a hedging instrument (or group of similar hedging instruments) and a hedged item (or group of similar hedged items), comparing a hedging instrument with an overall net position (eg the net of all fixed rate assets and fixed rate liabilities with similar maturities), rather than with a specific hedged item, does not qualify for hedge accounting.

Hedge accounting

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

86 Hedging relationships are of three types:

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

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

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

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

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

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

(b) The hedge is expected to be highly effective (see Appendix A paragraphs AG105-AG113A) in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistently with the originally documented risk management strategy for that particular hedging relationship.

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

(d) The effectiveness of the hedge can be reliably measured, ie the fair value or cash flows of the hedged item that are attributable to the hedged risk and the fair value of the hedging instrument can be reliably measured.

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

Fair value hedges

89 If a fair value hedge meets the conditions in paragraph 88 during the period, it shall be accounted for as follows:

(a) the gain or loss from remeasuring the hedging instrument at fair value (for a derivative hedging instrument) or the foreign currency component of its carrying amount measured in accordance with HKAS 21 (for a non-derivative hedging instrument) shall be recognised in profit or loss; and

(b) the gain or loss on the hedged item attributable to the hedged risk shall adjust the carrying amount of the hedged item and be recognised in profit or loss. This applies if the hedged item is otherwise measured at cost. Recognition of the gain or loss attributable to the hedged risk in profit or loss applies if the hedged item is a financial asset measured at fair value through other comprehensive income in accordance with paragraph 4.1.2A of HKFRS 9.

89A For a fair value hedge of the interest rate exposure of a portion of a portfolio of financial assets or financial liabilities (and only in such a hedge), the requirement in paragraph 89(b) may be met by presenting the gain or loss attributable to the hedged item either:

(a) in a single separate line item within assets, for those repricing time periods for which the hedged item is an asset; or

(b) in a single separate line item within liabilities, for those repricing time periods for which the hedged item is a liability.

The separate line items referred to in (a) and (b) above shall be presented next to financial assets or financial liabilities. Amounts included in these line items shall be removed from the statement of financial position when the assets or liabilities to which they relate are derecognised.

90 If only particular risks attributable to a hedged item are hedged, recognised changes in the fair value of the hedged item unrelated to the hedged risk are recognised as set out in paragraph 5.7.1 of HKFRS 9.

91 An entity shall discontinue prospectively the hedge accounting specified in paragraph 89 if:

(a) the hedging instrument expires or is sold, terminated or exercised. For this purpose, the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such replacement or rollover is part of the entity's documented hedging strategy. Additionally, for this purpose there is not an expiration or termination of the hedging instrument if:

(i) as a consequence of laws or regulations or the introduction of laws or regulations, the parties to the hedging instrument agree that one or more clearing counterparties replace their original counterparty to become the new counterparty to each of the parties. For this purpose, a clearing counterparty is a central counterparty (sometimes called a 'clearing organisation' or 'clearing agency') or an entity or entities, for example, a clearing member of a clearing organisation or a client of a clearing member of a clearing organisation, that are acting as counterparty in order to effect clearing by a central counterparty. However, when the parties to the hedging instrument replace their original counterparties with different counterparties this paragraph shall apply only if each of those parties effects clearing with the same central counterparty.

(ii) other changes, if any, to the hedging instrument are limited to those that are necessary to effect such a replacement of the counterparty. Such changes are limited to those that are consistent with the terms that would be expected if the hedging instrument were originally cleared with the clearing counterparty. These changes include changes in the collateral requirements, rights to offset receivables and payables balances, and charges levied.

(b) the hedge no longer meets the criteria for hedge accounting in paragraph 88; or

(c) the entity revokes the designation.

92 Any adjustment arising from paragraph 89(b) to the carrying amount of a hedged financial instrument for which the effective interest method is used (or, in the case of a portfolio hedge of interest rate risk, to the separate line item in the statement of financial position described in paragraph 89A) shall be amortised to profit or loss. Amortisation may begin as soon as an adjustment exists and shall begin no later than when the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged. The adjustment is based on a recalculated effective interest rate at the date amortisation begins. However, if, in the case of a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities (and only in such a hedge), amortising using a recalculated effective interest rate is not practicable, the adjustment shall be amortised using a straight-line method. The adjustment shall be amortised fully by maturity of the financial instrument or, in the case of a portfolio hedge of interest rate risk, by expiry of the relevant repricing time period.

93 When an unrecognised firm commitment is designated as a hedged item, the subsequent cumulative change in the fair value of the firm commitment attributable to the hedged risk is recognised as an asset or liability with a corresponding gain or loss recognised in profit or loss (see paragraph 89(b)). The changes in the fair value of the hedging instrument are also recognised in profit or loss.

94 When an entity enters into a firm commitment to acquire an asset or assume a liability that is a hedged item in a fair value hedge, the initial carrying amount of the asset or liability that results from the entity meeting the firm commitment is adjusted to include the cumulative change in the fair value of the firm commitment attributable to the hedged risk that was recognised in the statement of financial position.

Cash flow hedges

95 If a cash flow hedge meets the conditions in paragraph 88 during the period, it shall be accounted for as follows:

(a) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge (see paragraph 88) shall be recognised in other comprehensive income; and

(b) the ineffective portion of the gain or loss on the hedging instrument shall be recognised in profit or loss.

96 More specifically, a cash flow hedge is accounted for as follows:

(a) the separate component of equity associated with the hedged item is adjusted to the lesser of the following (in absolute amounts):

(i) the cumulative gain or loss on the hedging instrument from inception of the hedge; and

(ii) the cumulative change in fair value (present value) of the expected future cash flows on the hedged item from inception of the hedge;

(b) any remaining gain or loss on the hedging instrument or designated component of it (that is not an effective hedge) is recognised in profit or loss; and

(c) if an entity's documented risk management strategy for a particular hedging relationship excludes from the assessment of hedge effectiveness a specific component of the gain or loss or related cash flows on the hedging instrument (see paragraphs 74, 75 and 88(a)), that excluded component of gain or loss is recognised in accordance with paragraph5.7.1 of HKFRS 9.

97 If a hedge of a forecast transaction subsequently results in the recognition of a financial asset or a financial liability, the associated gains or losses that were recognised in other comprehensive income in accordance with paragraph 95 shall be reclassified from equity to profit or loss as a reclassification adjustment (see HKAS 1 (as revised in 2007)) in the same period or periods during which the hedged forecast cash flows affect profit or loss (such as in the periods that interest income or interest expense is recognised). However, if an entity expects that all or a portion of a loss recognised in other comprehensive income will not be recovered in one or more future periods, it shall reclassify into profit or loss as a reclassification adjustment the amount that is not expected to be recovered.

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98 If a hedge of a forecast transaction subsequently results in the recognition of a non-financial asset or a non-financial liability, or a forecast transaction for a non-financial asset or non-financial liability becomes a firm commitment for which fair value hedge accounting is applied, then the entity shall adopt (a) or (b) below:

(a) It reclassifies the associated gains and losses that were recognised in other comprehensive income in accordance with paragraph 95 to profit or loss as a reclassification adjustment (see HKAS 1 (revised 2007)) in the same period or periods during which the asset acquired or liability assumed affects profit or loss (such as in the periods that depreciation expense or cost of sales is recognised). However, if an entity expects that all or a portion of a loss recognised in other comprehensive income will not be recovered in one or more future periods, it shall reclassify from equity to profit or loss as a reclassification adjustment the amount that is not expected to be recovered.

(b) It removes the associated gains and losses that were recognised in other comprehensive income in accordance with paragraph 95, and includes them in the initial cost or other carrying amount of the asset or liability.

99 An entity shall adopt either (a) or (b) in paragraph 98 as its accounting policy and shall apply it consistently to all hedges to which paragraph 98 relates.

100 For cash flow hedges other than those covered by paragraphs 97 and 98, amounts that had been recognised in other comprehensive income shall be reclassified from equity to profit or loss as a reclassification adjustment (see HKAS 1 (revised 2007)) in the same period or periods during which the hedged forecast cash flows affect profit or loss (for example, when a forecast sale occurs).

101 In any of the following circumstances an entity shall discontinue prospectively the hedge accounting specified in paragraphs 95-100:

(a) The hedging instrument expires or is sold, terminated or exercised. In this case, the cumulative gain or loss on the hedging instrument that has been recognised in other comprehensive income from the period when the hedge was effective (see paragraph 95(a)) shall remain separately in equity until the forecast transaction occurs. When the transaction occurs, paragraph 97, 98 or 100 applies. For the purpose of this subparagraph, the replacement or rollover of a hedging instrument into another hedging instrument is not an expiration or termination if such replacement or rollover is part of the entity 's documented hedging strategy. Additionally, for the purpose of this subparagraph there is not an expiration or termination of the hedging instrument if:

(i) as a consequence of laws or regulations or the introduction of laws or regulations, the parties to the hedging instrument agree that one or more clearing counterparties replace their original counterparty to become the new counterparty to each of the parties. For this purpose, a clearing counterparty is a central counterparty (sometimes called a 'clearing organisation' or 'clearing agency') or an entity or entities, for example, a clearing member of a clearing organisation or a client of a clearing member of a clearing organisation, that are acting as counterparty in order to effect clearing by a central counterparty. However, when the parties to the hedging instrument replace their original counterparties with different counterparties this paragraph shall apply only if each of those parties effects clearing with the same central counterparty.

(ii) **other changes, if any, to the hedging instrument are limited to those that are necessary to effect such a replacement of the counterparty. Such changes are limited to those that are consistent with the terms that would be expected if the hedging instrument were originally cleared with the clearing counterparty. These changes include changes in the collateral requirements, rights to offset receivables and payables balances, and charges levied.**

(b) **The hedge no longer meets the criteria for hedge accounting in paragraph 88. In this case, the cumulative gain or loss on the hedging instrument that has been recognised in other comprehensive income from the period when the hedge was effective (see paragraph 95(a)) shall remain separately in equity until the forecast transaction occurs. When the transaction occurs, paragraph 97, 98 or 100 applies.**

(c) **The forecast transaction is no longer expected to occur, in which case any related cumulative gain or loss on the hedging instrument that has been recognised in other comprehensive income from the period when the hedge was effective (see paragraph 95(a)) shall be reclassified from equity to profit or loss as a reclassification adjustment. A forecast transaction that is no longer highly probable (see paragraph 88(c)) may still be expected to occur.**

(d) **The entity revokes the designation. For hedges of a forecast transaction, the cumulative gain or loss on the hedging instrument that has been recognised in other comprehensive income from the period when the hedge was effective (see paragraph 95(a)) shall remain separately in equity until the forecast transaction occurs or is no longer expected to occur. When the transaction occurs, paragraph 97, 98 or 100 applies. If the transaction is no longer expected to occur, the cumulative gain or loss that had been recognised in other comprehensive income shall be reclassified from equity to profit or loss as a reclassification adjustment.**

Hedges of a net investment

102 Hedges of a net investment in a foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment (see HKAS 21), shall be accounted for similarly to cash flow hedges:

(a) **the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge (see paragraph 88) shall be recognised in other comprehensive income; and**

(b) **the ineffective portion shall be recognised in profit or loss.**

The gain or loss on the hedging instrument relating to the effective portion of the hedge that has been recognised in other comprehensive income shall be reclassified from equity to profit or loss as a reclassification adjustment (see HKAS 1 (revised 2007)) in accordance with paragraphs 48-49 of HKAS 21 on the disposal or partial disposal of the foreign operation.

Temporary exceptions from applying specific hedge accounting requirements

102A An entity shall apply paragraphs 102D–102N and 108G to all hedging relationships directly affected by interest rate benchmark reform. These paragraphs apply only to such hedging relationships. A hedging relationship is directly affected by interest rate benchmark reform only if the reform gives rise to uncertainties about:

(a) the interest rate benchmark (contractually or non-contractually specified) designated as a hedged risk; and/or

(b) the timing or the amount of interest rate benchmark-based cash flows of the hedged item or of the hedging instrument.

102B For the purpose of applying paragraphs 102D–102N, the term 'interest rate benchmark reform' refers to the market-wide reform of an interest rate benchmark, including the replacement of an interest rate benchmark with an alternative benchmark rate such as that resulting from the recommendations set out in the Financial Stability Board's July 2014 report 'Reforming Major Interest Rate Benchmarks'.[1]

102C Paragraphs 102D–102N provide exceptions only to the requirements specified in these paragraphs. An entity shall continue to apply all other hedge accounting requirements to hedging relationships directly affected by interest rate benchmark reform.

Highly probable requirement for cash flow hedges

102D For the purpose of applying the requirement in paragraph 88(c) that a forecast transaction must be highly probable, an entity shall assume that the interest rate benchmark on which the hedged cash flows (contractually or non-contractually specified) are based is not altered as a result of interest rate benchmark reform.

Reclassifying the cumulative gain or loss recognised in other comprehensive income

102E For the purpose of applying the requirement in paragraph 101(c) in order to determine whether the forecast transaction is no longer expected to occur, an entity shall assume that the interest rate benchmark on which the hedged cash flows (contractually or non-contractually specified) are based is not altered as a result of interest rate benchmark reform.

Effectiveness assessment

102F For the purpose of applying the requirements in paragraphs 88(b) and AG105(a), an entity shall assume that the interest rate benchmark on which the hedged cash flows and/or the hedged risk (contractually or non-contractually specified) are based, or the interest rate benchmark on which the cash flows of the hedging instrument are based, is not altered as a result of interest rate benchmark reform.

102G For the purpose of applying the requirement in paragraph 88(e), an entity is not required to discontinue a hedging relationship because the actual results of the hedge do not meet the requirements in paragraph AG105(b). For the avoidance of doubt, an entity shall apply the other conditions in paragraph 88, including the prospective assessment in paragraph 88(b), to assess whether the hedging relationship must be discontinued.

[1] The report, 'Reforming Major Interest Rate Benchmarks', is available at http://www.fsb.org/wp-content/uploads/r_140722.pdf.

Designating financial items as hedged items

102H Unless paragraph 102I applies, for a hedge of a non-contractually specified benchmark portion of interest rate risk, an entity shall apply the requirement in paragraphs 81 and AG99F—that the designated portion shall be separately identifiable—only at the inception of the hedging relationship.

102I When an entity, consistent with its hedge documentation, frequently resets (ie discontinues and restarts) a hedging relationship because both the hedging instrument and the hedged item frequently change (ie the entity uses a dynamic process in which both the hedged items and the hedging instruments used to manage that exposure do not remain the same for long), the entity shall apply the requirement in paragraphs 81 and AG99F—that the designated portion is separately identifiable—only when it initially designates a hedged item in that hedging relationship. A hedged item that has been assessed at the time of its initial designation in the hedging relationship, whether it was at the time of the hedge inception or subsequently, is not reassessed at any subsequent redesignation in the same hedging relationship.

End of application

102J An entity shall prospectively cease applying paragraph 102D to a hedged item at the earlier of:

(a) when the uncertainty arising from interest rate benchmark reform is no longer present with respect to the timing and the amount of the interest rate benchmark-based cash flows of the hedged item; and

(b) when the hedging relationship that the hedged item is part of is discontinued.

102K An entity shall prospectively cease applying paragraph 102E at the earlier of:

(a) when the uncertainty arising from interest rate benchmark reform is no longer present with respect to the timing and the amount of the interest rate benchmark-based future cash flows of the hedged item; and

(b) when the entire cumulative gain or loss recognised in other comprehensive income with respect to that discontinued hedging relationship has been reclassified to profit or loss.

102L An entity shall prospectively cease applying paragraph 102F:

(a) to a hedged item, when the uncertainty arising from interest rate benchmark reform is no longer present with respect to the hedged risk or the timing and the amount of the interest rate benchmark-based cash flows of the hedged item; and

(b) to a hedging instrument, when the uncertainty arising from interest rate benchmark reform is no longer present with respect to the timing and the amount of the interest rate benchmark-based cash flows of the hedging instrument.

If the hedging relationship that the hedged item and the hedging instrument are part of is discontinued earlier than the date specified in paragraph 102L(a) or the date specified in paragraph 102L(b), the entity shall prospectively cease applying paragraph 102F to that hedging relationship at the date of discontinuation.

102M An entity shall prospectively cease applying paragraph 102G to a hedging relationship at the earlier of:

(a) when the uncertainty arising from interest rate benchmark reform is no longer present with respect to the hedged risk and the timing and the amount of the interest rate benchmark-based cash flows of the hedged item or of the hedging instrument; and

(b) when the hedging relationship to which the exception is applied is discontinued.

102N When designating a group of items as the hedged item, or a combination of financial instruments as the hedging instrument, an entity shall prospectively cease applying paragraphs 102D–102G to an individual item or financial instrument in accordance with paragraphs 102J, 102K, 102L, or 102M, as relevant, when the uncertainty arising from interest rate benchmark reform is no longer present with respect to the hedged risk and/or the timing and the amount of the interest rate benchmark-based cash flows of that item or financial instrument.

Effective date and transitional provisions

103 An entity shall apply this Standard for annual periods beginning on or after 1 January 2005. Earlier application is permitted. An entity shall not apply this Standard for annual periods beginning before 1 January 2005 unless it also applies HKAS 32. If an entity applies this Standard for a period beginning before 1 January 2005, it shall disclose that fact. Except as provided for in paragraph~~s~~ 104 ~~and 105~~ below, retrospective application is not permitted.

103A [Deleted]

103B [Deleted]

103C HKAS 1 (as revised in 2007) amended the terminology used throughout HKFRSs. In addition it amended paragraphs 95(a), 97, 98, 100, 102, 108 and AG99B. An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. If an entity applies HKAS 1 (revised 2007) for an earlier period, the amendments shall be applied for that earlier period.

103D [Deleted]

103E HKAS 27 (as amended in 2008) amended paragraph 102. An entity shall apply that amendment for annual periods beginning on or after 1 July 2009. If an entity applies HKAS 27 (amended 2008) for an earlier period, the amendment shall be applied for that earlier period.

103F [Deleted]

103G An entity shall apply paragraphs AG99BA, AG99E, AG99F, AG110A and AG110B retrospectively for annual periods beginning on or after 1 July 2009, in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Earlier application is permitted. If an entity applies *Eligible Hedged Items* (Amendment to HKAS 39) for periods beginning before 1 July 2009, it shall disclose that fact.

103H-103J [Deleted]

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

103L-103P [Deleted]

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

103R *Investment Entities* (Amendments to HKFRS 10, HKFRS 12 and HKAS 27), issued in December 2012, amended paragraphs 2 and 80. An entity shall apply those amendments for annual periods beginning on or after 1 January 2014. Earlier application of *Investment Entities* is permitted. If an entity applies those amendments earlier it shall also apply all amendments included in *Investment Entities* at the same time.

103S [Deleted]

103T HKFRS 15 *Revenue from Contracts with Customers*, issued in July 2014, amended paragraphs 2, 9, 43, 47, 55, AG2, AG4 and AG48 and added paragraphs 2A, 44A, 55A and AG8A–AG8C. An entity shall apply those amendments when it applies HKFRS 15.

103U HKFRS 9, as issued in September 2014, amended paragraphs 2, 8, 9, 71, ~~89~~88-90, 96, 104 AG95, AG114, AG118 and the headings above AG133 and deleted paragraphs 1, 2A, 4–7, 10–70, 103B, 103D, 103F, 103H–103J, 103L–103P, 103S, 105–107A, 108E–108F, AG1–AG93 and AG96. An entity shall apply those amendments when it applies HKFRS 9.

104 **The transition to this Standard should be as follows:**

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

(b) **[Deleted]**

(c) **[Deleted]**

(d) **at the beginning of the financial year in which this Standard is initially applied, any balance sheet positions in fair value hedges of existing assets and liabilities should be accounted for by adjusting their carrying amounts to reflect the fair value of the hedging instrument;**

(e) if an entity's hedge accounting policies prior to initial application of this Standard had included deferral, as assets and liabilities, of gains or losses on cash flow hedges, at the beginning of the financial year in which this Standard is initially applied, those deferred gains and losses should be reclassified as a separate component of equity to the extent that the transactions meet the criteria in paragraph 88 and, thereafter, accounted for as set out in paragraphs 97-100;

(f) transactions entered into before the beginning of the financial year in which this Standard is initially applied should not be retrospectively designated as hedges;

(g) [Deleted]

(h) [Deleted]

105-107A [Deleted]

108 [not used]

108A An entity shall apply the last sentence of paragraph 80, and paragraphs AG99A and AG99B, for annual periods beginning on or after 1 January 2006. Earlier application is encouraged. If an entity has designated as the hedged item an external forecast transaction that

(a) is denominated in the functional currency of the entity entering into the transaction,

(b) gives rise to an exposure that will have an effect on consolidated profit or loss (ie is denominated in a currency other than the group's presentation currency), and

(c) would have qualified for hedge accounting had it not been denominated in the functional currency of the entity entering into it,

it may apply hedge accounting in the consolidated financial statements in the period(s) before the date of application of the last sentence of paragraph 80, and paragraphs AG99A and AG99B.

108B An entity need not apply paragraph AG99B to comparative information relating to periods before the date of application of the last sentence of paragraph 80 and paragraph AG99A.

108C Paragraphs 73 and AG8 were amended by *Improvements to HKFRSs,* issued in October 2008. Paragraph 80 was amended by *Improvements to HKFRSs,* issued in May 2009. An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. Earlier application of all the amendments is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact.

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108D *Novation of Derivatives and Continuation of Hedge Accounting* (Amendments to HKAS 39), issued in July 2013, amended paragraphs 91 and 101 and added paragraph AG113A. An entity shall apply those paragraphs for annual periods beginning on or after 1 January 2014. An entity shall apply those amendments retrospectively in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Earlier application is permitted. If an entity applies those amendments for an earlier period it shall disclose that fact.

108E-108F [Deleted]

108G *Interest Rate Benchmark Reform*, which amended HKFRS 9, HKAS 39 and HKFRS 7, issued in November 2019, added paragraphs 102A–102N. An entity shall apply these amendments for annual periods beginning on or after 1 January 2020. Earlier application is permitted. If an entity applies these amendments for an earlier period, it shall disclose that fact. An entity shall apply these amendments retrospectively to those hedging relationships that existed at the beginning of the reporting period in which an entity first applies these amendments or were designated thereafter, and to the gain or loss recognised in other comprehensive income that existed at the beginning of the reporting period in which an entity first applies these amendments.

Withdrawal of other pronouncements

109 This Standard supersedes SSAP 24 *Accounting for Investments in Securities*.

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Appendix
Comparison with International Accounting Standards

This comparison appendix, which was prepared as at 20 April 2004 and deals only with significant differences in the standards extant, is produced for information only and does not form part of the standards in HKAS 39.

The International Accounting Standard comparable with HKAS 39 is IAS 39, *Financial Instruments: Recognition and Measurement*.

There are no major textual differences between HKAS 39 and IAS 39.

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Appendix A
Application guidance

This appendix is an integral part of the Standard.

AG1-AG93 [Deleted]

Hedging (paragraphs 71-102)

Hedging instruments (paragraphs 72-77)

Qualifying instruments (paragraphs 72 and 73)

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

AG95 A financial asset measured at amortised cost may be designated as a hedging instrument in a hedge of foreign currency risk.

AG96 [Deleted]

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

Hedged items (paragraphs 78-84)

Qualifying items (paragraphs 78-80)

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

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

AG99A Paragraph 80 states that in consolidated financial statements the foreign currency risk of a highly probable forecast intragroup transaction may qualify as a hedged item in a cash flow hedge, provided the transaction is denominated in a currency other than the functional currency of the entity entering into that transaction and the foreign currency risk will affect consolidated profit or loss. For this purpose an entity can be a parent, subsidiary, associate, joint venture or branch. If the foreign currency risk of a forecast intragroup transaction does not affect consolidated profit or loss, the intragroup transaction cannot qualify as a hedged item. This is usually the case for royalty payments, interest payments or management charges between members of the same group unless there is a related external transaction. However, when the foreign currency risk of a forecast intragroup transaction will affect consolidated profit or loss, the intragroup transaction can qualify as a hedged item. An example is forecast sales or purchases of inventories between members of the same group if there is an onward sale of the inventory to a party external to the group. Similarly, a forecast intragroup sale of plant and equipment from the group entity that manufactured it to a group entity that will use the plant and equipment in its operations may affect consolidated profit or loss. This could occur, for example, because the plant and equipment will be depreciated by the purchasing entity and the amount initially recognised for the plant and equipment may change if the forecast intragroup transaction is denominated in a currency other than the functional currency of the purchasing entity.

AG99B If a hedge of a forecast intragroup transaction qualifies for hedge accounting, any gain or loss that is recognised in other comprehensive income in accordance with paragraph 95(a) shall be reclassified from equity to profit or loss as a reclassification adjustment in the same period or periods during which the foreign currency risk of the hedged transaction affects consolidated profit or loss.

AG99BA An entity can designate all changes in the cash flows or fair value of a hedged item in a hedging relationship. An entity can also designate only changes in the cash flows or fair value of a hedged item above or below a specified price or other variable (a one-sided risk). The intrinsic value of a purchased option hedging instrument (assuming that it has the same principal terms as the designated risk), but not its time value, reflects a one-sided risk in a hedged item. For example, an entity can designate the variability of future cash flow outcomes resulting from a price increase of a forecast commodity purchase. In such a situation, only cash flow losses that result from an increase in the price above the specified level are designated. The hedged risk does not include the time value of a purchased option because the time value is not a component of the forecast transaction that affects profit or loss (paragraph 86(b)).

Designation of financial items as hedged items (paragraphs 81 and 81A)

AG99C If a portion of the cash flows of a financial asset or financial liability is designated as the hedged item, that designated portion must be less than the total cash flows of the asset or liability. For example, in the case of a liability whose effective interest rate is below LIBOR, an entity cannot designate (a) a portion of the liability equal to the principal amount plus interest at LIBOR and (b) a negative residual portion. However, the entity may designate all of the cash flows of the entire financial asset or financial liability as the hedged item and hedge them for only one particular risk (eg only for changes that are attributable to changes in LIBOR). For example, in the case of a financial liability whose effective interest rate is 100 basis points below LIBOR, an entity can designate as the hedged item the entire liability (ie principal plus interest at LIBOR minus 100 basis points) and hedge the change in the fair value or cash flows of that entire liability that is attributable to changes in LIBOR. The entity may also choose a hedge ratio of other than one to one in order to improve the effectiveness of the hedge as described in paragraph AG100.

AG99D In addition, if a fixed rate financial instrument is hedged some time after its origination and interest rates have changed in the meantime, the entity can designate a portion equal to a benchmark rate that is higher than the contractual rate paid on the item. The entity can do so provided that the benchmark rate is less than the effective interest rate calculated on the assumption that the entity had purchased the instrument on the day it first designates the hedged item. For example, assume an entity originates a fixed rate financial asset of CU100 that has an effective interest rate of 6 per cent at a time when LIBOR is 4 per cent. It begins to hedge that asset some time later when LIBOR has increased to 8 per cent and the fair value of the asset has decreased to CU90. The entity calculates that if it had purchased the asset on the date it first designates it as the hedged item for its then fair value of CU90, the effective yield would have been 9.5 per cent. Because LIBOR is less than this effective yield, the entity can designate a LIBOR portion of 8 per cent that consists partly of the contractual interest cash flows and partly of the difference between the current fair value (ie CU90) and the amount repayable on maturity (ie CU100).

AG99E Paragraph 81 permits an entity to designate something other than the entire fair value change or cash flow variability of a financial instrument. For example:

(a) all of the cash flows of a financial instrument may be designated for cash flow or fair value changes attributable to some (but not all) risks; or

(b) some (but not all) of the cash flows of a financial instrument may be designated for cash flow or fair value changes attributable to all or only some risks (ie a 'portion' of the cash flows of the financial instrument may be designated for changes attributable to all or only some risks).

AG99F To be eligible for hedge accounting, the designated risks and portions must be separately identifiable components of the financial instrument, and changes in the cash flows or fair value of the entire financial instrument arising from changes in the designated risks and portions must be reliably measurable. For example:

(a) for a fixed rate financial instrument hedged for changes in fair value attributable to changes in a risk-free or benchmark interest rate, the risk-free or benchmark rate is normally regarded as both a separately identifiable component of the financial instrument and reliably measurable.

(b) inflation is not separately identifiable and reliably measurable and cannot be designated as a risk or a portion of a financial instrument unless the requirements in (c) are met.

(c) a contractually specified inflation portion of the cash flows of a recognised inflation-linked bond (assuming there is no requirement to account for an embedded derivative separately) is separately identifiable and reliably measurable as long as other cash flows of the instrument are not affected by the inflation portion.

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Designation of non-financial items as hedged items (paragraph 82)

AG100 Changes in the price of an ingredient or component of a non-financial asset or non-financial liability generally do not have a predictable, separately measurable effect on the price of the item that is comparable to the effect of, say, a change in market interest rates on the price of a bond. Thus, a non-financial asset or non-financial liability is a hedged item only in its entirety or for foreign exchange risk. If there is a difference between the terms of the hedging instrument and the hedged item (such as for a hedge of the forecast purchase of Brazilian coffee using a forward contract to purchase Colombian coffee on otherwise similar terms), the hedging relationship nonetheless can qualify as a hedge relationship provided all the conditions in paragraph 88 are met, including that the hedge is expected to be highly effective. For this purpose, the amount of the hedging instrument may be greater or less than that of the hedged item if this improves the effectiveness of the hedging relationship. For example, a regression analysis could be performed to establish a statistical relationship between the hedged item (eg a transaction in Brazilian coffee) and the hedging instrument (eg a transaction in Colombian coffee). If there is a valid statistical relationship between the two variables (ie between the unit prices of Brazilian coffee and Colombian coffee), the slope of the regression line can be used to establish the hedge ratio that will maximise expected effectiveness. For example, if the slope of the regression line is 1.02, a hedge ratio based on 0.98 quantities of hedged items to 1.00 quantities of the hedging instrument maximises expected effectiveness. However, the hedging relationship may result in ineffectiveness that is recognised in profit or loss during the term of the hedging relationship.

Designation of groups of items as hedged items (paragraphs 83 and 84)

AG101 A hedge of an overall net position (eg the net of all fixed rate assets and fixed rate liabilities with similar maturities), rather than of a specific hedged item, does not qualify for hedge accounting. However, almost the same effect on profit or loss of hedge accounting for this type of hedging relationship can be achieved by designating as the hedged item part of the underlying items. For example, if a bank has CU100 of assets and CU90 of liabilities with risks and terms of a similar nature and hedges the net CU10 exposure, it can designate as the hedged item CU10 of those assets. This designation can be used if such assets and liabilities are fixed rate instruments, in which case it is a fair value hedge, or if they are variable rate instruments, in which case it is a cash flow hedge. Similarly, if an entity has a firm commitment to make a purchase in a foreign currency of CU100 and a firm commitment to make a sale in the foreign currency of CU90, it can hedge the net amount of CU10 by acquiring a derivative and designating it as a hedging instrument associated with CU10 of the firm purchase commitment of CU100.

Hedge accounting (paragraphs 85-102)

AG102 An example of a fair value hedge is a hedge of exposure to changes in the fair value of a fixed rate debt instrument as a result of changes in interest rates. Such a hedge could be entered into by the issuer or by the holder.

AG103 An example of a cash flow hedge is the use of a swap to change floating rate debt to fixed rate debt (ie a hedge of a future transaction where the future cash flows being hedged are the future interest payments).

AG104 A hedge of a firm commitment (eg a hedge of the change in fuel price relating to an unrecognised contractual commitment by an electric utility to purchase fuel at a fixed price) is a hedge of an exposure to a change in fair value. Accordingly, such a hedge is a fair value hedge. However, under paragraph 87 a hedge of the foreign currency risk of a firm commitment could alternatively be accounted for as a cash flow hedge.

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Assessing hedge effectiveness

AG105 A hedge is regarded as highly effective only if both of the following conditions are met:

(a) At the inception of the hedge and in subsequent periods, the hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated. Such an expectation can be demonstrated in various ways, including a comparison of past changes in the fair value or cash flows of the hedged item that are attributable to the hedged risk with past changes in the fair value or cash flows of the hedging instrument, or by demonstrating a high statistical correlation between the fair value or cash flows of the hedged item and those of the hedging instrument. The entity may choose a hedge ratio of other than one to one in order to improve the effectiveness of the hedge as described in paragraph AG100.

(b) The actual results of the hedge are within a range of 80-125 per cent. For example, if actual results are such that the loss on the hedging instrument is CU120 and the gain on the cash instrument is CU100, offset can be measured by 120 / 100, which is 120 per cent, or by 100 / 120, which is 83 per cent. In this example, assuming the hedge meets the condition in (a) the entity would conclude that the hedge has been highly effective.

AG106 Effectiveness is assessed, at a minimum, at the time an entity prepares its annual or interim financial statements.

AG107 This Standard does not specify a single method for assessing hedge effectiveness. The method an entity adopts for assessing hedge effectiveness depends on its risk management strategy. For example, if the entity's risk management strategy is to adjust the amount of the hedging instrument periodically to reflect changes in the hedged position, the entity needs to demonstrate that the hedge is expected to be highly effective only for the period until the amount of the hedging instrument is next adjusted. In some cases, an entity adopts different methods for different types of hedges. An entity's documentation of its hedging strategy includes its procedures for assessing effectiveness. Those procedures state whether the assessment includes all of the gain or loss on a hedging instrument or whether the instrument's time value is excluded.

AG107A If an entity hedges less than 100 per cent of the exposure on an item, such as 85 per cent, it shall designate the hedged item as being 85 per cent of the exposure and shall measure ineffectiveness based on the change in that designated 85 per cent exposure. However, when hedging the designated 85 per cent exposure, the entity may use a hedge ratio of other than one to one if that improves the expected effectiveness of the hedge, as explained in paragraph AG100.

AG108 If the principal terms of the hedging instrument and of the hedged asset, liability, firm commitment or highly probable forecast transaction are the same, the changes in fair value and cash flows attributable to the risk being hedged may be likely to offset each other fully, both when the hedge is entered into and afterwards. For example, an interest rate swap is likely to be an effective hedge if the notional and principal amounts, term, repricing dates, dates of interest and principal receipts and payments, and basis for measuring interest rates are the same for the hedging instrument and the hedged item. In addition, a hedge of a highly probable forecast purchase of a commodity with a forward contract is likely to be highly effective if:

(a) the forward contract is for the purchase of the same quantity of the same commodity at the same time and location as the hedged forecast purchase;

(b) the fair value of the forward contract at inception is zero; and

(c) either the change in the discount or premium on the forward contract is excluded from the assessment of effectiveness and recognised in profit or loss or the change in expected cash flows on the highly probable forecast transaction is based on the forward price for the commodity.

AG109 Sometimes the hedging instrument offsets only part of the hedged risk. For example, a hedge would not be fully effective if the hedging instrument and hedged item are denominated in different currencies that do not move in tandem. Also, a hedge of interest rate risk using a derivative would not be fully effective if part of the change in the fair value of the derivative is attributable to the counterparty's credit risk.

AG110 To qualify for hedge accounting, the hedge must relate to a specific identified and designated risk, and not merely to the entity's general business risks, and must ultimately affect the entity's profit or loss. A hedge of the risk of obsolescence of a physical asset or the risk of expropriation of property by a government is not eligible for hedge accounting; effectiveness cannot be measured because those risks are not measurable reliably.

AG110A Paragraph 74(a) permits an entity to separate the intrinsic value and time value of an option contract and designate as the hedging instrument only the change in the intrinsic value of the option contract. Such a designation may result in a hedging relationship that is perfectly effective in achieving offsetting changes in cash flows attributable to a hedged one-sided risk of a forecast transaction, if the principal terms of the forecast transaction and hedging instrument are the same.

AG110B If an entity designates a purchased option in its entirety as the hedging instrument of a one-sided risk arising from a forecast transaction, the hedging relationship will not be perfectly effective. This is because the premium paid for the option includes time value and, as stated in paragraph AG99BA, a designated one-sided risk does not include the time value of an option. Therefore, in this situation, there will be no offset between the cash flows relating to the time value of the option premium paid and the designated hedged risk.

AG111 In the case of interest rate risk, hedge effectiveness may be assessed by preparing a maturity schedule for financial assets and financial liabilities that shows the net interest rate exposure for each time period, provided that the net exposure is associated with a specific asset or liability (or a specific group of assets or liabilities or a specific portion of them) giving rise to the net exposure, and hedge effectiveness is assessed against that asset or liability.

AG112 In assessing the effectiveness of a hedge, an entity generally considers the time value of money. The fixed interest rate on a hedged item need not exactly match the fixed interest rate on a swap designated as a fair value hedge. Nor does the variable interest rate on an interest-bearing asset or liability need to be the same as the variable interest rate on a swap designated as a cash flow hedge. A swap's fair value derives from its net settlements. The fixed and variable rates on a swap can be changed without affecting the net settlement if both are changed by the same amount.

AG113 If an entity does not meet hedge effectiveness criteria, the entity discontinues hedge accounting from the last date on which compliance with hedge effectiveness was demonstrated. However, if the entity identifies the event or change in circumstances that caused the hedging relationship to fail the effectiveness criteria, and demonstrates that the hedge was effective before the event or change in circumstances occurred, the entity discontinues hedge accounting from the date of the event or change in circumstances.

AG113A For the avoidance of doubt, the effects of replacing the original counterparty with a clearing counterparty and making the associated changes as described in paragraphs 91(a)(ii) and 101(a)(ii) shall be reflected in the measurement of the hedging instrument and therefore in the assessment of hedge effectiveness and the measurement of hedge effectiveness.

Fair value hedge accounting for a portfolio hedge of interest rate risk

AG114 For a fair value hedge of interest rate risk associated with a portfolio of financial assets or financial liabilities, an entity would meet the requirements of this Standard if it complies with the procedures set out in (a)-(i) and paragraphs AG115-AG132 below.

(a) As part of its risk management process the entity identifies a portfolio of items whose interest rate risk it wishes to hedge. The portfolio may comprise only assets, only liabilities or both assets and liabilities. The entity may identify two or more portfolios, in which case it applies the guidance below to each portfolio separately.

(b) The entity analyses the portfolio into repricing time periods based on expected, rather than contractual, repricing dates. The analysis into repricing time periods may be performed in various ways including scheduling cash flows into the periods in which they are expected to occur, or scheduling notional principal amounts into all periods until repricing is expected to occur.

(c) On the basis of this analysis, the entity decides the amount it wishes to hedge. The entity designates as the hedged item an amount of assets or liabilities (but not a net amount) from the identified portfolio equal to the amount it wishes to designate as being hedged. This amount also determines the percentage measure that is used for testing effectiveness in accordance with paragraph AG126(b).

(d) The entity designates the interest rate risk it is hedging. This risk could be a portion of the interest rate risk in each of the items in the hedged position, such as a benchmark interest rate (eg LIBOR).

(e) The entity designates one or more hedging instruments for each repricing time period.

(f) Using the designations made in (c)-(e) above, the entity assesses at inception and in subsequent periods, whether the hedge is expected to be highly effective during the period for which the hedge is designated.

(g) Periodically, the entity measures the change in the fair value of the hedged item (as designated in (c)) that is attributable to the hedged risk (as designated in (d)), on the basis of the expected repricing dates determined in (b). Provided that the hedge is determined actually to have been highly effective when assessed using the entity's documented method of assessing effectiveness, the entity recognises the change in fair value of the hedged item as a gain or loss in profit or loss and in one of two line items in the statement of financial position as described in paragraph 89A. The change in fair value need not be allocated to individual assets or liabilities.

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(h) The entity measures the change in fair value of the hedging instrument(s) (as designated in (e)) and recognises it as a gain or loss in profit or loss. The fair value of the hedging instrument(s) is recognised as an asset or liability in the statement of financial position.

(i) Any ineffectiveness* will be recognised in profit or loss as the difference between the change in fair value referred to in (g) and that referred to in (h).

AG115 This approach is described in more detail below. The approach shall be applied only to a fair value hedge of the interest rate risk associated with a portfolio of financial assets or financial liabilities.

AG116 The portfolio identified in paragraph AG114(a) could contain assets and liabilities. Alternatively, it could be a portfolio containing only assets, or only liabilities. The portfolio is used to determine the amount of the assets or liabilities the entity wishes to hedge. However, the portfolio is not itself designated as the hedged item.

AG117 In applying paragraph AG114(b), the entity determines the expected repricing date of an item as the earlier of the dates when that item is expected to mature or to reprice to market rates. The expected repricing dates are estimated at the inception of the hedge and throughout the term of the hedge, based on historical experience and other available information, including information and expectations regarding prepayment rates, interest rates and the interaction between them. Entities that have no entity-specific experience or insufficient experience use peer group experience for comparable financial instruments. These estimates are reviewed periodically and updated in the light of experience. In the case of a fixed rate item that is prepayable, the expected repricing date is the date on which the item is expected to prepay unless it reprices to market rates on an earlier date. For a group of similar items, the analysis into time periods based on expected repricing dates may take the form of allocating a percentage of the group, rather than individual items, to each time period. An entity may apply other methodologies for such allocation purposes. For example, it may use a prepayment rate multiplier for allocating amortising loans to time periods based on expected repricing dates. However, the methodology for such an allocation shall be in accordance with the entity's risk management procedures and objectives.

AG118 As an example of the designation set out in paragraph AG114(c), if in a particular repricing time period an entity estimates that it has fixed rate assets of CU100 and fixed rate liabilities of CU80 and decides to hedge all of the net position of CU20, it designates as the hedged item assets in the amount of CU20 (a portion of the assets).† The designation is expressed as an 'amount of a currency' (eg an amount of dollars, euro, pounds or rand) rather than as individual assets. It follows that all of the assets (or liabilities) from which the hedged amount is drawn—ie all of the CU100 of assets in the above example—must be:

(a) items whose fair value changes in response to changes in the interest rate being hedged; and

* The same materiality considerations apply in this context as apply throughout HKFRSs.

† The Standard permits an entity to designate any amount of the available qualifying assets or liabilities, ie in this example any amount of assets between CU0 and CU100.

(b) items that could have qualified for fair value hedge accounting if they had been designated as hedged individually. In particular, because HKFRS 9 specifies that the fair value of a financial liability with a demand feature (such as demand deposits and some types of time deposits) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid, such an item cannot qualify for fair value hedge accounting for any time period beyond the shortest period in which the holder can demand payment. In the above example, the hedged position is an amount of assets. Hence, such liabilities are not a part of the designated hedged item, but are used by the entity to determine the amount of the asset that is designated as being hedged. If the position the entity wished to hedge was an amount of liabilities, the amount representing the designated hedged item must be drawn from fixed rate liabilities other than liabilities that the entity can be required to repay in an earlier time period, and the percentage measure used for assessing hedge effectiveness in accordance with paragraph AG126(b) would be calculated as a percentage of these other liabilities. For example, assume that an entity estimates that in a particular repricing time period it has fixed rate liabilities of CU100, comprising CU40 of demand deposits and CU60 of liabilities with no demand feature, and CU70 of fixed rate assets. If the entity decides to hedge all of the net position of CU30, it designates as the hedged item liabilities of CU30 or 50 per cent[*] of the liabilities with no demand feature.

AG119 The entity also complies with the other designation and documentation requirements set out in paragraph 88(a). For a portfolio hedge of interest rate risk, this designation and documentation specifies the entity's policy for all of the variables that are used to identify the amount that is hedged and how effectiveness is measured, including the following:

(a) which assets and liabilities are to be included in the portfolio hedge and the basis to be used for removing them from the portfolio.

(b) how the entity estimates repricing dates, including what interest rate assumptions underlie estimates of prepayment rates and the basis for changing those estimates. The same method is used for both the initial estimates made at the time an asset or liability is included in the hedged portfolio and for any later revisions to those estimates.

(c) the number and duration of repricing time periods.

(d) how often the entity will test effectiveness and which of the two methods in paragraph AG126 it will use.

(e) the methodology used by the entity to determine the amount of assets or liabilities that are designated as the hedged item and, accordingly, the percentage measure used when the entity tests effectiveness using the method described in paragraph AG126(b).

(f) when the entity tests effectiveness using the method described in paragraph AG126(b), whether the entity will test effectiveness for each repricing time period individually, for all time periods in aggregate, or by using some combination of the two.

[*] CU30 ÷ (CU100 – CU40) = 50 per cent

The policies specified in designating and documenting the hedging relationship shall be in accordance with the entity's risk management procedures and objectives. Changes in policies shall not be made arbitrarily. They shall be justified on the basis of changes in market conditions and other factors and be founded on and consistent with the entity's risk management procedures and objectives.

AG120 The hedging instrument referred to in paragraph AG114(e) may be a single derivative or a portfolio of derivatives all of which contain exposure to the hedged interest rate risk designated in paragraph AG114(d) (eg a portfolio of interest rate swaps all of which contain exposure to LIBOR). Such a portfolio of derivatives may contain offsetting risk positions. However, it may not include written options or net written options, because the Standard[†] does not permit such options to be designated as hedging instruments (except when a written option is designated as an offset to a purchased option). If the hedging instrument hedges the amount designated in paragraph AG114(c) for more than one repricing time period, it is allocated to all of the time periods that it hedges. However, the whole of the hedging instrument must be allocated to those repricing time periods because the Standard[*] does not permit a hedging relationship to be designated for only a portion of the time period during which a hedging instrument remains outstanding.

AG121 When the entity measures the change in the fair value of a prepayable item in accordance with paragraph AG114(g), a change in interest rates affects the fair value of the prepayable item in two ways: it affects the fair value of the contractual cash flows and the fair value of the prepayment option that is contained in a prepayable item. Paragraph 81 of the Standard permits an entity to designate a portion of a financial asset or financial liability, sharing a common risk exposure, as the hedged item, provided effectiveness can be measured. For prepayable items, paragraph 81A permits this to be achieved by designating the hedged item in terms of the change in the fair value that is attributable to changes in the designated interest rate on the basis of *expected*, rather than *contractual*, repricing dates. However, the effect that changes in the hedged interest rate have on those expected repricing dates shall be included when determining the change in the fair value of the hedged item. Consequently, if the expected repricing dates are revised (eg to reflect a change in expected prepayments), or if actual repricing dates differ from those expected, ineffectiveness will arise as described in paragraph AG126. Conversely, changes in expected repricing dates that (a) clearly arise from factors other than changes in the hedged interest rate, (b) are uncorrelated with changes in the hedged interest rate and (c) can be reliably separated from changes that are attributable to the hedged interest rate (eg changes in prepayment rates clearly arising from a change in demographic factors or tax regulations rather than changes in interest rate) are excluded when determining the change in the fair value of the hedged item, because they are not attributable to the hedged risk. If there is uncertainty about the factor that gave rise to the change in expected repricing dates or the entity is not able to separate reliably the changes that arise from the hedged interest rate from those that arise from other factors, the change is assumed to arise from changes in the hedged interest rate.

AG122 The Standard does not specify the techniques used to determine the amount referred to in paragraph AG114(g), namely the change in the fair value of the hedged item that is attributable to the hedged risk. If statistical or other estimation techniques are used for such measurement, management must expect the result to approximate closely that which would have been obtained from measurement of all the individual assets or liabilities that constitute the hedged item. It is not appropriate to assume that changes in the fair value of the hedged item equal changes in the value of the hedging instrument.

[†] see paragraphs 77 and AG94

[*] see paragraph 75

AG123 Paragraph 89A requires that if the hedged item for a particular repricing time period is an asset, the change in its value is presented in a separate line item within assets. Conversely, if the hedged item for a particular repricing time period is a liability, the change in its value is presented in a separate line item within liabilities. These are the separate line items referred to in paragraph AG114(g). Specific allocation to individual assets (or liabilities) is not required.

AG124 Paragraph AG114(i) notes that ineffectiveness arises to the extent that the change in the fair value of the hedged item that is attributable to the hedged risk differs from the change in the fair value of the hedging derivative. Such a difference may arise for a number of reasons, including:

(a) actual repricing dates being different from those expected, or expected repricing dates being revised;

(b) items in the hedged portfolio becoming impaired or being derecognised;

(c) the payment dates of the hedging instrument and the hedged item being different; and

(d) other causes (eg when a few of the hedged items bear interest at a rate below the benchmark rate for which they are designated as being hedged, and the resulting ineffectiveness is not so great that the portfolio as a whole fails to qualify for hedge accounting).

Such ineffectiveness[*] shall be identified and recognised in profit or loss.

AG125 Generally, the effectiveness of the hedge will be improved:

(a) if the entity schedules items with different prepayment characteristics in a way that takes account of the differences in prepayment behaviour.

(b) when the number of items in the portfolio is larger. When only a few items are contained in the portfolio, relatively high ineffectiveness is likely if one of the items prepays earlier or later than expected. Conversely, when the portfolio contains many items, the prepayment behaviour can be predicted more accurately.

(c) when the repricing time periods used are narrower (eg 1-month as opposed to 3-month repricing time periods). Narrower repricing time periods reduce the effect of any mismatch between the repricing and payment dates (within the repricing time period) of the hedged item and those of the hedging instrument.

(d) the greater the frequency with which the amount of the hedging instrument is adjusted to reflect changes in the hedged item (eg because of changes in prepayment expectations).

[*] The same materiality considerations apply in this context as apply throughout HKFRSs.

AG126 An entity tests effectiveness periodically. If estimates of repricing dates change between one date on which an entity assesses effectiveness and the next, it shall calculate the amount of effectiveness either:

(a) as the difference between the change in the fair value of the hedging instrument (see paragraph AG114(h)) and the change in the value of the entire hedged item that is attributable to changes in the hedged interest rate (including the effect that changes in the hedged interest rate have on the fair value of any embedded prepayment option); or

(b) using the following approximation. The entity:

(i) calculates the percentage of the assets (or liabilities) in each repricing time period that was hedged, on the basis of the estimated repricing dates at the last date it tested effectiveness.

(ii) applies this percentage to its revised estimate of the amount in that repricing time period to calculate the amount of the hedged item based on its revised estimate.

(iii) calculates the change in the fair value of its revised estimate of the hedged item that is attributable to the hedged risk and presents it as set out in paragraph AG114(g).

(iv) recognises ineffectiveness equal to the difference between the amount determined in (iii) and the change in the fair value of the hedging instrument (see paragraph AG114(h)).

AG127 When measuring effectiveness, the entity distinguishes revisions to the estimated repricing dates of existing assets (or liabilities) from the origination of new assets (or liabilities), with only the former giving rise to ineffectiveness. All revisions to estimated repricing dates (other than those excluded in accordance with paragraph AG121), including any reallocation of existing items between time periods, are included when revising the estimated amount in a time period in accordance with paragraph AG126(b)(ii) and hence when measuring effectiveness. Once ineffectiveness has been recognised as set out above, the entity establishes a new estimate of the total assets (or liabilities) in each repricing time period, including new assets (or liabilities) that have been originated since it last tested effectiveness, and designates a new amount as the hedged item and a new percentage as the hedged percentage. The procedures set out in paragraph AG126(b) are then repeated at the next date it tests effectiveness.

AG128 Items that were originally scheduled into a repricing time period may be derecognised because of earlier than expected prepayment or write-offs caused by impairment or sale. When this occurs, the amount of change in fair value included in the separate line item referred to in paragraph AG114(g) that relates to the derecognised item shall be removed from the statement of financial position, and included in the gain or loss that arises on derecognition of the item. For this purpose, it is necessary to know the repricing time period(s) into which the derecognised item was scheduled, because this determines the repricing time period(s) from which to remove it and hence the amount to remove from the separate line item referred to in paragraph AG114(g). When an item is derecognised, if it can be determined in which time period it was included, it is removed from that time period. If not, it is removed from the earliest time period if the derecognition resulted from higher than expected prepayments, or allocated to all time periods containing the derecognised item on a systematic and rational basis if the item was sold or became impaired.

AG129 In addition, any amount relating to a particular time period that has not been derecognised when the time period expires is recognised in profit or loss at that time (see paragraph 89A). For example, assume an entity schedules items into three repricing time periods. At the previous redesignation, the change in fair value reported in the single line item in the statement of financial position was an asset of CU25. That amount represents amounts attributable to periods 1, 2 and 3 of CU7, CU8 and CU10, respectively. At the next redesignation, the assets attributable to period 1 have been either realised or rescheduled into other periods. Therefore, CU7 is derecognised from the statement of financial position and recognised in profit or loss. CU8 and CU10 are now attributable to periods 1 and 2, respectively. These remaining periods are then adjusted, as necessary, for changes in fair value as described in paragraph AG114(g).

AG130 As an illustration of the requirements of the previous two paragraphs, assume that an entity scheduled assets by allocating a percentage of the portfolio into each repricing time period. Assume also that it scheduled CU100 into each of the first two time periods. When the first repricing time period expires, CU110 of assets are derecognised because of expected and unexpected repayments. In this case, all of the amount contained in the separate line item referred to in paragraph AG114(g) that relates to the first time period is removed from the statement of financial position, plus 10 per cent of the amount that relates to the second time period.

AG131 If the hedged amount for a repricing time period is reduced without the related assets (or liabilities) being derecognised, the amount included in the separate line item referred to in paragraph AG114(g) that relates to the reduction shall be amortised in accordance with paragraph 92.

AG132 An entity may wish to apply the approach set out in paragraphs AG114-AG131 to a portfolio hedge that had previously been accounted for as a cash flow hedge in accordance with HKAS 39. Such an entity would revoke the previous designation of a cash flow hedge in accordance with paragraph 101(d), and apply the requirements set out in that paragraph. It would also redesignate the hedge as a fair value hedge and apply the approach set out in paragraphs AG114-AG131 prospectively to subsequent accounting periods.

Transition (paragraphs 103-108C)

AG133 An entity may have designated a forecast intragroup transaction as a hedged item at the start of an annual period beginning on or after 1 January 2005 (or, for the purpose of restating comparative information, the start of an earlier comparative period) in a hedge that would qualify for hedge accounting in accordance with this Standard (as amended by the last sentence of paragraph 80). Such an entity may use that designation to apply hedge accounting in consolidated financial statements from the start of the annual period beginning on or after 1 January 2005 (or the start of the earlier comparative period). Such an entity shall also apply paragraphs AG99A and AG99B from the start of the annual period beginning on or after 1 January 2005. However, in accordance with paragraph 108B, it need not apply paragraph AG99B to comparative information for earlier periods.

Appendix B
Amendments to Other Pronouncements

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

* * *

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

HKAS 39 BC
Revised ~~November 2019~~August 2020

Basis for Conclusions
Hong Kong Accounting Standard 39

Financial Instruments: Recognition and Measurement

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

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

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

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

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

IFRS 9 Financial Instruments replaced IAS 39. However the Board did not reconsider most of the requirements of IAS 39 relating to scope, classification and measurement of financial liabilities or derecognition of financial assets and financial liabilities. Accordingly the following were relocated to IFRS 9: paragraphs BC11C, BC15-BC24Y, BC30-BC79A and BC85-BC104.

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

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

BC2-BC130 [Deleted]

Hedging

BC131 The Exposure Draft proposed few changes to the hedge accounting guidance in the original IAS 39. The comments on the Exposure Draft raised several issues in the area of hedge accounting suggesting that the Board should consider these issues in the revised IAS 39. The Board's decisions with regard to these issues are presented in the following paragraphs.

Consideration of the shortcut method in SFAS 133

BC132 SFAS 133 *Accounting for Derivative Instruments and Hedging Activities* issued by the FASB allows an entity to assume no ineffectiveness in a hedge of interest rate risk using an interest rate swap as the hedging instrument, provided specified criteria are met (the 'shortcut method').

BC133 The original IAS 39 and the Exposure Draft precluded the use of the shortcut method. Many comments received on the Exposure Draft argued that IAS 39 should permit use of the shortcut method. The Board considered the issue in developing the Exposure Draft, and discussed it in the roundtable discussions that were held in the process of finalising IAS 39.

BC134 The Board noted that, if the shortcut method were permitted, an exception would have to be made to the principle in IAS 39 that ineffectiveness in a hedging relationship is measured and recognised in profit or loss. The Board agreed that no exception to this principle should be made, and therefore concluded that IAS 39 should not permit the shortcut method.

BC135 Additionally, IAS 39 permits the hedging of portions of financial assets and financial liabilities in cases when US GAAP does not. The Board noted that under IAS 39 an entity may hedge a portion of a financial instrument (eg interest rate risk or credit risk), and that if the critical terms of the hedging instrument and the hedged item are the same, the entity would, in many cases, recognise no ineffectiveness.

Hedges of portions of financial assets and financial liabilities (paragraphs 81, 81A, AG99A and AG99B)

BC135A IAS 39 permits a hedged item to be designated as a portion of the cash flows or fair value of a financial asset or financial liability. In finalising the Exposure Draft *Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk,* the Board received comments that demonstrated that the meaning of a 'portion' was unclear in this context. Accordingly, the Board decided to amend IAS 39 to provide further guidance on what may be designated as a hedged portion, including confirmation that it is not possible to designate a portion that is greater than the total cash flows of the asset or liability.

Expected effectiveness (paragraphs AG105–AG113)

BC136 Qualification for hedge accounting is based on expectations of future effectiveness (prospective) and evaluation of actual effectiveness (retrospective). In the original IAS 39, the prospective test was expressed as 'almost fully offset', whereas the retrospective test was 'within a range of 80-125 per cent'. The Board considered whether to amend IAS 39 to permit the prospective effectiveness to be within the range of 80-125 per cent rather than "almost fully offset". The Board noted that an undesirable consequence of such an amendment could be that entities would deliberately underhedge a hedged item in a cash flow hedge so as to reduce recognised ineffectiveness. Therefore, the Board initially decided to retain the guidance in the original IAS 39.

BC136A However, when subsequently finalising the requirements for portfolio hedges of interest rate risk, the Board received representations from constituents that some hedges would fail the "almost fully offset" test in IAS 39, including some hedges that would qualify for the short-cut method in US GAAP and thus be assumed to be 100 per cent effective. The Board was persuaded that the concern described in the previous paragraph that an entity might deliberately underhedge would be met by an explicit statement that an entity could not deliberately hedge less than 100 per cent of the exposure on an item and designate the hedge as a hedge of 100 per cent of the exposure. Therefore, the Board decided to amend IAS 39:

(a) to remove the words 'almost fully offset' from the prospective effectiveness test, and replace them by a requirement that the hedge is expected to be "highly effective". (This amendment is consistent with the wording in US GAAP.)

(b) to include a statement in the Application Guidance in IAS 39 that if an entity hedges less than 100 per cent of the exposure on an item, such as 85 per cent, it shall designate the hedged item as being 85 per cent of the exposure and shall measure ineffectiveness on the basis of the change in the whole of that designated 85 per cent exposure.

BC136B Additionally, comments made in response to the Exposure Draft *Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk* demonstrated that it was unclear how the prospective effectiveness test was to be applied. The Board noted that the objective of the test was to ensure there was firm evidence to support an expectation of high effectiveness. Therefore, the Board decided to amend the Standard to clarify that an expectation of high effectiveness may be demonstrated in various ways, including a comparison of past changes in the fair value or cash flows of the hedged item that are attributable to the hedged risk with past changes in the fair value or cash flows of the hedging instrument, or by demonstrating a high statistical correlation between the fair value of cash flows of the hedged item and those of the hedging instrument. The Board noted that the entity may choose a hedge ratio of other than one to one in order to improve the effectiveness of the hedge as described in paragraph AG100.

Hedges of portions of non-financial assets and non-financial liabilities for risk other than foreign currency risk (paragraph 82)

BC137 The Board considered comments on the Exposure Draft that suggested that IAS 39 should permit designating as the hedged risk a risk portion of a non-financial item other than foreign currency risk.

BC138 The Board concluded that IAS 39 should not be amended to permit such designation. It noted that in many cases, changes in the cash flows or fair value of a portion of a non-financial hedged item are difficult to isolate and measure. Moreover, the Board noted that permitting portions of non-financial assets and non-financial liabilities to be designated as the hedged item for risk other than foreign currency risk would compromise the principles of identification of the hedged item and effectiveness testing that the Board has confirmed because the portion could be designated so that no ineffectiveness would ever arise.

BC139 The Board confirmed that non-financial items may be hedged in their entirety when the item the entity is hedging is not the standard item underlying contracts traded in the market. In this context, the Board decided to clarify that a hedge ratio of other than one-to-one may maximise expected effectiveness, and to include guidance on how the hedge ratio that maximises expected effectiveness can be determined.

Loan servicing rights

BC140 The Board also considered whether IAS 39 should permit the interest rate risk portion of loan servicing rights to be designated as the hedged item.

BC141 The Board considered the argument that interest rate risk can be separately identified and measured in loan servicing rights, and that changes in market interest rates have a predictable and separately measurable effect on the value of loan servicing rights. The Board also considered the possibility of treating loan servicing rights as financial assets (rather than non-financial assets).

BC142 However, the Board concluded that no exceptions should be permitted for this matter. The Board noted that (a) the interest rate risk and prepayment risk in loan servicing rights are interdependent, and thus inseparable, (b) the fair values of loan servicing rights do not change in a linear fashion as interest rates increase or decrease, and (c) concerns exist about how to isolate and measure the interest rate risk portion of a loan servicing right. Moreover, the Board expressed concern that in jurisdictions in which loan servicing right markets are not developed, the interest rate risk portion may not be measurable.

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BC143 The Board also considered whether IAS 39 should be amended to allow, on an elective basis, the inclusion of loan servicing rights in its scope provided that they are measured at fair value with changes in fair value recognised immediately in profit or loss. The Board noted that this would create two exceptions to the general principles in IAS 39. First, it would create a scope exception because IAS 39 applies only to financial assets and financial liabilities; loan servicing rights are non-financial assets. Second, *requiring* an entity to measure loan servicing rights at fair value through profit or loss would create a further exception, because this treatment is optional (except for items that are held for trading). The Board therefore decided not to amend the scope of IAS 39 for loan servicing rights.

Whether to permit hedge accounting using cash instruments

BC144 In finalising the amendments to IAS 39, the Board discussed whether an entity should be permitted to designate a financial asset or financial liability other than a derivative (ie a 'cash instrument') as a hedging instrument in hedges of risks other than foreign currency risk. The original IAS 39 precluded such designation because of the different bases for measuring derivatives and cash instruments. The Exposure Draft did not propose a change to this limitation. However, some commentators suggested a change, noting that entities do not distinguish between derivative and non-derivative financial instruments in their hedging and other risk management activities and that entities may have to use a non-derivative financial instrument to hedge risk if no suitable derivative financial instrument exists.

BC145 The Board acknowledged that some entities use non-derivatives to manage risk. However, it decided to retain the restriction against designating non-derivatives as hedging instruments in hedges of risks other than foreign currency risk. It noted the following arguments in support of this conclusion:

(a) The need for hedge accounting arises in part because derivatives are measured at fair value, whereas the items they hedge may be measured at cost or not recognised at all. Without hedge accounting, an entity might recognise volatility in profit or loss for matched positions. For non-derivative items that are not measured at fair value or for which changes in fair value are not recognised in profit or loss, there is generally no need to adjust the accounting of the hedging instrument or the hedged item to achieve matched recognition of gains and losses in profit or loss.

(b) To allow designation of cash instruments as hedging instruments would diverge from US GAAP: SFAS 133 precludes the designation of non-derivative instruments as hedging instruments except for some foreign currency hedges.

(c) To allow designation of cash instruments as hedging instruments would add complexity to the Standard. More financial instruments would be measured at an amount that represents neither amortised cost nor fair value. Hedge accounting is, and should be, an exception to the normal measurement requirements.

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(d) If cash instruments were permitted to be designated as hedging instruments, there would be much less discipline in the accounting model because, in the absence of hedge accounting, a non-derivative may not be selectively measured at fair value. If the entity subsequently decides that it would rather not apply fair value measurement to a cash instrument that had been designated as a hedging instrument, it can breach one of the hedge accounting requirements, conclude that the non-derivative no longer qualifies as a hedging instrument and selectively avoid recognising the changes in fair value of the non-derivative instrument in equity (for a cash flow hedge) or profit or loss (for a fair value hedge).

(e) The most significant use of cash instruments as hedging instruments is to hedge foreign currency exposures, which is permitted under IAS 39.

Whether to treat hedges of forecast transactions as fair value hedges

BC146 The Board considered a suggestion made in some of the comment letters received on the Exposure Draft that a hedge of a forecast transaction should be treated as a fair value hedge, rather than as a cash flow hedge. Some argued that the hedge accounting provisions should be simplified by having only one type of hedge accounting. Some also raised concern about an entity's ability, in some cases, to choose between two hedge accounting methods for the same hedging strategy (ie the choice between designating a forward contract to sell an existing asset as a fair value hedge of the asset or a cash flow hedge of a forecast sale of the asset).

BC147 The Board acknowledged that the hedge accounting provisions would be simplified, and their application more consistent in some situations, if the Standard permitted only one type of hedge accounting. However, the Board concluded that IAS 39 should continue to distinguish between fair value hedge accounting and cash flow hedge accounting. It noted that removing either type of hedge accounting would narrow the range of hedging strategies that could qualify for hedge accounting.

BC148 The Board also noted that treating a hedge of a forecast transaction as a fair value hedge is not appropriate for the following reasons: (a) it would result in the recognition of an asset or liability before the entity has become a party to the contract; (b) amounts would be recognised in the balance sheet that do not meet the definitions of assets and liabilities in the *Framework*; and (c) transactions in which there is no fair value exposure would be treated as if there were a fair value exposure.

Hedges of firm commitments (paragraphs 93 and 94)

BC149 The previous version of IAS 39 required a hedge of a firm commitment to be accounted for as a cash flow hedge. In other words, hedging gains and losses, to the extent that the hedge is effective, were initially recognised in equity and were subsequently 'recycled' to profit or loss in the same period(s) that the hedged firm commitment affected profit or loss (although, when basis adjustment was used, they adjusted the initial carrying amount of an asset or liability recognised in the meantime). Some believe this is appropriate because cash flow hedge accounting for hedges of firm commitments avoids partial recognition of the firm commitment that would otherwise not be recognised. Moreover, some believe it is conceptually incorrect to recognise the hedged fair value exposure of a firm commitment as an asset or liability merely because it has been hedged.

BC150 The Board considered whether hedges of firm commitments should be treated as cash flow hedges or fair value hedges. The Board concluded that hedges of firm commitments should be accounted for as fair value hedges.

BC151 The Board noted that, in concept, a hedge of a firm commitment is a fair value hedge. This is because the fair value of the item being hedged (the firm commitment) changes with changes in the hedged risk.

BC152 The Board was not persuaded by the argument that it is conceptually incorrect to recognise an asset or liability for a firm commitment merely because it has been hedged. It noted that for all fair value hedges, applying hedge accounting has the effect that amounts are recognised as assets or liabilities that would otherwise not be recognised. For example, assume an entity hedges a fixed rate loan asset with a pay-fixed, receive-variable interest rate swap. If there is a loss on the swap, applying fair value hedge accounting requires the offsetting gain on the loan to be recognised, ie the carrying amount of the loan is increased. Thus, applying hedge accounting has the effect of recognising a part of an asset (the increase in the loan's value attributable to interest rate movements) that would otherwise not have been recognised. The only difference in the case of a firm commitment is that, without hedge accounting, none of the commitment is recognised, ie the carrying amount is zero. However, this difference merely reflects that the historical cost of a firm commitment is usually zero. It is not a fundamental difference in concept.

BC153 Furthermore, the Board's decision converges with SFAS 133, and thus eliminates practical problems and eases implementation for entities that report under both standards.

BC154 However, the Board clarified that a hedge of the foreign currency risk of a firm commitment may be treated as either a fair value hedge or a cash flow hedge because foreign currency risk affects both the cash flows and the fair value of the hedged item. Accordingly a foreign currency cash flow hedge of a forecast transaction need not be re-designated as a fair value hedge when the forecast transaction becomes a firm commitment.

Basis adjustments (paragraphs 97-99)

BC155 The question of basis adjustment arises when an entity hedges the future purchase of an asset or the future issue of a liability. One example is that of a US entity that expects to make a future purchase of a German machine that it will pay for in euro. The entity enters into a derivative to hedge against possible future changes in the US dollar / euro exchange rate. Such a hedge is classified as a cash flow hedge under IAS 39, with the effect that gains and losses on the hedging instrument (to the extent that the hedge is effective) are initially recognised in equity.* The question the Board considered is what the accounting should be once the future transaction takes place. In its deliberations on this issue, the Board discussed the following approaches:

(a) to remove the hedging gain or loss from equity and recognise it as part of the initial carrying amount of the asset or liability (in the example above, the machine). In future periods, the hedging gain or loss is automatically recognised in profit or loss by being included in amounts such as depreciation expense (for a fixed asset), interest income or expense (for a financial asset or financial liability), or cost of sales (for inventories). This treatment is commonly referred to as 'basis adjustment'.

* As a consequence of the revision of IAS 1 *Presentation of Financial Statements* in 2007 such gains and losses are recognised in other comprehensive income.

(b) to leave the hedging gain or loss in equity. In future periods, the gain or loss on the hedging instrument is ‘recycled’ to profit or loss in the same period(s) as the acquired asset or liability affects profit or loss. This recycling requires a separate adjustment and is not automatic.

BC156 It should be noted that both approaches have the same effect on profit or loss and net assets for all periods affected, so long as the hedge is accounted for as a cash flow hedge. The difference relates to balance sheet presentation and, possibly, the line item in the income statement.

BC157 In the Exposure Draft, the Board proposed that the ‘basis adjustment’ approach for forecast transactions (approach (a)) should be eliminated and replaced by approach (b) above. It further noted that eliminating the basis adjustment approach would enable IAS 39 to converge with SFAS 133.

BC158 Many of the comments received from constituents disagreed with the proposal in the Exposure Draft. Those responses argued that it would unnecessarily complicate the accounting to leave the hedging gain or loss in equity when the hedged forecast transaction occurs. They particularly noted that tracking the effects of cash flow hedges after the asset or liability is acquired would be complicated and would require systems changes. They also pointed out that treating hedges of firm commitments as fair value hedges has the same effect as a basis adjustment when the firm commitment results in the recognition of an asset or liability. For example, for a perfectly effective hedge of the foreign currency risk of a firm commitment to buy a machine, the effect is to recognise the machine initially at its foreign currency price translated at the forward rate in effect at the inception of the hedge rather than the spot rate. Therefore, they questioned whether it is consistent to treat a hedge of a firm commitment as a fair value hedge while precluding basis adjustments for hedges of forecast transactions.

BC159 Others believe that a basis adjustment is difficult to justify in principle for forecast transactions, and also argue that such basis adjustments impair comparability of financial information. In other words, two identical assets that are purchased at the same time and in the same way, except for the fact that one was hedged, should not be recognised at different amounts.

BC160 The Board concluded that IAS 39 should distinguish between hedges of forecast transactions that will result in the recognition of a *financial* asset or a *financial* liability and those that will result in the recognition of a *non-financial* asset or a *non-financial* liability.

Basis adjustments for hedges of forecast transactions that will result in the recognition of a financial asset or a financial liability

BC161 For hedges of forecast transactions that will result in the recognition of a financial asset or a financial liability, the Board concluded that basis adjustments are not appropriate. Its reason was that basis adjustments cause the initial carrying amount of acquired assets (or assumed liabilities) arising from forecast transactions to move away from fair value and hence would override the requirement in IAS 39 to measure a financial instrument initially at its fair value.

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BC161A If a hedged forecast transaction results in the recognition of a financial asset or a financial liability, paragraph 97 of IAS 39 required the associated gains or losses on hedging instruments to be reclassified from equity to profit or loss as a reclassification adjustment in the same period or periods during which the hedged item affects profit or loss (such as in the periods that interest income or interest expense is recognised).

BC161B The Board was informed that there was uncertainty about how paragraph 97 should be applied when the designated cash flow exposure being hedged differs from the financial instrument arising from the hedged forecast cash flows.

BC161C The example below illustrates the issue:

> An entity applies the guidance in the answer to Question F.6.2 of the guidance on implementing IAS 39.[a] On 1 January 20X0 the entity designates forecast cash flows for the risk of variability arising from changes in interest rates. Those forecast cash flows arise from the repricing of existing financial instruments and are scheduled for 1 April 20X0. The entity is exposed to variability in cash flows for the three-month period beginning on 1 April 20X0 attributable to changes in interest rate risk that occur from 1 January 20X0 to 31 March 20X0.
>
> The occurrence of the forecast cash flows is deemed to be highly probable and all the other relevant hedge accounting criteria are met.
>
> The financial instrument that results from the hedged forecast cash flows is a five-year interest-bearing instrument.
>
> (a) IFRS 9 *Financial Instruments* deletes the guidance in IAS 39.

BC161D Paragraph 97 required the gains or losses on the hedging instrument to be reclassified from equity to profit or loss as a reclassification adjustment in the same period or periods during which the asset acquired or liability assumed affected profit or loss. The financial instrument that was recognised is a five-year instrument that will affect profit or loss for five years. The wording in paragraph 97 suggested that the gains or losses should be reclassified over five years, even though the cash flows designated as the hedged item were hedged for the effects of interest rate changes over only a three-month period.

BC161E The Board believes that the wording of paragraph 97 did not reflect the underlying rationale in hedge accounting, ie that the gains or losses on the hedging instrument should offset the gains or losses on the hedged item, and the offset should be reflected in profit or loss by way of reclassification adjustments.

BC161F The Board believes that in the example set out above the gains or losses should be reclassified over a period of three months beginning on 1 April 20X0, and not over a period of five years beginning on 1 April 20X0.

BC161G Consequently, in *Improvements to IFRSs* issued in April 2009, the Board amended paragraph 97 of IAS 39 to clarify that the gains or losses on the hedged instrument should be reclassified from equity to profit or loss during the period that the hedged forecast cash flows affect profit or loss. The Board also decided that to avoid similar confusion paragraph 100 of IAS 39 should be amended to be consistent with paragraph 97.

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Basis adjustments for hedges of forecast transactions that will result in the recognition of a non-financial asset or a non-financial liability

BC162 For hedges of forecast transactions that will result in the recognition of a non-financial asset or a non-financial liability, the Board decided to permit entities a choice of whether to apply basis adjustment.

BC163 The Board considered the argument that changes in the fair value of the hedging instrument are appropriately included in the initial carrying amount of the recognised asset or liability because such changes represent a part of the 'cost' of that asset or liability. Although the Board has not yet considered the broader issue of what costs may be capitalised at initial recognition, the Board believes that its decision to provide an option for basis adjustments in the case of non-financial items will not pre-empt that future discussion. The Board also recognised that financial items and non-financial items are not necessarily measured at the same amount on initial recognition, because financial items are measured at fair value and non-financial items are measured at cost.

BC164 The Board concluded that, on balance, providing entities with a choice in this case was appropriate. The Board took the view that allowing basis adjustments addresses the concern that precluding basis adjustments complicates the accounting for hedges of forecast transactions. In addition, the number of balance sheet line items that could be affected is quite small, generally being only property, plant and equipment, inventory and the cash flow hedge line item in equity. The Board also noted that US GAAP precludes basis adjustments and that applying a basis adjustment is inconsistent with the accounting for hedges of forecast transactions that will result in the recognition of a financial asset or a financial liability. The Board acknowledged the merits of these arguments, and recognised that by permitting a choice in IAS 39, entities could apply the accounting treatment required by US GAAP.

Hedging using internal contracts

BC165 IAS 39 does not preclude entities from using internal contracts as a risk management tool, or as a tracking device in applying hedge accounting for external contracts that hedge external positions. Furthermore, IAS 39 permits hedge accounting to be applied to transactions between entities in the same group in the *separate reporting* of those entities. However, IAS 39 does not permit hedge accounting for transactions between entities in the same group in consolidated financial statements. The reason is the fundamental requirement of consolidation that the accounting effects of internal contracts should be eliminated in consolidated financial statements, including any internally generated gains or losses. Designating internal contracts as hedging instruments could result in non-elimination of internal gains and losses and have other accounting effects. The Exposure Draft did not propose any change in this area.

BC166 To illustrate, assume the banking book division of Bank A enters into an internal interest rate swap with the trading book division of the same bank. The purpose is to hedge the net interest rate risk exposure in the banking book of a group of similar fixed rate loan assets funded by floating rate liabilities. Under the swap, the banking book pays fixed interest payments to the trading book and receives variable interest rate payments in return. The bank wants to designate the internal interest rate swap in the banking book as a hedging instrument in its consolidated financial statements.

BC167 If the internal swap in the banking book is designated as a hedging instrument in a cash flow hedge of the liabilities, and the internal swap in the trading book is classified as held for trading, internal gains and losses on that internal swap would not be eliminated. This is because the gains and losses on the internal swap in the banking book would be recognised in equity* to the extent the hedge is effective and the gains and losses on the internal swap in the trading book would be recognised in profit or loss.

BC168 If the internal swap in the banking book is designated as a hedging instrument in a fair value hedge of the loan assets and the internal swap in the trading book is classified as held for trading, the changes in the fair value of the internal swap would offset both in total net assets in the balance sheet and profit or loss. However, without elimination of the internal swap, there would be an adjustment to the carrying amount of the hedged loan asset in the banking book to reflect the change in the fair value attributable to the risk hedged by the internal contract. Moreover, to reflect the effect of the internal swap the bank would in effect recognise the fixed rate loan at a floating interest rate and recognise an offsetting trading gain or loss in the income statement. Hence the internal swap would have accounting effects.

BC169 Some respondents to the Exposure Draft and some participants in the round-tables objected to not being able to obtain hedge accounting in the consolidated financial statements for internal contracts between subsidiaries or between a subsidiary and the parent (as illustrated above). Among other things, they emphasised that the use of internal contracts is a key risk management tool and that the accounting should reflect the way in which risk is managed. Some suggested that IAS 39 should be changed to make it consistent with US GAAP, which allows the designation of internal derivative contracts as hedging instruments in cash flow hedges of forecast foreign currency transactions in specified, limited circumstances.

BC170 In considering these comments, the Board noted that the following principles apply to consolidated financial statements:

(a) financial statements provide financial information about an entity or group as a whole (as that of a single entity). Financial statements do not provide financial information about an entity as if it were two separate entities.

(b) a fundamental principle of consolidation is that intragroup balances and intragroup transactions are eliminated in full. Permitting the designation of internal contracts as hedging instruments would require a change to the consolidation principles.

(c) it is conceptually wrong to permit an entity to recognise internally generated gains and losses or make other accounting adjustments because of internal transactions. No external event has occurred.

(d) an ability to recognise internally generated gains and losses could result in abuse in the absence of requirements about how entities should manage and control the associated risks. It is not the purpose of accounting standards to prescribe how entities should manage and control risks.

* As a consequence of the revision of IAS 1 *Presentation of Financial Statements* in 2007 such gains and losses are recognised in other comprehensive income.

(e) permitting the designation of internal contracts as hedging instruments violates the following requirements in IAS 39:

(i) the prohibition against designating as a hedging instrument a non-derivative financial asset or non-derivative financial liability for other than foreign currency risk. To illustrate, if an entity has two offsetting internal contracts and one is the designated hedging instrument in a fair value hedge of a non-derivative asset and the other is the designated hedging instrument in a fair value hedge of a non-derivative liability, from the entity's perspective the effect is to designate a hedging relationship between the asset and the liability (ie a non-derivative asset or non-derivative liability is used as the hedging instrument).

(ii) the prohibition on designating a net position of assets and liabilities as the hedged item. To illustrate, an entity has two internal contracts. One is designated in a fair value hedge of an asset and the other in a fair value hedge of a liability. The two internal contracts do not fully offset, so the entity lays off the net risk exposure by entering into a net external derivative. In that case, the effect from the entity's perspective is to designate a hedging relationship between the net external derivative and a net position of an asset and a liability.

(iii) the option to fair value assets and liabilities does not extend to portions of assets and liabilities.

(f) the Board is considering separately whether to make an amendment to IAS 39 to facilitate fair value hedge accounting for portfolio hedges of interest rate risk. The Board believes that that is a better way to address the concerns raised about symmetry with risk management systems than permitting the designation of internal contracts as hedging instruments.

(g) the Board decided to permit an option to measure any financial asset or financial liability at fair value with changes in fair value recognised in profit or loss. This enables an entity to measure matching asset/liability positions at fair value without a need for hedge accounting.

BC171 The Board reaffirmed that it is a fundamental principle of consolidation that any accounting effect of internal contracts is eliminated on consolidation. The Board decided that no exception to this principle should be made in IAS 39. Consistently with this decision, the Board also decided not to explore an amendment to permit internal derivative contracts to be designated as hedging instruments in hedges of some forecast foreign currency transactions, as is permitted by SFAS 138 *Accounting for Certain Derivative Instruments and Certain Hedging Activities*.

BC172 The Board also decided to clarify that IAS 39 does not preclude hedge accounting for transactions between entities in the same group in individual or separate financial statements of those entities because they are not internal to the entity (ie the individual entity).

BC172A Previously, paragraphs 73 and 80 referred to the need for hedging instruments to involve a party external to the reporting entity. In doing so, ~~it~~ they used a segment as an example of a reporting entity. However, IFRS 8 *Operating Segments* requires disclosure of information that is reported to the chief operating decision maker even if this is on a non-IFRS basis. Therefore, the two IFRSs appeared to conflict. In *Improvements to IFRSs* issued in May 2008 and April 2009, the Board removed from paragraphs 73 and 80 references to the designation of hedging instruments at the segment level.

Eligible hedged items in particular situations (paragraphs AG99BA, AG99E, AG99F, AG110A and AG110B)

BC172B The Board amended IAS 39 in July 2008 to clarify the application of the principles that determine whether a hedged risk or portion of cash flows is eligible for designation in particular situations. This followed a request by the IFRIC for guidance.

BC172C The responses to the exposure draft *Exposures Qualifying for Hedge Accounting* demonstrated that diversity in practice existed, or was likely to occur, in two situations:

(a) the designation of a one-sided risk in a hedged item

(b) the designation of inflation as a hedged risk or portion in particular situations.

Designation of a one-sided risk in a hedged item

BC172D The IFRIC received requests for guidance on whether an entity can designate a purchased option in its entirety as the hedging instrument in a cash flow hedge of a highly probable forecast transaction in such a way that all changes in the fair value of the purchased option, including changes in the time value, are regarded as effective and would be recognised in other comprehensive income. The exposure draft proposed to amend IAS 39 to clarify that such a designation was not allowed.

BC172E After considering the responses to the exposure draft, the Board confirmed that the designation set out in paragraph BC172D is not permitted.

BC172F The Board reached that decision by considering the variability of future cash flow outcomes resulting from a price increase of a forecast commodity purchase (a one-sided risk). The Board noted that the forecast transaction contained no separately identifiable risk that affects profit or loss that is equivalent to the time value of a purchased option hedging instrument (with the same principal terms as the designated risk). The Board concluded that the intrinsic value of a purchased option, but not its time value, reflects a one-sided risk in a hedged item. The Board then considered a purchased option designated in its entirety as the hedging instrument. The Board noted that hedge accounting is based on a principle of offsetting changes in fair value or cash flows between the hedging instrument and the hedged item. Because a designated one-sided risk does not contain the time value of a purchased option hedging instrument, the Board noted that there will be no offset between the cash flows relating to the time value of the option premium paid and the designated hedged risk. Therefore, the Board concluded that a purchased option designated in its entirety as the hedging instrument of a one-sided risk will not be perfectly effective.

Designation of inflation in particular situations

BC172G The IFRIC received a request for guidance on whether, for a hedge of a fixed rate financial instrument, an entity can designate inflation as the hedged item. The exposure draft proposed to amend IAS 39 to clarify that such a designation was not allowed.

BC172H After considering the responses to the exposure draft, the Board acknowledged that expectations of future inflation rates can be viewed as an economic component of nominal interest. However, the Board also noted that hedge accounting is an exception to normal accounting principles for the hedged item (fair value hedges) or hedging instrument (cash flow hedges). To ensure a disciplined use of hedge accounting the Board noted that restrictions regarding eligible hedged items are necessary, especially if something other than the entire fair value or cash flow variability of a hedged item is designated.

BC172I The Board noted that paragraph 81 permits an entity to designate as the hedged item something other than the entire fair value change or cash flow variability of a financial instrument. For example, an entity may designate some (but not all) risks of a financial instrument, or some (but not all) cash flows of a financial instrument (a 'portion').

BC172J The Board noted that, to be eligible for hedge accounting, the designated risks and portions must be separately identifiable components of the financial instrument, and changes in the fair value or cash flows of the entire financial instrument arising from changes in the designated risks and portions must be reliably measurable. The Board noted that these principles were important in order for the effectiveness requirements set out in paragraph 88 to be applied in a meaningful way. The Board also noted that deciding whether designated risks and portions are separately identifiable and reliably measurable requires judgement. However, the Board confirmed that unless the inflation portion is a contractually specified portion of cash flows and other cash flows of the financial instrument are not affected by the inflation portion, inflation is not separately identifiable and reliably measurable and is not eligible for designation as a hedged risk or portion of a financial instrument.

Fair value hedge accounting for a portfolio hedge of interest rate risk

Background

BC173 The Exposure Draft of proposed improvements to IAS 39 published in June 2002 did not propose any substantial changes to the requirements for hedge accounting as they applied to a portfolio hedge of interest rate risk. However, some of the comment letters on the Exposure Draft and participants in the round-table discussions raised this issue. In particular, some were concerned that portfolio hedging strategies they regarded as effective hedges would not have qualified for fair value hedge accounting in accordance with previous versions of IAS 39. Rather, they would have either:

(a) not qualified for hedge accounting at all, with the result that reported profit or loss would be volatile; or

(b) qualified only for cash flow hedge accounting, with the result that reported equity would be volatile.

BC174 In the light of these concerns, the Board decided to explore whether and how IAS 39 could be amended to enable fair value hedge accounting to be used more readily for portfolio hedges of interest rate risk. As a result, in August 2003 the Board published a second Exposure Draft, *Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk*, with a comment deadline of 14 November 2003. More than 120 comment letters were received. The amendments proposed in this second Exposure Draft were finalised in March 2004. Paragraphs BC135A-BC136B and BC175-BC220 summarise the Board's considerations in reaching conclusions on the issues raised.

Scope

BC175 The Board decided to limit any amendments to IAS 39 to applying fair value hedge accounting to a hedge of interest rate risk on a portfolio of items. In making this decision it noted that:

(a) implementation guidance on IAS 39[*] explains how to apply cash flow hedge accounting to a hedge of the interest rate risk on a portfolio of items.

(b) the issues that arise for a portfolio hedge of interest rate risk are different from those that arise for hedges of individual items and for hedges of other risks. In particular, the three issues discussed in paragraph BC176 do not arise in combination for such other hedging arrangements.

The issue: why fair value hedge accounting was difficult to achieve in accordance with previous versions of IAS 39

BC176 The Board identified the following three main reasons why a portfolio hedge of interest rate risk might not have qualified for fair value hedge accounting in accordance with previous versions of IAS 39.

(a) Typically, many of the assets that are included in a portfolio hedge are prepayable, ie the counterparty has a right to repay the item before its contractual repricing date. Such assets contain a prepayment option whose fair value changes as interest rates change. However, the derivative that is used as the hedging instrument typically is not prepayable, ie it does not contain a prepayment option. When interest rates change, the resulting change in the fair value of the hedged item (which is prepayable) differs from the change in fair value of the hedging derivative (which is not prepayable), with the result that the hedge may not meet IAS 39's effectiveness tests.[#] Furthermore, prepayment risk may have the effect that the items included in a portfolio hedge fail the requirement[ˀ] that a group of hedged assets or liabilities must be 'similar' and the related requirement[+] that 'the change in fair value attributable to the hedged risk for each individual item in the group shall be expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group of items'.

[*] IFRS 9 *Financial Instruments* deleted the guidance on implementing IAS 39.
[#] see IAS 39, paragraph AG105
[ˀ] see IAS 39, paragraph 78
[+] see IAS 39, paragraph 83

(b) IAS 39[◈] prohibits the designation of an overall net position (eg the net of fixed rate assets and fixed rate liabilities) as the hedged item. Rather, it requires individual assets (or liabilities), or groups of similar assets (or similar liabilities), that share the risk exposure equal in amount to the net position to be designated as the hedged item. For example, if an entity has a portfolio of CU100 of assets and CU80 of liabilities, IAS 39 requires that individual assets or a group of similar assets of CU20 are designated as the hedged item. However, for risk management purposes, entities often seek to hedge the net position. This net position changes each period as items are repriced or derecognised and as new items are originated. Hence, the individual items designated as the hedged item also need to be changed each period. This requires de- and redesignation of the individual items that constitute the hedged item, which gives rise to significant systems needs.

(c) Fair value hedge accounting requires the carrying amount of the hedged item to be adjusted for the effect of changes in the hedged risk.[**] Applied to a portfolio hedge, this could involve changing the carrying amounts of many thousands of individual items. Also, for any items subsequently de-designated from being hedged, the revised carrying amount must be amortised over the item's remaining life.[†] This, too, gives rise to significant systems needs.

BC177 The Board decided that any change to IAS 39 must be consistent with the principles that underlie IAS 39's requirements on derivatives and hedge accounting. The three principles that are most relevant to a portfolio hedge of interest rate risk are:

(a) derivatives should be measured at fair value;

(b) hedge ineffectiveness should be identified and recognised in profit or loss;[♦] and

(c) only items that are assets and liabilities should be recognised as such in the balance sheet. Deferred losses are not assets and deferred gains are not liabilities. However, if an asset or liability is hedged, any change in its fair value that is attributable to the hedged risk should be recognised in the balance sheet.

Prepayment risk

BC178 In considering the issue described in paragraph BC176(a), the Board noted that a prepayable item can be viewed as a combination of a non-prepayable item and a prepayment option. It follows that the fair value of a fixed rate prepayable item changes for two reasons when interest rates move:

(a) the fair value of the contracted cash flows to the contractual repricing date changes (because the rate used to discount them changes); and

(b) the fair value of the prepayment option changes (reflecting, among other things, that the likelihood of prepayment is affected by interest rates).

◈ see IAS 39, paragraph AG101
** see IAS 39, paragraph 89(b)
† see IAS 39, paragraph 92
♦ Subject to the same materiality considerations that apply in this context as throughout IFRSs.

BC179 The Board also noted that, for risk management purposes, many entities do not consider these two effects separately. Instead they incorporate the effect of prepayments by grouping the hedged portfolio into repricing time periods based on *expected* repayment dates (rather than contractual repayment dates). For example, an entity with a portfolio of 25-year mortgages of CU100 may expect 5 per cent of that portfolio to repay in one year's time, in which case it schedules an amount of CU5 into a 12-month time period. The entity schedules all other items contained in its portfolio in a similar way (ie on the basis of expected repayment dates) and hedges all or part of the resulting overall net position in each repricing time period.

BC180 The Board decided to permit the scheduling that is used for risk management purposes, ie on the basis of expected repayment dates, to be used as a basis for the designation necessary for hedge accounting. As a result, an entity would not be required to compute the effect that a change in interest rates has on the fair value of the prepayment option embedded in a prepayable item. Instead, it could incorporate the effect of a change in interest rates on prepayments by grouping the hedged portfolio into repricing time periods based on expected repayment dates. The Board noted that this approach has significant practical advantages for preparers of financial statements, because it allows them to use the data they use for risk management. The Board also noted that the approach is consistent with paragraph 81 of IAS 39, which permits hedge accounting for a portion of a financial asset or financial liability. However, as discussed further in paragraphs BC193-BC206, the Board also concluded that if the entity changes its estimates of the time periods in which items are expected to repay (eg in the light of recent prepayment experience), ineffectiveness will arise, regardless of whether the revision in estimates results in more or less being scheduled in a particular time period.

BC181 The Board also noted that if the items in the hedged portfolio are subject to different amounts of prepayment risk, they may fail the test in paragraph 78 of being similar and the related requirement in paragraph 83 that the change in fair value attributable to the hedged risk for each individual item in the group is expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group of items. The Board decided that, in the context of a portfolio hedge of interest rate risk, these requirements could be inconsistent with the Board's decision, set out in the previous paragraph, on how to incorporate the effects of prepayment risk. Accordingly, the Board decided that they should not apply. Instead, the financial assets or financial liabilities included in a portfolio hedge of interest rate risk need only share the risk being hedged.

Designation of the hedged item and liabilities with a demand feature

BC182 The Board considered two main ways to overcome the issue noted in paragraph BC176(b). These were:

(a) to designate the hedged item as the overall net position that results from a portfolio containing assets and liabilities. For example, if a repricing time period contains CU100 of fixed rate assets and CU90 of fixed rate liabilities, the net position of CU10 would be designated as the hedged item.

(b) to designate the hedged item as a portion of the assets (ie assets of CU10 in the above example), but not to require individual assets to be designated.

BC183 Some of those who commented on the Exposure Draft favoured designation of the overall net position in a portfolio that contains assets and liabilities. In their view, existing asset-liability management (ALM) systems treat the identified assets and liabilities as a natural hedge. Management's decisions about additional hedging focus on the entity's remaining net exposure. They observe that designation based on a portion of either the assets or the liabilities is not consistent with existing ALM systems and would entail additional systems costs.

BC184 In considering questions of designation, the Board was also concerned about questions of measurement. In particular, the Board observed that fair value hedge accounting requires measurement of the change in fair value of the hedged item attributable to the risk being hedged. Designation based on the net position would require the assets and the liabilities in a portfolio each to be measured at fair value (for the risk being hedged) in order to compute the fair value of the net position. Although statistical and other techniques can be used to estimate these fair values, the Board concluded that it is not appropriate to assume that the change in fair value of the hedging instrument is equal to the change in fair value of the net position.

BC185 The Board noted that under the first approach in paragraph BC182 (designating an overall net position), an issue arises if the entity has liabilities that are repayable on demand or after a notice period (referred to below as 'demandable liabilities'). This includes items such as demand deposits and some types of time deposits. The Board was informed that, when managing interest rate risk, many entities that have demandable liabilities include them in a portfolio hedge by scheduling them to the date when they *expect* the total amount of demandable liabilities in the portfolio to be due because of net withdrawals from the accounts in the portfolio. This expected repayment date is typically a period covering several years into the future (eg 0-10 years hence). The Board was also informed that some entities wish to apply fair value hedge accounting based on this scheduling, ie they wish to include demandable liabilities in a fair value portfolio hedge by scheduling them on the basis of their expected repayment dates. The arguments for this view are:

(a) it is consistent with how demandable liabilities are scheduled for risk management purposes. Interest rate risk management involves hedging the interest rate margin resulting from assets and liabilities and not the fair value of all or part of the assets and liabilities included in the hedged portfolio. The interest rate margin of a specific period is subject to variability as soon as the amount of fixed rate assets in that period differs from the amount of fixed rate liabilities in that period.

(b) it is consistent with the treatment of prepayable assets to include demandable liabilities in a portfolio hedge based on expected repayment dates.

(c) as with prepayable assets, expected maturities for demandable liabilities are based on the historical behaviour of customers.

(d) applying the fair value hedge accounting framework to a portfolio that includes demandable liabilities would not entail an immediate gain on origination of such liabilities because all assets and liabilities enter the hedged portfolio at their carrying amounts. Furthermore, IAS 39 requires the carrying amount of a financial liability on its initial recognition to be its fair value, which normally equates to the transaction price (ie the amount deposited).*

* IFRS 9 *Financial Instruments* replaced IAS 39.

(e) historical analysis shows that a base level of a portfolio of demandable liabilities, such as chequing accounts, is very stable. Whilst a portion of the demandable liabilities varies with interest rates, the remaining portion—the base level—does not. Hence, entities regard this base level as a long-term fixed rate item and include it as such in the scheduling that is used for risk management purposes.

(f) the distinction between 'old' and 'new' money makes little sense at a portfolio level. The portfolio behaves like a long-term item even if individual liabilities do not.

BC186 The Board noted that this issue is related to that of how to measure the fair value of a demandable liability. In particular, it interrelates with the requirement in IAS 39 that the fair value of a liability with a demand feature is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.[+] This requirement applies to all liabilities with a demand feature, not only to those included in a portfolio hedge.

BC187 The Board also noted that:

(a) although entities, when managing risk, may schedule demandable liabilities based on the expected repayment date of the total balance of a portfolio of accounts, the deposit liabilities included in that balance are unlikely to be outstanding for an extended period (eg several years). Rather, these deposits are usually expected to be withdrawn within a short time (eg a few months or less), although they may be replaced by new deposits. Put another way, the balance of the portfolio is relatively stable only because withdrawals on some accounts (which usually occur relatively quickly) are offset by new deposits into others. Thus, the liability being hedged is actually the forecast replacement of existing deposits by the receipt of new deposits. IAS 39 does not permit a hedge of such a forecast transaction to qualify for fair value hedge accounting. Rather, fair value hedge accounting can be applied only to the liability (or asset) or firm commitment that exists today.

(b) a portfolio of demandable liabilities is similar to a portfolio of trade payables. Both comprise individual balances that usually are expected to be paid within a short time (eg a few months or less) and replaced by new balances. Also, for both, there is an amount—the base level—that is expected to be stable and present indefinitely. Hence, if the Board were to permit demandable liabilities to be included in a fair value hedge on the basis of a stable base level created by expected replacements, it should similarly allow a hedge of a portfolio of trade payables to qualify for fair value hedge accounting on this basis.

(c) a portfolio of similar core deposits is not different from an individual deposit, other than that, in the light of the 'law of large numbers', the behaviour of the portfolio is more predictable. There are no diversification effects from aggregating many similar items.

[+] IFRS 9 *Financial Instruments* replaced IAS 39.

(d) it would be inconsistent with the requirement in IAS 39 that the fair value of a liability with a demand feature is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid, to schedule such liabilities for hedging purposes using a different date. For example, consider a deposit of CU100 that can be withdrawn on demand without penalty. IAS 39 states that the fair value of such a deposit is CU100. That fair value is unaffected by interest rates and does not change when interest rates move. Accordingly, the demand deposit cannot be included in a fair value hedge of interest rate risk—there is no fair value exposure to hedge.

BC188 For these reasons, the Board concluded that demandable liabilities should not be included in a portfolio hedge on the basis of the expected repayment date of the *total balance of a portfolio* of demandable liabilities, ie including expected rollovers or replacements of existing deposits by new ones. However, as part of its consideration of comments received on the Exposure Draft, the Board also considered whether a demandable liability, such as a demand deposit, could be included in a portfolio hedge based on the expected repayment date of the *existing balance of individual deposits*, ie ignoring any rollovers or replacements of existing deposits by new deposits. The Board noted the following.

(a) For many demandable liabilities, this approach would imply a much earlier expected repayment date than is generally assumed for risk management purposes. In particular, for chequing accounts it would probably imply an expected maturity of a few months or less. However, for other demandable liabilities, such as fixed term deposits that can be withdrawn only by the depositor incurring a significant penalty, it might imply an expected repayment date that is closer to that assumed for risk management.

(b) This approach implies that the *fair value* of the demandable liability should also reflect the expected repayment date of the existing balance, ie that the fair value of a demandable deposit liability is the present value of the amount of the deposit discounted from the expected repayment date. The Board noted that it would be inconsistent to permit fair value hedge accounting to be based on the expected repayment date, but to measure the fair value of the liability on initial recognition on a different basis. The Board also noted that this approach would give rise to a difference on initial recognition between the amount deposited and the fair value recognised in the balance sheet. This, in turn, gives rise to the issue of what the difference represents. Possibilities the Board considered include (i) the value of the depositor's option to withdraw its money before the expected maturity, (ii) prepaid servicing costs or (iii) a gain. The Board did not reach a conclusion on what the difference represents, but agreed that if it were to require such differences to be recognised, this would apply to all demandable liabilities, not only to those included in a portfolio hedge. Such a requirement would represent a significant change from present practice.

(c) If the fair value of a demandable deposit liability at the date of initial recognition is deemed to equal the amount deposited, a fair value portfolio hedge based on an expected repayment date is unlikely to be effective. This is because such deposits typically pay interest at a rate that is significantly lower than that being hedged (eg the deposits may pay interest at zero or at very low rates, whereas the interest rate being hedged may be LIBOR or a similar benchmark rate). Hence, the fair value of the deposit will be significantly less sensitive to interest rate changes than that of the hedging instrument.

(d) The question of how to fair value a demandable liability is closely related to issues being debated by the Board in other projects, including Insurance (phase II), Revenue Recognition, Leases and Measurement. The Board's discussions in these other projects are continuing and it would be premature to reach a conclusion in the context of portfolio hedging without considering the implications for these other projects.

BC189 As a result, the Board decided:

(a) to confirm the requirement in IAS 39 that 'the fair value of a financial liability with a demand feature (eg a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid',* and

(b) consequently, that a demandable liability cannot qualify for fair value hedge accounting for any time period beyond the shortest period in which the counterparty can demand payment.

The Board noted that, depending on the outcome of its discussions in other projects (principally Insurance (phase II), Revenue Recognition, Leases and Measurement), it might reconsider these decisions at some time in the future.

BC190 The Board also noted that what is designated as the hedged item in a portfolio hedge affects the relevance of this issue, at least to some extent. In particular, if the hedged item is designated as a portion *of the assets* in a portfolio, this issue is irrelevant. To illustrate, assume that in a particular repricing time period an entity has CU100 of fixed rate assets and CU80 of what it regards as fixed rate liabilities and the entity wishes to hedge its net exposure of CU20. Also assume that all of the liabilities are demandable liabilities and the time period is later than that containing the earliest date on which the items can be repaid. If the hedged item is designated as CU20 of *assets*, then the demandable *liabilities* are not included in the hedged item, but rather are used only to determine how much of the assets the entity wishes to designate as being hedged. In such a case, whether the demandable liabilities can be designated as a hedged item in a fair value hedge is irrelevant. However, if the overall net position were to be designated as the hedged item, because the net position comprises CU100 of assets and CU80 of demandable liabilities, whether the demandable liabilities can be designated as a hedged item in a fair value hedge becomes critical.

BC191 Given the above points, the Board decided that a portion of assets or liabilities (rather than an overall net position) may be designated as the hedged item, to overcome part of the demandable liabilities issue. It also noted that this approach is consistent with IAS 39**, whereas designating an overall net position is not. IAS 39† prohibits an overall net position from being designated as the hedged item, but permits a similar effect to be achieved by designating an amount of assets (or liabilities) equal to the net position.

* IFRS 9 *Financial Instruments* replaced IAS 39.
** see IAS 39, paragraph 84
† see IAS 39, paragraph AG101

BC192 However, the Board also recognised that this method of designation would not fully resolve the demandable liabilities issue. In particular, the issue is still relevant if, in a particular repricing time period, the entity has so many demandable liabilities whose earliest repayment date is before that time period that (a) they comprise nearly all of what the entity regards as its fixed rate liabilities and (b) its fixed rate liabilities (including the demandable liabilities) exceed its fixed rate assets in this repricing time period. In this case, the entity is in a net liability position. Thus, it needs to designate an amount of the *liabilities* as the hedged item. But unless it has sufficient fixed rate liabilities other than those that can be demanded before that time period, this implies designating the demandable liabilities as the hedged item. Consistently with the Board's decision discussed above, such a hedge does not qualify for fair value hedge accounting. (If the liabilities are non-interest bearing, they cannot be designated as the hedged item in a cash flow hedge because their cash flows do not vary with changes in interest rates, ie there is no cash flow exposure to interest rates. However, the hedging relationship may qualify for cash flow hedge accounting if designated as a hedge of associated assets.)

What portion of assets should be designated and the impact on ineffectiveness

BC193 Having decided that a portion of assets (or liabilities) could be designated as the hedged item, the Board considered how to overcome the systems problems noted in paragraph BC176(b) and (c). The Board noted that these problems arise from designating individual assets (or liabilities) as the hedged item. Accordingly, the Board decided that the hedged item could be expressed as an *amount* (of assets or liabilities) rather than as individual assets or liabilities.

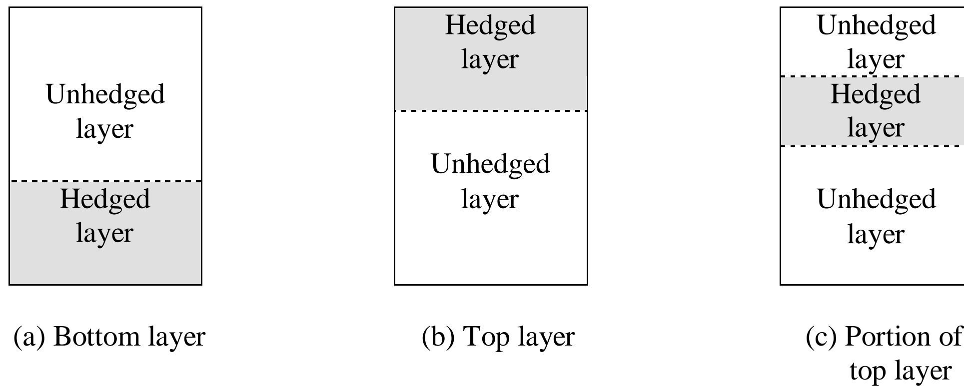
BC194 The Board noted that this decision—that the hedged item may be designated as an amount of assets or liabilities rather than as specified items—gives rise to the issue of how the amount designated should be specified. The Board considered comments received on the Exposure Draft that it should not specify any method for designating the hedged item and hence measuring effectiveness. However, the Board concluded that if it provided no guidance, entities might designate in different ways, resulting in little comparability between them. The Board also noted that its objective, when permitting an amount to be designated, was to overcome the systems problems associated with designating individual items whilst achieving a very similar accounting result. Accordingly, it concluded that it should require a method of designation that closely approximates the accounting result that would be achieved by designating individual items.

BC195 Additionally, the Board noted that designation determines how much, if any, ineffectiveness arises if actual repricing dates in a particular repricing time period vary from those estimated or if the estimated repricing dates are revised. Taking the above example of a repricing time period in which there are CU100 of fixed rate assets and the entity designates as the hedged item an amount of CU20 of assets, the Board considered two approaches (a layer approach and a percentage approach) that are summarised below.

Layer approach

BC196 The first of these approaches, illustrated in figure 1, designates the hedged item as a 'layer' (eg (a) the bottom layer, (b) the top layer or (c) a portion of the top layer) of the assets (or liabilities) in a repricing time period. In this approach, the portfolio of CU100 in the above example is considered to comprise a hedged layer of CU20 and an unhedged layer of CU80.

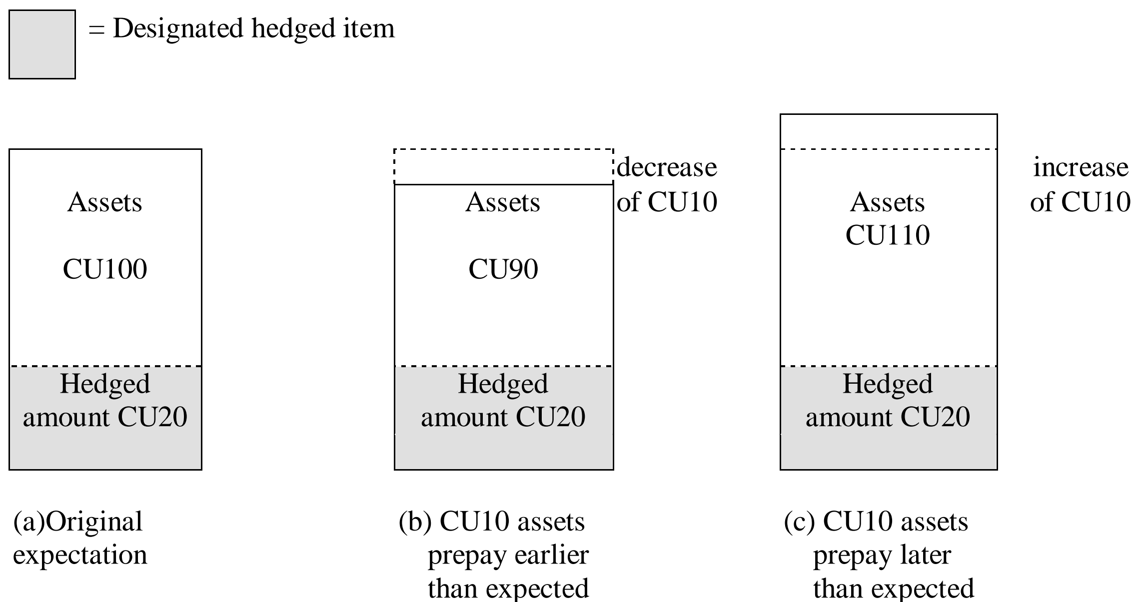
Figure 1: Illustrating the designation of an amount of assets as a layer



(a) Bottom layer (b) Top layer (c) Portion of top layer

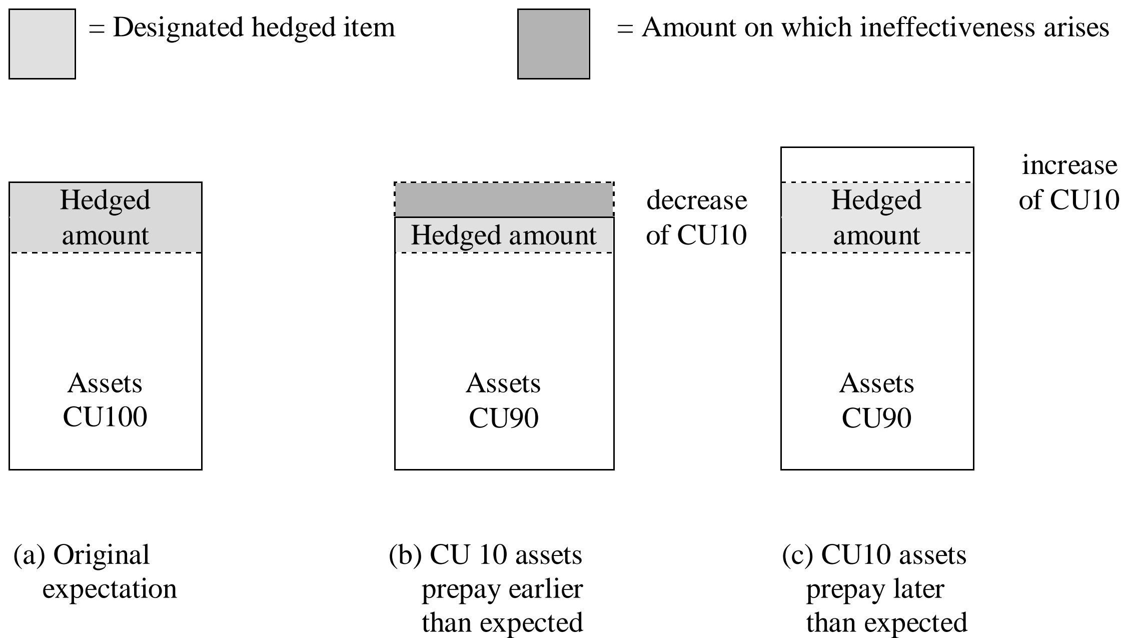
BC197 The Board noted that the layer approach does not result in the recognition of ineffectiveness in all cases when the estimated amount of assets (or liabilities) changes. For example, in a bottom layer approach (see figure 2), if some assets prepay earlier than expected so that the entity revises downward its estimate of the amount of assets in the repricing time period (eg from CU100 to CU90), these reductions are assumed to come first from the unhedged top layer (figure 2(b)). Whether any ineffectiveness arises depends on whether the downward revision reaches the hedged layer of CU20. Thus, if the bottom layer is designated as the hedged item, it is unlikely that the hedged (bottom) layer will be reached and that any ineffectiveness will arise. Conversely, if the top layer is designated (see figure 3), any downward revision to the estimated amount in a repricing time period will reduce the hedged (top) layer and ineffectiveness will arise (figure 3(b)).

Figure 2: Illustrating the effect on changes in prepayments in a bottom layer approach



(a)Original expectation (b) CU10 assets prepay earlier than expected (c) CU10 assets prepay later than expected

Figure 3: Illustrating the effect on changes in prepayments in a top layer approach



(a) Original expectation

(b) CU 10 assets prepay earlier than expected

(c) CU10 assets prepay later than expected

BC198 Finally, if some assets prepay *later* than expected so that the entity revises *upward* its estimate of the amount of assets in this repricing time period (eg from CU100 to CU110, see figures 2(c) and 3(c)), no ineffectiveness arises no matter how the layer is designated, on the grounds that the hedged layer of CU20 is still there and that was all that was being hedged.

Percentage approach

BC199 The percentage approach, illustrated in figure 4, designates the hedged item as a percentage of the assets (or liabilities) in a repricing time period. In this approach, in the portfolio in the above example, 20 per cent of the assets of CU100 in this repricing time period is designated as the hedged item (figure 4(a)). As a result, if some assets prepay *earlier* than expected so that the entity revises *downwards* its estimate of the amount of assets in this repricing time period (eg from CU100 to CU90, figure 4(b)), ineffectiveness arises on 20 per cent of the decrease (in this case ineffectiveness arises on CU2). Similarly, if some assets prepay *later* than expected so that the entity revises *upwards* its estimate of the amount of assets in this repricing time period (eg from CU100 to CU110, figure 4(c)), ineffectiveness arises on 20 per cent of the increase (in this case ineffectiveness arises on CU2).

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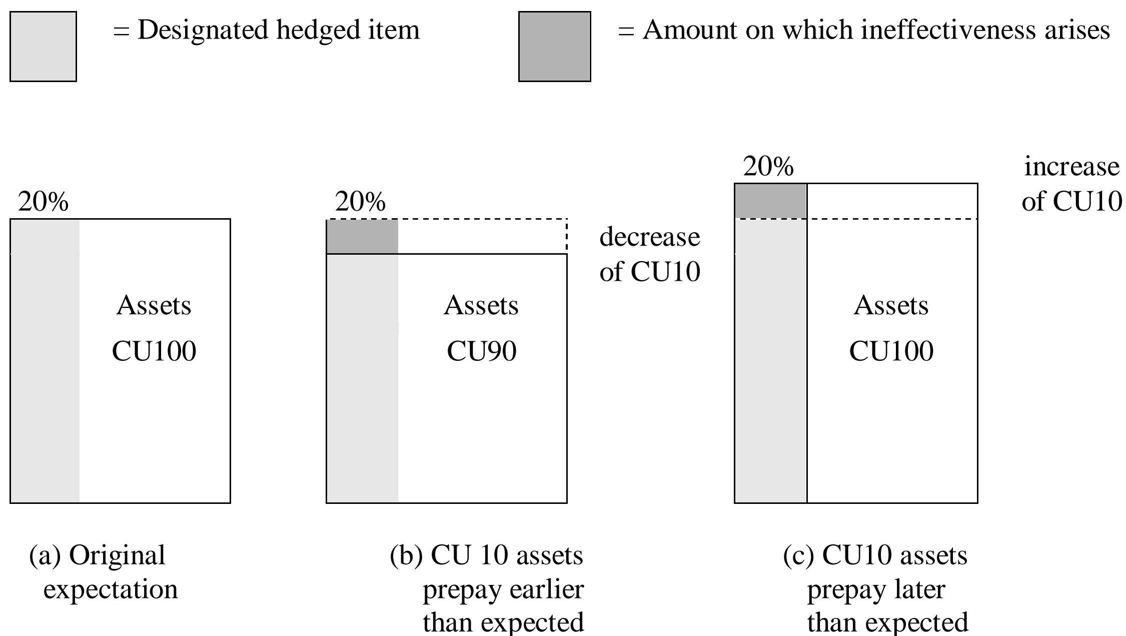
Figure 4: Illustrating the designation of an amount of assets as a percentage



Arguments for and against the layer approach

BC200 The arguments for the layer approach are as follows:

(a) Designating a bottom layer would be consistent with the answers to Questions F.6.1 and F.6.2 of the Guidance on Implementing IAS 39, which allow, for a cash flow hedge, the 'bottom' portion of reinvestments of collections from assets to be designated as the hedged item.*

(b) The entity is hedging interest rate risk rather than prepayment risk. Any changes to the portfolio because of changes in prepayments do not affect how effective the hedge was in mitigating interest rate risk.

(c) The approach captures all ineffectiveness on the hedged portion. It merely allows the hedged portion to be defined in such a way that, at least in a bottom layer approach, the first of any potential ineffectiveness relates to the unhedged portion.

(d) It is correct that no ineffectiveness arises if changes in prepayment estimates cause more assets to be scheduled into that repricing time period. So long as assets equal to the hedged layer remain, there is no ineffectiveness and upward revisions of the amount in a repricing time period do not affect the hedged layer.

* IFRS 9 *Financial Instruments* deleted the guidance on implementing IAS 39.

(e) A prepayable item can be viewed as a combination of a non-prepayable item and a prepayment option. The designation of a bottom layer can be viewed as hedging a part of the life of the non-prepayable item, but none of the prepayment option. For example, a 25-year prepayable mortgage can be viewed as a combination of (i) a non-prepayable, fixed term, 25-year mortgage and (ii) a written prepayment option that allows the borrower to repay the mortgage early. If the entity hedges this asset with a 5-year derivative, this is equivalent to hedging the first five years of component (i). If the position is viewed in this way, no ineffectiveness arises when interest rate changes cause the value of the prepayment option to change (unless the option is exercised and the asset prepaid) because the prepayment option was not hedged.

BC201 The arguments against the layer approach are as follows:

(a) The considerations that apply to a fair value hedge are different from those that apply to a cash flow hedge. In a cash flow hedge, it is the cash flows associated with the reinvestment of probable future collections that are hedged. In a fair value hedge it is the fair value of the assets that currently exist.

(b) The fact that no ineffectiveness is recognised if the amount in a repricing time period is re-estimated upwards (with the effect that the entity becomes underhedged) is not in accordance with IAS 39. For a fair value hedge, IAS 39 requires that ineffectiveness is recognised both when the entity becomes overhedged (ie the derivative exceeds the hedged item) and when it becomes underhedged (ie the derivative is smaller than the hedged item).

(c) As noted in paragraph BC200(e), a prepayable item can be viewed as a combination of a non-prepayable item and a prepayment option. When interest rates change, the fair value of both of these components changes.

(d) The objective of applying fair value hedge accounting to a hedged item designated in terms of an amount (rather than as individual assets or liabilities) is to obtain results that closely approximate those that would have been obtained if individual assets or liabilities had been designated as the hedged item. If individual prepayable assets had been designated as the hedged item, the change in both the components noted in (c) above (to the extent they are attributable to the hedged risk) would be recognised in profit or loss, both when interest rates increase and when they decrease. Accordingly, the change in the fair value of the hedged asset would differ from the change in the fair value of the hedging derivative (unless that derivative includes an equivalent prepayment option) and ineffectiveness would be recognised for the difference. It follows that in the simplified approach of designating the hedged item as an amount, ineffectiveness should similarly arise.

(e) *All* prepayable assets in a repricing time period, and not just a layer of them, contain a prepayment option whose fair value changes with changes in interest rates. Accordingly, when interest rates change, the fair value of the hedged assets (which include a prepayment option whose fair value has changed) will change by an amount different from that of the hedging derivative (which typically does not contain a prepayment option), and ineffectiveness will arise. This effect occurs regardless of whether interest rates increase or decrease— ie regardless of whether re-estimates of prepayments result in the amount in a time period being more or less.

(f) Interest rate risk and prepayment risk are so closely interrelated that it is not appropriate to separate the two components referred to in paragraph BC200(e) and designate only one of them (or a part of one of them) as the hedged item. Often the biggest single cause of changes in prepayment rates is changes in interest rates. This close relationship is the reason why IAS 39 prohibits a held-to-maturity asset[+] from being a hedged item with respect to either interest rate risk or prepayment risk. Furthermore, most entities do not separate the two components for risk management purposes. Rather, they incorporate the prepayment option by scheduling amounts based on expected maturities. When entities choose to use risk management practices—based on not separating prepayment and interest rate risk—as the basis for designation for hedge accounting purposes, it is not appropriate to separate the two components referred to in paragraph BC200(e) and designate only one of them (or a part of one of them) as the hedged item.

(g) If interest rates change, the effect on the fair value of a portfolio of prepayable items will be different from the effect on the fair value of a portfolio of otherwise identical but non-prepayable items. However, using a layer approach, this difference would not be recognised—if both portfolios were hedged to the same extent, both would be recognised in the balance sheet at the same amount.

BC202 The Board was persuaded by the arguments in paragraph BC201 and rejected layer approaches. In particular, the Board concluded that the hedged item should be designated in such a way that if the entity changes its estimates of the repricing time periods in which items are expected to repay or mature (eg in the light of recent prepayment experience), ineffectiveness arises. It also concluded that ineffectiveness should arise both when estimated prepayments decrease, resulting in more assets in a particular repricing time period, and when they increase, resulting in fewer.

Arguments for a third approach—measuring directly the change in fair value of the entire hedged item

BC203 The Board also considered comments on the Exposure Draft that:

(a) some entities hedge prepayment risk and interest rate risk separately, by hedging to the expected prepayment date using interest rate swaps, and hedging possible variations in these expected prepayment dates using swaptions.

(b) the embedded derivatives provisions of IAS 39 require some prepayable assets to be separated into a prepayment option and a non-prepayable host contract (unless the entity is unable to measure separately the prepayment option, in which case it treats the entire asset as held for trading). This seems to conflict with the view in the Exposure Draft that the two risks are too difficult to separate for the purposes of a portfolio hedge.[#]

[+] IFRS 9 eliminated the category of held-to-maturity.

[#] IFRS 9 replaced IAS 39.

BC204 In considering these arguments, the Board noted that the percentage approach described in paragraph AG126(b) is a proxy for measuring the change in the fair value of the *entire* asset (or liability)—including any embedded prepayment option—that is attributable to changes in interest rates. The Board had developed this proxy in the Exposure Draft because it had been informed that most entities (a) do not separate interest rate risk and prepayment risk for risk management purposes and hence (b) were unable to value the change in the value of the entire asset (including any embedded prepayment option) that is attributable to changes in the hedged interest rates. However, the comments described in paragraph BC203 indicated that in some cases, entities may be able to measure this change in value directly. The Board noted that such a direct method of measurement is conceptually preferable to the proxy described in paragraph AG126(b) and, accordingly, decided to recognise it explicitly. Thus, for example, if an entity that hedges prepayable assets using a combination of interest rate swaps and swaptions is able to measure directly the change in fair value of the entire asset, it could measure effectiveness by comparing the change in the value of the swaps and swaptions with the change in the fair value of the entire asset (including the change in the value of the prepayment option embedded in them) that is attributable to changes in the hedged interest rate. However, the Board also decided to permit the proxy proposed in the Exposure Draft for those entities that are unable to measure directly the change in the fair value of the entire asset.

Consideration of systems requirements

BC205 Finally, the Board was informed that, to be practicable in terms of systems needs, any approach should not require tracking of the amount in a repricing time period for multiple periods. Therefore it decided that ineffectiveness should be calculated by determining the change in the estimated amount in a repricing time period between one date on which effectiveness is measured and the next, as described more fully in paragraphs AG126 and AG127. This requires the entity to track how much of the change in each repricing time period between these two dates is attributable to revisions in estimates and how much is attributable to the origination of new assets (or liabilities). However, once ineffectiveness has been determined as set out above, the entity in essence starts again, ie it establishes the new amount in each repricing time period (including new items that have been originated since it last tested effectiveness), designates a new hedged item, and repeats the procedures to determine ineffectiveness at the next date it tests effectiveness. Thus the tracking is limited to movements between one date when effectiveness is measured and the next. It is not necessary to track for multiple periods. However, the entity will need to keep records relating to each repricing time period (a) to reconcile the amounts for each repricing time period with the total amounts in the two separate line items in the balance sheet (see paragraph AG114(f)), and (b) to ensure that amounts in the two separate line items are derecognised no later than when the repricing time period to which they relate expires.

BC206 The Board also noted that the amount of tracking required by the percentage approach is no more than what would be required by any of the layer approaches. Thus, the Board concluded that none of the approaches was clearly preferable from the standpoint of systems needs.

The carrying amount of the hedged item

BC207 The last issue noted in paragraph BC176 is how to present in the balance sheet the change in fair value of the hedged item. The Board noted the concern of respondents that the hedged item may contain many—even thousands of—individual assets (or liabilities) and that to change the carrying amounts of each of these individual items would be impracticable. The Board considered dealing with this concern by permitting the change in value to be presented in a single line item in the balance sheet. However, the Board noted that this could result in a decrease in the fair value of a financial asset (financial liability) being recognised as a financial liability (financial asset). Furthermore, for some repricing time periods the hedged item may be an asset, whereas for others it may be a liability. The Board concluded that it would be incorrect to present together the changes in fair value for such repricing time periods, because to do so would combine changes in the fair value of assets with changes in the fair value of liabilities.

BC208 Accordingly, the Board decided that two line items should be presented, as follows:

(a) for those repricing time periods for which the hedged item is an asset, the change in its fair value is presented in a single separate line item within assets; and

(b) for those repricing time periods for which the hedged item is a liability, the change in its fair value is presented in a single separate line item within liabilities.

BC209 The Board noted that these line items represent changes in the fair value of the hedged item. For this reason, the Board decided that they should be presented next to financial assets or financial liabilities.

Derecognition of amounts included in the separate line items

Derecognition of an asset (or liability) in the hedged portfolio

BC210 The Board discussed how and when amounts recognised in the separate balance sheet line items should be removed from the balance sheet. The Board noted that the objective is to remove such amounts from the balance sheet in the same periods as they would have been removed had individual assets or liabilities (rather than an amount) been designated as the hedged item.

BC211 The Board noted that this objective could be fully met only if the entity schedules individual assets or liabilities into repricing time periods and tracks both for how long the scheduled individual items have been hedged and how much of each item was hedged in each time period. In the absence of such scheduling and tracking, some assumptions would need to be made about these matters and, hence, about how much should be removed from the separate balance sheet line items when an asset (or liability) in the hedged portfolio is derecognised. In addition, some safeguards would be needed to ensure that amounts included in the separate balance sheet line items are removed from the balance sheet over a reasonable period and do not remain in the balance sheet indefinitely. With these points in mind, the Board decided to require that:

(a) whenever an asset (or liability) in the hedged portfolio is derecognised—whether through earlier than expected prepayment, sale or write-off from impairment—any amount included in the separate balance sheet line item relating to that derecognised asset (or liability) should be removed from the balance sheet and included in the gain or loss on derecognition.

(b) if an entity cannot determine into which time period(s) a derecognised asset (or liability) was scheduled:

(i) it should assume that higher than expected prepayments occur on assets scheduled into the first available time period; and

(ii) it should allocate sales and impairments to assets scheduled into all time periods containing the derecognised item on a systematic and rational basis.

(c) the entity should track how much of the total amount included in the separate line items relates to each repricing time period, and should remove the amount that relates to a particular time period from the balance sheet no later than when that time period expires.

Amortisation

BC212 The Board also noted that if the designated hedged amount for a repricing time period is reduced, IAS 39[*] requires that the separate balance sheet line item described in paragraph 89A relating to that reduction is amortised on the basis of a recalculated effective interest rate. The Board noted that for a portfolio hedge of interest rate risk, amortisation based on a recalculated effective interest rate could be complex to determine and could demand significant additional systems requirements. Consequently, the Board decided that in the case of a portfolio hedge of interest rate risk (and only in such a hedge), the line item balance may be amortised using a straight-line method when a method based on a recalculated effective interest rate is not practicable.

The hedging instrument

BC213 The Board was asked by commentators to clarify whether the hedging instrument may be a portfolio of derivatives containing offsetting risk positions. Commentators noted that previous versions of IAS 39 were unclear on this point.

BC214 The issue arises because the assets and liabilities in each repricing time period change over time as prepayment expectations change, as items are derecognised and as new items are originated. Thus the net position, and the amount the entity wishes to designate as the hedged item, also changes over time. If the hedged item decreases, the hedging instrument needs to be reduced. However, entities do not normally reduce the hedging instrument by disposing of some of the derivatives contained in it. Instead, entities adjust the hedging instrument by entering into new derivatives with an offsetting risk profile.

BC215 The Board decided to permit the hedging instrument to be a portfolio of derivatives containing offsetting risk positions for both individual and portfolio hedges. It noted that all of the derivatives concerned are measured at fair value. It also noted that the two ways of adjusting the hedging instrument described in the previous paragraph can achieve substantially the same effect. Therefore the Board clarified paragraph 77 to this effect.

[*] see paragraph 92

Hedge effectiveness for a portfolio hedge of interest rate risk

BC216 Some respondents to the Exposure Draft questioned whether IAS 39's effectiveness tests[**] should apply to a portfolio hedge of interest rate risk. The Board noted that its objective in amending IAS 39 for a portfolio hedge of interest rate risk is to permit fair value hedge accounting to be used more easily, whilst continuing to meet the principles of hedge accounting. One of these principles is that the hedge is highly effective. Thus, the Board concluded that the effectiveness requirements in IAS 39 apply equally to a portfolio hedge of interest rate risk.

BC217 Some respondents to the Exposure Draft sought guidance on how the effectiveness tests are to be applied to a portfolio hedge. In particular, they asked how the prospective effectiveness test is to be applied when an entity periodically 'rebalances' a hedge (ie adjusts the amount of the hedging instrument to reflect changes in the hedged item). The Board decided that if the entity's risk management strategy is to change the amount of the hedging instrument periodically to reflect changes in the hedged position, that strategy affects the determination of the term of the hedge. Thus, the entity needs to demonstrate that the hedge is expected to be highly effective only for the period until the amount of the hedging instrument is next adjusted. The Board noted that this decision does not conflict with the requirement in paragraph 75 that "a hedging relationship may not be designated for only a portion of the time period during which a hedging instrument remains outstanding". This is because the entire hedging instrument is designated (and not only some of its cash flows, for example, those to the time when the hedge is next adjusted). However, expected effectiveness is assessed by considering the change in the fair value of the entire hedging instrument only for the period until it is next adjusted.

BC218 A third issue raised in the comment letters was whether, for a portfolio hedge, the retrospective effectiveness test should be assessed for all time buckets in aggregate or individually for each time bucket. The Board decided that entities could use any method to assess retrospective effectiveness, but noted that the chosen method would form part of the documentation of the hedging relationship made at the inception of the hedge in accordance with paragraph 88(a) and hence could not be decided at the time the retrospective effectiveness test is performed.

Transition to fair value hedge accounting for portfolios of interest rate risk

BC219 In finalising the amendments to IAS 39, the Board considered whether to provide additional guidance for entities wishing to apply fair value hedge accounting to a portfolio hedge that had previously been accounted for using cash flow hedge accounting. The Board noted that such entities could apply paragraph 101(d) to revoke the designation of a cash flow hedge and re-designate a new fair value hedge using the same hedged item and hedging instrument, and decided to clarify this in the Application Guidance. Additionally, the Board concluded that clarification was not required for first-time adopters because IFRS 1 already contained sufficient guidance.

BC220 The Board also considered whether to permit retrospective designation of a portfolio hedge. The Board noted that this would conflict with the principle in paragraph 88(a) that 'at the inception of the hedge there is formal designation and documentation of the hedging relationship' and accordingly, decided not to permit retrospective designation.

[**] see paragraph AG105

Novation of derivatives and continuation of hedge accounting

BC220A The IASB received an urgent request to clarify whether an entity is required to discontinue hedge accounting for hedging relationships in which a derivative has been designated as a hedging instrument in accordance with IAS 39 when that derivative is novated to a central counterparty (CCP) due to the introduction of a new law or regulation.*

BC220B The IASB considered the derecognition requirements of IAS 39 to determine whether the novation in such a circumstance leads to the derecognition of an existing derivative that has been designated as a hedging instrument. The IASB noted that a derivative should be derecognised only when it meets both the derecognition criteria for a financial asset and the derecognition criteria for a financial liability in circumstances in which the derivative involves two-way payments between parties (ie the payments are or could be from and to each of the parties).

BC220C The IASB observed that paragraph 17(a) of IAS 39 requires that a financial asset is derecognised when the contractual rights to the cash flows from the financial asset expire. The IASB noted that through novation to a CCP, a party (Party A) to the original derivative has new contractual rights to cash flows from a (new) derivative with the CCP, and this new contract replaces the original contract with a counterparty (Party B). Thus the original derivative with Party B has expired and as a consequence the original derivative through which Party A has engaged with Party B shall meet the derecognition criteria for a financial asset.*

BC220D The IASB also observed that paragraph AG57(b) of IAS 39 states that a financial liability is extinguished when the debtor is legally released from primary responsibility for the liability. The IASB noted that the novation to the CCP would release Party A from the responsibility to make payments to Party B and also would oblige Party A to make payments to the CCP. Consequently, the original derivative through which Party A has transacted with Party B also meets the derecognition criteria for a financial liability.#

BC220E Consequently, the IASB concluded that the novation of a derivative to a CCP would be accounted for as the derecognition of the original derivative and the recognition of the (new) novated derivative.

BC220F Taking into account the conclusion of the assessment on the derecognition requirements, the IASB considered paragraphs 91(a) and 101(a) of IAS 39, which require an entity to discontinue hedge accounting prospectively if the hedging instrument expires or is sold, terminated or exercised. The IASB noted that novation to a CCP would require the entity to discontinue hedge accounting because the derivative that was designated as a hedging instrument has been derecognised and consequently the hedging instrument in the existing hedging relationship no longer exists.

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* In this context, the term 'novation' indicates that the parties to a derivative agree that one or more clearing counterparties replace their original counterparty to become the new counterparty to each of the parties. For this purpose, a clearing counterparty is a central counterparty or an entity or entities, for example, a clearing member of a clearing organisation or a client of a clearing member of a clearing organisation, that are acting as counterparty in order to effect clearing by a central counterparty.

* IFRS 9 replaced IAS 39.

IFRS 9 replaced IAS 39.

BC220G The IASB, however, was concerned about the financial reporting effects that would arise from novations that result from new laws or regulations. The IASB noted that the requirement to discontinue hedge accounting meant that although an entity could designate the new derivative as the hedging instrument in a new hedging relationship, this could result in more hedge ineffectiveness, especially for cash flow hedges, compared to a continuing hedging relationship. This is because the derivative that would be newly designated as the hedging instrument would be on terms that would be different from a new derivative, ie it was unlikely to be 'at-market' (for example, a non-option derivative such as a swap or forward might have a significant fair value) at the time of the novation. The IASB also noted that there would be an increased risk that the hedging relationship would fail to fall within the 80–125 per cent hedge effectiveness range required by IAS 39.

BC220H The IASB, taking note of these financial reporting effects, was convinced that accounting for the hedging relationship that existed before the novation as a continuing hedging relationship, in this specific situation, would provide more useful information to users of financial statements. The IASB also considered the feedback from outreach that involved the members of the International Forum of Accounting Standard Setters (IFASS) and securities regulators and noted that this issue is not limited to a specific jurisdiction because many jurisdictions have introduced, or are expected to mandate, laws or regulations that encourage or require the novation of derivatives to a CCP.

BC220I The IASB noted that the widespread legislative changes across jurisdictions were prompted by a G20 commitment to improve transparency and regulatory oversight of over-the-counter (OTC) derivatives in an internationally consistent and non-discriminatory way. Specifically, the G20 agreed to improve OTC derivatives markets so that all standardised OTC derivatives contracts are cleared through a CCP.

BC220J The IASB also considered the draft requirements of the forthcoming hedge accounting chapter of IFRS 9. The IASB noted that those draft requirements also would require hedge accounting to be discontinued if the novation to a CCP occurs.

BC220K Consequently, the IASB decided to publish, in January 2013, the Exposure Draft *Novation of Derivatives and Continuation of Hedge Accounting* ('ED/2013/2'), which proposed amendments to IAS 39 and IFRS 9. In ED/2013/2, the IASB proposed to amend paragraphs 91(a) and 101(a) of IAS 39 to provide relief from discontinuing hedge accounting when the novation to a CCP is required by new laws or regulations and meets certain criteria. The IASB decided to set the comment period for those proposals to 30 days. The IASB noted that the reduced comment period was necessary because the amendments should be completed urgently because the new laws or regulations to effect CCP clearing of OTC derivatives would come into force within a short period; the contents of the proposed amendments were short; and there was likely to be a broad consensus on the topic.

BC220L When developing ED/2013/2, the IASB tentatively decided that the terms of the novated derivative should be unchanged other than the change in counterparty, however, the IASB noted that, in practice, other changes may arise as a direct consequence of the novation. For example, in order to enter into a derivative with a CCP it may be necessary to make adjustments to the collateral arrangements. Such narrow changes that are a direct consequence of or are incidental to the novation were acknowledged in the proposed amendments. However, this would not include changes to, for example, the maturity of the derivatives, the payment dates, or the contractual cash flows or the basis of their calculation, except for charges that may arise as a consequence of transacting with a CCP.

BC220M When developing ED/2013/2, the IASB also discussed whether to require an entity to disclose that it has been able to continue hedge accounting by applying the relief provided by these proposed amendments to IAS 39 and IFRS 9. The IASB tentatively decided that it was not appropriate to mandate specific disclosure in this situation because, from the perspective of a user of financial statements, the hedge accounting would be continuing.

BC220N A total of 78 respondents commented on ED/2013/2. The vast majority of respondents agreed that the proposed amendments are necessary. However, a few respondents expressed disagreement with the proposal on the basis that they disagreed with the IASB's conclusion that hedge accounting would be required to be discontinued as a result of such novations. In expressing such disagreement some noted that IAS 39 expressly acknowledges that certain replacements or rollovers of hedging instruments are not expirations or terminations for the purposes of discontinuing hedge accounting. The IASB noted that this exception applies if '[a] replacement or rollover is part of the entity's documented hedging strategy'(IAS 39.91(a) and IAS 39.101(a)). The IASB questioned whether replacement of a contract as a result of unforeseen legislative changes (even if documented) fits the definition of a replacement that is part of a 'documented hedging strategy'.

BC220O Even though the vast majority of respondents agreed with the proposal, a considerable majority of respondents disagreed with the scope of the proposed amendments. They believed that the proposed scope of 'novation required by laws or regulations' is too restrictive and that the scope therefore should be expanded by removing this criterion. In particular, they argued that voluntary novation to a CCP should be provided with the same relief as novation required by laws or regulations. A few respondents further requested that the scope should not be limited to novation to a central counterparty and that novation in other circumstances should also be considered.

BC220P In considering respondents' comments, the IASB noted that voluntary novation to a CCP could be prevalent in some circumstances such as novation in anticipation of regulatory changes, novation due to operational ease, and novation induced but not actually mandated by laws or regulations as a result of the imposition of charges or penalties. The IASB also noted that many jurisdictions would not require the existing stock of outstanding historical derivatives to be moved to CCPs, although this was encouraged by the G20 commitment.

BC220Q The IASB observed, however, that for hedge accounting to continue voluntary novation to a CCP should be associated with laws or regulations that are relevant to central clearing of derivatives. The IASB noted that while a novation need not be required by laws or regulations for hedge accounting to be allowed to continue, allowing all novations to CCPs to be accommodated was broader than the IASB had intended. In addition, the IASB agreed that hedge accounting should continue when novations are performed as a consequence of laws or regulations or the introduction of laws of regulations but noted that the mere possibility of laws or regulations being introduced was not a sufficient basis for the continuation of hedge accounting.

BC220R Some respondents were concerned that restricting the relief to novation directly to a CCP was too narrow. In considering respondents' comments, the IASB noted that in some cases a CCP has a contractual relationship only with its 'clearing members', and therefore an entity must have a contractual relationship with a clearing member in order to transact with a CCP; a clearing member of a CCP provides a clearing service to its client who cannot access a CCP directly. The IASB also noted that some jurisdictions are introducing a so-called 'indirect clearing' arrangement in their laws or regulations to effect clearing with a CCP, by which a client of a clearing member of a CCP provides a (indirect) clearing service to its client in the same way as a clearing member of a CCP provides a clearing service to its client. In addition, the IASB observed that an intragroup novation also can occur in order to access a CCP; for example, if only particular group entities can transact directly with a CCP.

BC220S On the basis of respondents' comments, the IASB decided to expand the scope of the amendments by providing relief for novations to entities other than a CCP if such novation is undertaken with the objective of effecting clearing with a CCP rather than limiting relief to situations in which novation is directly to a CCP. The IASB decided that in these circumstances the novation had occurred in order to effect clearing through a CCP, albeit indirectly. The IASB thus decided also to include such novations in the scope of the amendments because they are consistent with the objective of the proposed amendments—they enable hedge accounting to continue when novations occur as a consequence of laws or regulations or the introduction of laws or regulations that increase the use of CCPs. However, the IASB noted that when parties to a hedging instrument enter into novations with different counterparties (for example, with different clearing members), these amendments only apply if each of those parties ultimately effects clearing with the same central counterparty.

BC220T Respondents raised a concern about the phrase 'if and only if' that was used in ED/2013/2 when describing that the relief is provided 'if and only if' the criteria are met. In considering respondents' comments, the IASB noted that ED/2013/2 was intended to address a narrow issue—novation to CCPs—and therefore changing the phrase 'if and only if' to 'if' would target the amendment on the fact patterns that the IASB sought to address. The IASB noted that this would have the effect of requiring an analysis of whether the general conditions for continuation of hedge accounting are satisfied in other cases (for example, as was raised by some respondents, in determining the effect of intragroup novations in consolidated financial statements).

BC220U The IASB decided to make equivalent amendments to the forthcoming chapter on hedge accounting that will be incorporated into IFRS 9, as proposed in ED/2013/2; no respondents opposed this proposal.

BC220V ED/2013/2 did not propose any additional disclosures. The vast majority of respondents agreed with this. The IASB confirmed that additional disclosures are not required. However, the IASB noted that an entity may consider disclosures in accordance with IFRS 7 *Financial Instruments: Disclosures*, which requires qualitative and quantitative disclosures about credit risk.

BC220W The IASB also decided to retain in the final amendments the transition requirements proposed in ED/2013/2 so that the amendments should apply retrospectively and early application should be permitted. The IASB noted that even with retrospective application, if an entity had previously discontinued hedge accounting, as a result of a novation, that (pre-novation) hedge accounting relationship could not be reinstated because doing so would be inconsistent with the requirements for hedge accounting (ie hedge accounting cannot be applied retrospectively).

BC221-BC222 [Deleted]

Amendments for Interest Rate Benchmark Reform (September 2019)

BC223 Interest rate benchmarks such as interbank offered rates (IBORs) play an important role in global financial markets. These interest rate benchmarks index trillions of dollars and other currencies in a wide variety of financial products, from derivatives to residential mortgages. However, cases of attempted market manipulation of some interest rate benchmarks, together with the post-crisis decline in liquidity in interbank unsecured funding markets, have undermined confidence in the reliability and robustness of some interest rate benchmarks. Against this background, the G20 asked the Financial Stability Board (FSB) to undertake a fundamental review of major interest rate benchmarks. Following the review, the FSB published a report setting out its recommended reforms of some major interest rate benchmarks such as IBORs. Public authorities in many jurisdictions have since taken steps to implement those recommendations. In some jurisdictions, there is already clear progress towards the reform of interest rate benchmarks, or the replacement of interest rate benchmarks with alternative, nearly risk-free interest rates that are based, to a greater extent, on transaction data (alternative benchmark rates). This has in turn led to uncertainty about the long-term viability of some interest rate benchmarks. In these amendments, the term 'interest rate benchmark reform' refers to the market-wide reform of an interest rate benchmark including its replacement with an alternative benchmark rate, such as that resulting from the FSB's recommendations set out in its July 2014 report 'Reforming Major Interest Rate Benchmarks' (the reform).*

BC224 In 2018 the Board noted the increasing levels of uncertainty about the long-term viability of some interest rate benchmarks and decided to address as a priority the issues affecting financial reporting in the period before the reform (referred to as pre-replacement issues).

BC225 As part of the pre-replacement issues, the Board considered the implications for specific hedge accounting requirements in IFRS 9 and IAS 39, which require forward-looking analysis. As a result of the reform, contractual cash flows of hedged items and hedging instruments based on an existing interest rate benchmark will likely change when that interest rate benchmark is subject to the reform—in these amendments, contractual cash flows encompass both contractually specified and non-contractually specified cash flows. The same uncertainty arising from the reform regarding the timing and the amount of future cash flows will likely affect the changes in fair value of hedged items and hedging instruments in a fair value hedge of the interest rate benchmark exposure. Until decisions are made about what the alternative benchmark rate is, and when and how the reform will occur, including specifying its effects on particular contracts, uncertainties will exist regarding the timing and the amount of future cash flows of the hedged item and the hedging instrument.

* The report, 'Reforming Major Interest Rate Benchmarks', is available at http://www.fsb.org/wp-content/uploads/r_140722.pdf.

BC226 The Board noted that the hedge accounting requirements in IFRS 9 and IAS 39 provide a clear basis for accounting for such uncertainties. In applying these requirements, the uncertainties about the timing and the amount of future cash flows could affect an entity's ability to meet those specific forward-looking hedge accounting requirements in the period when uncertainty is created by the reform. In some cases, solely due to such uncertainties, entities could be required to discontinue hedge accounting for hedging relationships that would otherwise qualify for hedge accounting. Also, because of the uncertainties arising from the reform, entities may not be able to designate new hedging relationships that would otherwise qualify for hedge accounting applying IFRS 9 and IAS 39. In some cases, discontinuation of hedge accounting would require an entity to recognise gains or losses in profit or loss.

BC227 In the Board's view, discontinuation of hedge accounting solely due to such uncertainties before the reform's economic effects on hedged items and hedging instruments are known would not provide useful information to users of financial statements. Therefore, the Board decided to publish in May 2019 the Exposure Draft *Interest Rate Benchmark Reform* (2019 Exposure Draft), which proposed exceptions to IFRS 9 and IAS 39 to provide relief during this period of uncertainty.

BC228 The 2019 Exposure Draft proposed exceptions to specific hedge accounting requirements such that entities would apply those requirements assuming the interest rate benchmark on which the hedged risk and/or cash flows of the hedged item or of the hedging instrument are based is not altered as a result of the reform. The proposed exceptions applied only to the hedge accounting requirements specified in that Exposure Draft and were not intended to provide relief from all consequences arising from the reform.

BC229 Almost all respondents to the 2019 Exposure Draft agreed with the Board's decision to address pre-replacement issues. Many highlighted the urgency of these issues, especially in some jurisdictions where there is already clear progress towards the reform or replacement of interest rate benchmarks with alternative benchmark rates.

BC230 In September 2019 the Board amended IFRS 9, IAS 39 and IFRS 7 by issuing *Interest Rate Benchmark Reform*, which confirmed with modifications the proposals in the 2019 Exposure Draft. In the amendments issued in September 2019, the Board added paragraphs 102A–102N and 108G to IAS 39.

BC231 The Board decided to propose amendments to IAS 39 as well as IFRS 9 because when entities first apply IFRS 9, they are permitted to choose as an accounting policy to continue to apply the hedge accounting requirements of IAS 39. The Board understands that a significant number of IFRS preparers—financial institutions in particular—have made such an accounting policy choice.

Scope of the exceptions

BC232 In the 2019 Exposure Draft, the Board noted that the hedge accounting issues being addressed arise in the context of interest rate benchmark reform, and, therefore, the proposed exceptions would apply only to hedging relationships of interest rate risk that are affected by the reform. However, some respondents expressed the view that the scope of the exceptions, as set out in the 2019 Exposure Draft, would not include other types of hedging relationships that may be affected by uncertainties arising from the reform such as hedging relationships in which an entity designates cross-currency interest rate swaps to hedge its exposure to both foreign currency and interest rate risk. These respondents asked the Board to clarify whether the scope of the exceptions was meant to include such hedging relationships.

BC233 In its redeliberations on the 2019 Exposure Draft, the Board clarified that it did not intend to exclude from the scope of the amendments hedging relationships in which interest rate risk is not the only designated hedged risk. The Board agreed with respondents that other hedging relationships could be directly affected by the reform when the reform gives rise to uncertainties about the timing or the amount of interest rate benchmark-based cash flows of the hedged item or of the hedging instrument. Therefore, the Board confirmed that the exceptions would apply to the interest rate benchmark-based cash flows in these situations. The Board noted that many derivatives, designated in hedging relationships in which there is no uncertainty about the timing or the amount of interest rate benchmark-based cash flows, could be indirectly affected by the reform. For example, this would be the case when the valuation of the derivatives is affected by general uncertainty in the market caused by the reform. The Board confirmed that the exceptions do not apply to these hedging relationships, despite the indirect effect the uncertainties arising from the reform could have on the valuation of derivatives.

BC234 Consequently, the Board clarified the wording in paragraph 102A of IAS 39 to refer to all hedging relationships that are directly affected by interest rate benchmark reform. Paragraph 102A of IAS 39 explains that a hedging relationship is directly affected by interest rate benchmark reform only if the reform gives rise to uncertainties about the interest rate benchmark (contractually or non-contractually specified) designated as a hedged risk and/or the timing or the amount of interest rate benchmark-based cash flows of the hedged item or of the hedging instrument. The scope of the exceptions does not exclude hedging relationships in which interest rate risk is not the only hedged risk.

Highly probable requirement

BC235 The Board noted that if an entity designates a forecast transaction as the hedged item in a cash flow hedge, applying paragraph 88(c) of IAS 39, that transaction must be highly probable (highly probable requirement). This requirement is intended to ensure that changes in the fair value of designated hedging instruments are recognised in other comprehensive income only for those hedged forecast transactions that are highly probable to occur. This requirement is an important discipline in applying hedge accounting to forecast transactions. The Board noted that the requirements in IAS 39 provide a clear basis to account for the effects of the reform—that is, if the effects of the reform are such that the hedged cash flows are no longer highly probable, hedge accounting should be discontinued. As set out in paragraph BC227, in the Board's view, discontinuing all affected hedging relationships solely due to such uncertainty would not provide useful information to users of financial statements.

BC236 Therefore, the Board amended IAS 39 to provide an exception to the highly probable requirement that would provide targeted relief during this period of uncertainty. More specifically, applying the exception, if the hedged future cash flows are based on an interest rate benchmark that is subject to the reform, an entity assumes that the interest rate benchmark on which the hedged cash flows are based is not altered when assessing whether the future cash flows are highly probable. If the hedged future cash flows are based on a highly probable forecast transaction, by applying the exception in paragraph 102D of IAS 39 when performing the assessment of the highly probable requirement for that forecast transaction, the entity would assume that the interest rate benchmark on which the hedged cash flows are based will not be altered in the future contract as a result of the reform. For example, for a future issuance of a London Interbank Offered Rate (LIBOR)-referenced debt instrument, the entity would assume that the LIBOR benchmark rate on which the hedged cash flows are based will not be altered as a result of the reform.

BC237 The Board noted that this exception does not necessarily result in an entity determining that the hedged cash flows are highly probable. In the example described in paragraph BC236, the entity assumed that the interest rate benchmark in the future contract would not be altered as a result of the reform when determining whether that forecast transaction is highly probable. However, if the entity decides not to issue the debt instrument because of uncertainty arising from the reform or for any other reason, the hedged future cash flows are no longer highly probable (and are no longer expected to occur). The exception would not permit or require the entity to assume otherwise. In this case, the entity would conclude that the LIBOR-based cash flows are no longer highly probable (and are no longer expected to occur).

BC238 The Board also included an exception for discontinued hedging relationships. Applying this exception, any amount remaining in other comprehensive income when a hedging relationship is discontinued would be reclassified to profit or loss in the same period(s) during which the hedged cash flows affect profit or loss, based on the assumption that the interest rate benchmark on which the hedged cash flows are based is not altered as a result of the reform. If, however, the hedged future cash flows are no longer expected to occur for other reasons, the entity is required to immediately reclassify to profit or loss any amount remaining in other comprehensive income. In addition, the exception would not exempt entities from reclassifying the amount that is not expected to be recovered into profit or loss as required by paragraph 97 of IAS 39.

Effectiveness assessment

BC239 Applying IAS 39, a hedging relationship qualifies for hedge accounting only if the conditions in paragraph 88 are met. Two of the conditions in that paragraph—the prospective assessment and the retrospective assessment—require that the hedging relationship is highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk. If either of these conditions is not met, paragraphs 91(b) and 101(b) require the entity to discontinue hedge accounting prospectively.

Prospective assessment

BC240 When applying paragraph 88(b) of IAS 39, demonstrating that a hedging relationship is expected to be highly effective requires the estimation of future cash flows because the assessment is prospective in nature. Interest rate benchmark reform could affect this assessment for hedging relationships that may extend beyond the timing of the reform. That is because entities would have to consider possible changes to the fair value or future cash flows of hedged items and hedging instruments in determining whether a hedging relationship is expected to be highly effective. Consequently, at some point in time, it is possible that entities would not be able to meet the condition in paragraph 88(b) of IAS 39 solely because of uncertainties arising from the reform.

BC241 The Board considered the usefulness of the information that would result from the potential discontinuation of hedge accounting for affected hedging relationships and decided to amend the requirement in IAS 39 to provide an exception for the prospective assessment for the same reasons as discussed in paragraph BC227.

BC242 Applying this exception, an entity shall assess whether the hedge is expected to be highly effective in achieving offsetting as required by IAS 39, based on the assumption that the hedged risk or the interest rate benchmark on which the hedged item or the hedging instrument is based is not altered as a result of the reform. Similarly, if an entity designates a highly probable forecast transaction as the hedged item, the entity shall perform the prospective assessment based on the assumption that the interest rate benchmark on which the hedged cash flows are based will not change as a result of the reform.

BC243 The Board noted that an offset between the hedged item and the hedging instrument is a fundamental principle of the hedge accounting model in IAS 39 and, therefore, the Board considered it critical to maintain this principle. The exception addresses only the uncertainties arising from the reform. Therefore, if an entity is unable to demonstrate that a hedging relationship is expected to be highly effective for other reasons, the entity shall discontinue hedge accounting as required by IAS 39.

Retrospective assessment

BC244 When developing the 2019 Exposure Draft, the Board decided not to propose an exception to the retrospective assessment required by paragraph 88(e) and AG105(b) of IAS 39 for the effects of the reform. As described in the 2019 Exposure Draft, that assessment is based on the actual results of the hedging relationship based on the extent to which hedging gains or losses on the hedged item attributable to the hedged risk offset changes in the fair value of the hedging instrument. The Board noted that existing IFRS Standards already provide an adequate basis for measuring ineffectiveness.

BC245 Most respondents disagreed with the Board's decision not to propose an exception to the retrospective assessment. Respondents noted that due to the inherent interaction between the assessment of the forward-looking cash flows of the hedged item and its effect on both prospective and retrospective assessments, the proposed amendments would not achieve their intended effect unless an exception is also provided for the retrospective assessment.

BC246 Furthermore, these respondents expressed the view that the discontinuation of hedge accounting because hedging relationships do not meet the requirements in paragraph AG105(b) of IAS 39, as a result of the temporary ineffectiveness caused by the reform, would not reflect an entity's risk management strategy and, therefore, would not provide useful information to users of financial statements.

BC247 In its redeliberations on the amendments to IAS 39, the Board considered the feedback received. The Board discussed three approaches that it could apply for providing an exception to the retrospective assessment for the impact of the uncertainty arising from the reform.

BC248 The Board observed that one possible approach would be to require entities to assume that the interest rate benchmark is not altered similar to the prospective assessment. Applying this approach would require entities to separate the assessment of retrospective effectiveness from the measurement of hedge ineffectiveness. More specifically, the Board considered that the objective of this approach would be to exclude the uncertainty arising from the reform from the assessment of whether a hedge is considered to be highly effective and that hedge accounting is continued when the results of this assessment are within the range of 80–125 per cent as required in paragraph AG105(b) of IAS 39, even if the measurement of actual ineffectiveness is outside that range. The Board was of the view that even though this approach is consistent with the other exceptions provided in the amendments to IAS 39, the requirement to perform two effectiveness calculations based on different assumptions could be burdensome on preparers. The Board therefore rejected this approach.

BC249 The Board also considered an approach that was recommended by respondents to the 2019 Exposure Draft, in which entities would be required, for the purposes of the retrospective assessment, to demonstrate the existence of an economic relationship between the hedged item and hedging instrument similar to the requirements in IFRS 9. However, the Board noted that the existence of an economic relationship between the hedged item and the hedging instrument, is only one of the requirements in IFRS 9 for a hedging relationship to be highly effective. The Board considered that the requirements in paragraph 6.4.1(c) of IFRS 9 are inherently linked and the application of the economic relationship in isolation might not achieve the intended objective and could result in unintended consequences. The Board therefore rejected this approach.

BC250 The Board decided on an approach whereby an entity could continue to apply hedge accounting for hedging relationships directly affected by the reform, even if the actual results of the hedging relationship do not meet the requirements in paragraph AG105(b) of IAS 39, if the ineffectiveness arose from uncertainty arising from the reform or other sources, subject to satisfying the other conditions in paragraph 88 of IAS 39, including the prospective assessment (as amended by paragraph 102F of IAS 39).

BC251 The Board acknowledged that such an approach might provide less discipline compared to the approach described in paragraph BC248, which would introduce additional requirements to mitigate the risk of continuing hedge accounting for hedging relationships that failed the retrospective assessment for reasons other than the reform. However, the Board noted that its approach still maintains a level of discipline around the application of the IAS 39 hedge accounting model through the prospective assessment and neither imposes additional costs or burden for preparers nor introduces new requirements in IAS 39.

BC252 The Board noted that any exception to the retrospective assessment will apply only to a well-defined population of hedging relationships during the period of uncertainty on the hedged items and hedging instruments arising from the reform. Furthermore, the Board noted that the risk of allowing hedge accounting to be applied for hedging relationships that would not otherwise qualify for hedge accounting is mitigated by the required prospective assessment as only the uncertainty arising from the reform is excluded from that assessment. Any other sources of ineffectiveness would continue to be included in the assessment of whether the hedge is expected to be highly effective in future periods. The Board noted that any high level of ineffectiveness arising in a hedging relationship is expected to be captured by the prospective assessment. The Board also noted that all ineffectiveness would be recognised and measured and thus be transparent in financial reporting. The Board, therefore, decided to provide an exception from the requirement to discontinue hedge accounting as a result of paragraph 88(e) of IAS 39 because the actual results of the hedge do not meet the requirements in paragraph AG105(b) of IAS 39.

Measurement of ineffectiveness

BC253 The Board noted that the exceptions were not intended to change the requirement that entities measure and recognise hedge ineffectiveness. The Board considered that the actual results of the hedging relationships would provide useful information to users of financial statements during the period of uncertainty arising from the reform. Therefore, the Board decided that entities should continue to measure and recognise hedge ineffectiveness as required by IFRS Standards.

BC254 The Board also considered whether any exceptions should be made to the measurement of hedged items or hedging instruments because of the uncertainty arising from the reform. However, the Board noted that such an exception would be inconsistent with the decision not to change the requirements to measure and recognise hedge ineffectiveness in the financial statements. Therefore, the Board decided not to provide an exception from the measurement of hedging instruments and hedged items. This means that the fair value of a derivative designated as the hedging instrument should continue to be measured using the assumptions that market participants would use when pricing that derivative as required by IFRS 13 Fair Value Measurement.

BC255 For a hedged item designated in a fair value hedge, IAS 39 requires an entity to remeasure the hedged item for changes in fair value attributable to the hedged risk and recognise the gain or loss related to that fair value hedge adjustment in profit or loss. In doing so, the entity uses the assumptions that market participants would use when pricing the hedged item for changes in fair value attributable to the hedged risk. This would include a risk premium for uncertainty inherent in the hedged risk that market participants would consider. For example, to measure changes in fair value attributable to the hedged risk such as the IBOR component of a fixed-rate loan, an entity needs to reflect the uncertainty caused by the reform. When applying a present value technique to calculate the changes in fair value attributable to the designated risk component, such measurement should reflect market participants' assumptions about the uncertainty arising from the reform.

BC256 When an entity designates interest rate benchmark-based cash flows as the hedged item in a cash flow hedge, to calculate the change in the value of the hedged item for the purpose of measuring hedge ineffectiveness, the entity may use a derivative that would have terms that match the critical terms of the designated cash flows and the hedged risk (this is commonly referred to as a 'hypothetical derivative'). As the Board decided that entities should continue to measure and recognise hedge ineffectiveness as required by IFRS Standards, entities should continue to apply assumptions that are consistent with those applied to the hedged risk of the hedged item. For example, if an entity designated interest rate benchmark-based cash flows as the hedged item in a cash flow hedge, the entity would not assume for the purpose of measuring hedge ineffectiveness that the expected replacement of the interest rate benchmark with an alternative benchmark rate will result in zero cash flows after the replacement. The hedging gain or loss on the hedged item should be measured using the interest rate benchmark-based cash flows (that is, the cash flows on which the hypothetical derivative is based) when applying a present value technique, discounted at a market-based discount rate that reflects market participants' assumptions about the uncertainty arising from the reform. The Board concluded that reflecting market participants' assumptions when measuring hedge ineffectiveness provides useful information to users of financial statements about the effects of the uncertainty arising from the reform on an entity's hedging relationships. Therefore, the Board decided that no exceptions are needed for the measurement of actual ineffectiveness.

Hedges of designated portions

BC257 The Board noted that in accordance with IAS 39 an entity may designate an item in its entirety or only a portion thereof, as the hedged item in a hedging relationship. For example, an entity that issues a 5-year floating-rate debt instrument that bears interest at 3-month LIBOR + 1%, could designate as the hedged item either the entire debt instrument (that is, all of the cash flows) or only the 3-month LIBOR portion of the floating-rate debt instrument. Specifically, paragraphs 81 and AG99F of IAS 39 allow entities to designate only changes in the cash flows or fair value of an item attributable to a specific risk or risks (designated portion), provided that the designated portion is separately identifiable and reliably measurable.

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BC258 The Board observed that an entity's ability to conclude that an interest rate benchmark is a separately identifiable designated portion in accordance with paragraph 81 of IAS 39 requires a continuous assessment over the duration of the hedging relationship and could be affected by the reform. For example, if the outcome of the reform affects the market structure of an interest rate benchmark, it could affect an entity's assessment of whether a non-contractually specified LIBOR portion is separately identifiable and, therefore, an eligible hedged item in a hedging relationship. The Board considered only those designated portions that are implicit in the fair value or the cash flows of an item of which they are a part (referred to as non-contractually specified) because the same issue does not arise for designated portions that are explicitly specified in the contract.

BC259 For the reasons outlined in paragraph BC227, the Board noted that discontinuing hedging relationships due to uncertainty arising from the reform would not provide useful information. Consequently, the Board decided to propose amending IAS 39 so that entities would not discontinue hedge accounting solely because the designated portion is no longer separately identifiable as a result of the reform. In the 2019 Exposure Draft, the Board proposed that the separately identifiable requirement for hedges of the benchmark portion of interest rate risk be applied only at the inception of those hedging relationships affected by the reform.

BC260 The Board proposed not to extend the relief to allow entities to designate the benchmark portion of interest rate risk as the hedged item in a new hedging relationship if the designated portion is not separately identifiable at the inception of the hedging relationship. In the Board's view, allowing hedge accounting for designated portions that are not separately identifiable at the inception would be inconsistent with the objective of the exception. The Board noted that such circumstances are different from allowing continued designation as the hedged item for designated portions that had met the requirement at the inception of the hedging relationship.

BC261 Furthermore, the Board did not propose any exception from the requirement that changes in the fair value or cash flows of the designated portion must be reliably measurable. As noted in paragraph BC243, in the Board's view, an offset between the hedged item and the hedging instrument is a fundamental principle of the hedge accounting model in IAS 39 and, therefore, the Board considered reliable measurement of the hedged item and the hedging instrument to be critical to maintain this principle.

BC262 Almost all respondents agreed with the exception proposed in the 2019 Exposure Draft to apply the separately identifiable requirement only at the inception of a hedging relationship. However, some respondents noted that the proposed exception did not provide equivalent relief to hedging relationships that frequently reset (ie discontinue and restart). In those hedging relationships both the hedging instrument and the hedged item frequently change (ie the entity uses a dynamic process in which both the hedged items and the hedging instruments used to manage that exposure do not remain the same for long). As hedging instruments and hedged items are being added or removed from a portfolio, entities are de-designating and redesignating hedging relationships regularly to adjust the exposure. If each redesignation of the hedging relationship is considered to be the inception of a new hedging relationship (even though it is still the same hedging strategy), then the separately identifiable requirement would need to be assessed for all hedged items at each redesignation even if they have been assessed previously. For the same reasons as those noted in paragraph BC258, this could affect an entity's ability to conclude that a non-contractually specified risk component remains separately identifiable and, therefore, an eligible hedged item for hedge accounting purposes.

BC263 The Board noted that the exception proposed in the 2019 Exposure Draft has the effect that if a non-contractually specified designated portion meets the separately identifiable requirement at the inception of a hedging relationship, then that requirement would not be reassessed subsequently. Hence, providing a similar exception for hedging relationships that frequently reset (ie discontinue and restart) would be consistent with the objective of the exception originally provided in the 2019 Exposure Draft.

BC264 Thus, the Board confirmed the proposal that a designated portion is only required to be separately identifiable at the inception of the hedging relationship. In addition, to respond to the feedback described in paragraph BC262, the Board added the exception in paragraph 102I of IAS 39 for hedging relationships that, consistent with an entity's hedge documentation, frequently reset (ie discontinue and restart) because both the hedging instrument and the hedged item frequently change. Applying that paragraph, an entity shall determine whether the designated portion is separately identifiable only when it initially designates an item as a hedged item in the hedging relationship. The hedged item is not reassessed at any subsequent redesignation in the same hedging relationship.

BC265 In reaching its decision for the exception in paragraph 102I of IAS 39 the Board considered an example when an entity applies hedge accounting for a portfolio hedge of interest rate risk under IAS 39 and designates the LIBOR portion of floating-rate loans as the hedged risk. At the inception of the relationship, the entity assesses whether LIBOR is a separately identifiable designated portion for all loans designated within the hedging relationship. As the entity updates the risk position with the origination of new loans and the maturity or repayment of existing loans, the hedging relationship is adjusted by de-designating the 'old' hedging relationship and redesignating a 'new' hedging relationship for the updated amount of the hedged items. Applying the exception in paragraph 102I of IAS 39 requires the entity to assess whether LIBOR is a separately identifiable designated portion only for the new loans added to the hedging relationship. The entity would not reassess the separately identifiable requirement for the loans that have been redesignated.

Mandatory application

BC266 The Board decided to require entities to apply the exceptions in paragraphs 102D–102N of IAS 39 to all hedging relationships to which the exceptions are applicable. In other words, the Board decided that an entity is required to apply the exceptions to all hedging relationships that are directly affected by the uncertainties arising from the reform and continue to apply the exceptions until required to cease their application as specified in paragraphs 102J–102N of IAS 39.

BC267 The Board considered but rejected alternatives that would have allowed entities to apply the exceptions voluntarily. In the Board's view, voluntary application of these exceptions could give rise to selective discontinuation of hedge accounting and selective reclassification of the amounts recorded in other comprehensive income related to previously discontinued hedging relationships. The Board does not expect that requiring entities to apply the exceptions would entail significant cost for preparers and other affected parties because the exceptions require entities to assume that the interest rate benchmark, on which the hedged risk and the hedged cash flows and cash flows of the hedging instrument are based, is not altered as a result of the reform.

BC268 In addition, the Board observed that in some circumstances the exceptions in paragraphs 102D–102N of IAS 39 may not be applicable. For example, for a particular interest rate benchmark not subject to the reform or replacement with an alternative benchmark rate, there is no uncertainty affecting the timing or the amount of the interest rate benchmark-based cash flows arising from a hedged item or a hedging instrument. The exceptions set out in paragraphs 102D–102N of IAS 39 would not be applicable to such a hedging relationship.

BC269 Furthermore, for a particular hedging relationship the exceptions may be applicable to some but not all aspects of the hedging relationship. For example, if an entity designates a hedged item that is based on LIBOR against a hedging instrument that is already referenced to an alternative benchmark rate (assuming the entity can demonstrate that hedging relationship meets the qualifying criteria for hedge accounting in IAS 39), the exceptions in paragraphs 102D and 102F of IAS 39 would apply for the hedged item because there is uncertainty related to its future cash flows. However, there is no uncertainty regarding how the reform would impact the cash flows of the hedging instrument and, therefore, the exception in paragraph 102F of IAS 39 is not applicable for the hedging instrument. Similarly, the exception applicable to non-contractually specified designated portions would not be relevant for hedging relationships that do not involve the designation of non-contractually specified portions.

End of application

BC270 As described in paragraph BC227, the Board decided to amend IAS 39 to address specific aspects of hedge accounting affected by uncertainties in relation to the hedged items and hedging instruments about when the interest rate benchmarks will change to alternative benchmark rates, when any spread adjustment between the interest rate benchmark and the alternative benchmark rate will be determined (collectively, timing) and what the cash flows based on the alternative benchmark rate will be, including their frequency of reset, and any spread adjustment between the interest rate benchmark and the alternative benchmark rate (collectively, amount). Therefore, the Board intended the exceptions set out in paragraphs 102D–102N of IAS 39 to be available only while these uncertainties are present.

BC271 The Board considered whether to provide an explicit end date for the exceptions but decided not to do so. The reform is following different timelines in different markets and jurisdictions and contracts are being modified at different times and, therefore, at this stage, it is not possible to define a period of applicability for the exceptions.

BC272 The Board decided that an entity ceases applying the exceptions at the earlier of (a) when the uncertainty regarding the timing and the amount of interest rate benchmark-based cash flows is no longer present as it relates to a hedged item and/or hedging instrument (depending on the particular exception) and (b) the discontinuation of the hedging relationship.* The exceptions require entities to apply specific hedge accounting requirements assuming the interest rate benchmark on which the hedged risk, hedged cash flows or the cash flows of the hedging instrument are based is not altered as a result of the reform. The end of applicability of the exceptions means that entities would from that date apply all hedge accounting requirements in IAS 39 without applying these exceptions.

* For the purpose of applying the exception in paragraph 102E of IAS 39 to a discontinued hedging relationship, the amendments require an entity to cease applying the exception at the earlier of (a) as described above and (b) when the entire amount that had been recognised in other comprehensive income with respect to the hedging relationship has been reclassified to profit or loss. See paragraph 102K of IAS 39.

BC273 In the Board's view, for uncertainty regarding the timing and the amount of cash flows arising from a change in an interest rate benchmark to be eliminated, the underlying contracts are generally required to be amended to specify the timing and the amount of cash flows based on the alternative benchmark rate (and any spread adjustment between the interest rate benchmark and the alternative benchmark rate). The Board noted that, in some cases, a contract may be amended to include reference to the alternative benchmark rate without actually altering the interest rate benchmark-based cash flows in the contract. Such an amendment may not eliminate the uncertainty regarding the timing and the amount of interest rate benchmark-based cash flows in the contract. The Board considered the following scenarios to assess the robustness of the end of application requirements. However, these scenarios are not exhaustive and other scenarios may exist in which the uncertainties arising from the reform regarding the timing and the amount of cash flows would no longer be present.

BC274 Scenario A—a contract is amended to include a clause that specifies (a) the date the interest rate benchmark will be replaced by an alternative benchmark rate and (b) the alternative benchmark rate on which the cash flows will be based and the relevant spread adjustment between the interest rate benchmark and the alternative benchmark rate. In this case, the uncertainty regarding the timing and the amount of cash flows for this contract is eliminated when the contract is amended to include this clause.

BC275 Scenario B—a contract is amended to include a clause that states modifications of contractual cash flows will occur due to the reform but that specifies neither the date that the interest rate benchmark will be replaced nor the alternative benchmark rate on which the amended cash flows will be based. In this case, the uncertainty regarding the timing and the amount of cash flows for this contract has not been eliminated by amending the contract to include this clause.

BC276 Scenario C—a contract is amended to include a clause which states that conditions specifying the amount and timing of interest rate benchmark-based cash flows will be determined by a central authority at some point in the future. But the clause does not specify those conditions. In this case, the uncertainty regarding the timing and the amount of the interest rate benchmark-based cash flows for this contract has not been eliminated by including this clause in the contract. Uncertainty regarding both the timing and the amount of cash flows for this contract will be present until the central authority specifies when the replacement of the benchmark will become effective and what the alternative benchmark rate and any related spread adjustment will be.

BC277 Scenario D—a contract is amended to include a clause in anticipation of the reform that specifies the date the interest rate benchmark will be replaced and any spread adjustment between the interest rate benchmark and the alternative benchmark rate will be determined. However, the amendment does not specify the alternative benchmark rate or the spread adjustment between the interest rate benchmark and the alternative benchmark rate on which the cash flows will be based. In this scenario, by amending the contract to include this clause, uncertainty regarding the timing has been eliminated but uncertainty about the amount remains.

BC278 Scenario E—a contract is amended to include a clause in anticipation of the reform that specifies the alternative benchmark rate on which the cash flows will be based and the spread adjustment between the interest rate benchmark and the alternative benchmark rate but does not specify the date from which the amendment to the contract will become effective. In this scenario, by amending the contract to include this clause, uncertainty about the amount has been eliminated but uncertainty with respect to timing remains.

BC279 Scenario F—in preparation for the reform, a central authority in its capacity as the administrator of an interest rate benchmark undertakes a multi-step process to replace an interest rate benchmark with an alternative benchmark rate. The objective of the reform is to cease the publication of the current interest rate benchmark and replace it with an alternative benchmark rate. As part of the reform, the administrator introduces an interim benchmark rate and determines a fixed spread adjustment based on the difference between the interim benchmark rate and the current interest rate benchmark. Uncertainty about the timing or the amount of the alternative benchmark rate-based cash flows will not be eliminated during the interim period because the interim benchmark rate (including the fixed spread adjustment determined by the administrator) represent an interim measure in progressing towards the reform but it does not represent the alternative benchmark rate (or any related spread adjustment agreed between parties to the contract).

BC280 For reasons similar to those described in paragraph BC269, the Board noted that there could be situations in which the uncertainty for particular elements of a single hedging relationship could end at different times. For example, assume an entity is required to apply the relevant exceptions to both the hedged item and the hedging instrument. If the hedging instrument in that hedging relationship is subsequently amended through market protocols covering all derivatives in that market, and will be based on an alternative benchmark rate such that the uncertainty about the timing and the amount of interest rate benchmark-based cash flows of the hedging instrument is eliminated, the relevant exceptions would continue to apply to the hedged item but would no longer apply to the hedging instrument.*

BC281 The Board observed that continuing to apply the exception after the uncertainty was resolved would not faithfully represent the actual characteristics of the elements of the hedging relationship in which the uncertainty arising from the reform is eliminated. The Board considered whether it should extend the relief provided such that the exceptions would apply at the hedging relationship level for as long as any element of that hedging relationship was affected by the uncertainties arising from the reform. The Board agreed that doing so would be beyond the objective of addressing only those issues directly affected by the uncertainty arising from the reform. This is also because the exceptions in paragraphs 102D–102N of IAS 39 and the respective requirements in IAS 39 apply to the same elements of the hedging relationship. Therefore, applying each exception at the hedging relationship level would be inconsistent with how the underlying requirements are applied.

BC282 The Board decided that the end of application requirement would also apply to hedges of a forecast transaction. The Board noted that IAS 39 requires an entity to identify and document a forecast transaction with sufficient specificity so that, when the transaction occurs, the entity is able to determine whether the transaction is the hedged transaction. For example, if an entity designates a future issuance of a LIBOR-based debt instrument as the hedged item, although there may be no contract at the time of designation, the hedge documentation would refer specifically to LIBOR. Consequently, the Board concluded that entities should be able to identify when the uncertainty regarding the timing and the amount of the resulting cash flows of a forecast transaction is no longer present.

* In this scenario, the entity would first consider the accounting consequences of amending the contractual terms of the hedging instrument. The Board will consider the accounting consequences of the actual amendment of financial instruments as a result of interest rate benchmark reform in the next phase of this project (ie the replacement phase).

BC283 In addition, the Board decided not to require end of application with respect to the exception for the separately identifiable requirements set out in paragraphs 102H and 102I of IAS 39. Applying these exceptions, entities would continue applying hedge accounting when an interest rate benchmark meets the separately identifiable requirement at the inception of the hedging relationship (assuming all other hedge accounting requirements continue to be met). If the Board included an end date for these exceptions, an entity may be required to immediately discontinue hedge accounting because, at some point, as the reform progresses, the designated portion based on the interest rate benchmark may no longer be separately identifiable (for example, as the market for the alternative benchmark rate is established). Such immediate discontinuation of hedge accounting would be inconsistent with the objective of the exception. The Board noted that linking the end of application for these exceptions to contract amendments would not achieve the Board's intention either because, by definition, non-contractually specified designated portions are not explicitly stated in a contract and, therefore, these contracts may not be amended for the reform. This is particularly relevant for fair value hedges of a fixed-rate debt instrument. Therefore, the Board decided that an entity should cease applying the exceptions to a hedging relationship only when the hedging relationship is discontinued applying IAS 39.

BC284 Some respondents to the 2019 Exposure Draft noted that the Board had not addressed when an entity ceases applying the proposed exceptions to a group of items designated as the hedged item or a combination of financial instruments designated as the hedging instrument. Specifically, when assessing whether the uncertainty arising from the reform is no longer present, these respondents asked whether that assessment should be performed on an individual basis (that is, for each individual item within the group or financial instrument within the combination) or on a group basis (that is, for all items in the group or all financial instruments in the combination until there is no uncertainty surrounding any of the items or financial instruments).

BC285 Consequently, the Board decided to add paragraph 102N of IAS 39 to clarify that, when designating a group of items as the hedged item or a combination of financial instruments as the hedging instrument, entities assess when the uncertainty arising from the reform with respect to the hedged risk and/or the timing and amount of the interest rate benchmark-based cash flows of that item or financial instrument is no longer present on an individual basis—that is, for each individual item in the group or financial instrument in the combination.

Effective date and transition

BC286 The Board decided that entities shall apply the amendments for annual periods beginning on or after 1 January 2020, with earlier application permitted.

BC287 The Board decided that the amendments apply retrospectively. The Board highlighted that retrospective application of the amendments would not allow reinstating hedge accounting that has already been discontinued. Nor would it allow designation in hindsight. If an entity had not designated a hedging relationship, the exceptions, even though applied retrospectively, would not allow the entity to apply hedge accounting in prior periods to items that were not designated for hedge accounting. Doing so would be inconsistent with the requirement that hedge accounting applies prospectively. Retrospective application of the exceptions would enable entities to continue hedge accounting for a hedging relationship that the entity had previously designated and that qualifies for hedge accounting applying IAS 39.

BC288 Many respondents to the 2019 Exposure Draft commented on the clarity of the proposed retrospective application and suggested that further explanation be provided in the Standard. Consequently, the Board amended the transition paragraph to specify that retrospective application applies only to those hedging relationships that existed at the beginning of the reporting period in which an entity first applies these amendments or were designated thereafter, and to the gain or loss recognised in other comprehensive income that existed at the beginning of the reporting period in which an entity first applies these amendments. The Board used this wording to permit an entity to apply the amendments from the beginning of the reporting period in which an entity first applies these amendments even if the reporting period is not an annual period.

Dissent of John T Smith from the issue in March 2004 of *Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk* (Amendment to IAS 39)

DO1 Mr Smith dissents from these Amendments to IAS 39 Financial Instruments: Recognition and Measurement *Fair Value Hedge Accounting for a Portfolio Hedge of Interest Rate Risk*. He agrees with the objective of finding a macro hedging solution that would reduce systems demands without undermining the fundamental accounting principles related to derivative instruments and hedging activities. However, Mr Smith believes that some respondents' support for these Amendments and their willingness to accept IAS 39 is based more on the extent to which the Amendments reduce recognition of ineffectiveness, volatility of profit or loss, and volatility of equity than on whether the Amendments reduce systems demands without undermining the fundamental accounting principles.

DO2 Mr Smith believes some decisions made during the Board's deliberations result in an approach to hedge accounting for a portfolio hedge that does not capture what was originally intended, namely a result that is substantially equivalent to designating an individual asset or liability as the hedged item. He understands some respondents will not accept IAS 39 unless the Board provides still another alternative that will further reduce reported volatility. Mr Smith believes that the Amendments already go beyond their intended objective. In particular, he believes that features of these Amendments can be applied to smooth out ineffectiveness and achieve results substantially equivalent to the other methods of measuring ineffectiveness that the Board considered when developing the Exposure Draft. The Board rejected those methods because they did not require the immediate recognition of all ineffectiveness. He also believes those features could be used to manage earnings.

IAS 39 *Financial Instruments: Recognition and Measurement* Illustrative example

This example accompanies, but is not part of, IAS 39.

Facts

IE1 On 1 January 20X1, Entity A identifies a portfolio comprising assets and liabilities whose interest rate risk it wishes to hedge. The liabilities include demandable deposit liabilities that the depositor may withdraw at any time without notice. For risk management purposes, the entity views all of the items in the portfolio as fixed rate items.

IE2 For risk management purposes, Entity A analyses the assets and liabilities in the portfolio into repricing time periods based on expected repricing dates. The entity uses monthly time periods and schedules items for the next five years (ie it has 60 separate monthly time periods).[*] The assets in the portfolio are prepayable assets that Entity A allocates into time periods based on the expected prepayment dates, by allocating a percentage of all of the assets, rather than individual items, into each time period. The portfolio also includes demandable liabilities that the entity expects, on a portfolio basis, to repay between one month and five years and, for risk management purposes, are scheduled into time periods on this basis. On the basis of this analysis, Entity A decides what amount it wishes to hedge in each time period.

IE3 This example deals only with the repricing time period expiring in three months' time, ie the time period maturing on 31 March 20X1 (a similar procedure would be applied for each of the other 59 time periods). Entity A has scheduled assets of CU100 million[†] and liabilities of CU80 million into this time period. All of the liabilities are repayable on demand.

IE4 Entity A decides, for risk management purposes, to hedge the net position of CU20 million and accordingly enters into an interest rate swap[**] on 1 January 20x1 to pay a fixed rate and receive LIBOR, with a notional principal amount of CU20 million and a fixed life of three months.

IE5 This example makes the following simplifying assumptions:

(a) the coupon on the fixed leg of the swap is equal to the fixed coupon on the asset;

(b) the coupon on the fixed leg of the swap becomes payable on the same dates as the interest payments on the asset; and

(c) the interest on the variable leg of the swap is the overnight LIBOR rate. As a result, the entire fair value change of the swap arises from the fixed leg only, because the variable leg is not exposed to changes in fair value due to changes in interest rates.

[*] In this example principal cash flows have been scheduled into time periods but the related interest cash flows have been included when calculating the change in the fair value of the hedged item. Other methods of scheduling assets and liabilities are also possible. Also, in this example, monthly repricing time periods have been used. An entity may choose narrower or wider time periods.

[†] In this example monetary amounts are denominated in 'currency units (CU)'.

[**] The example uses a swap as the hedging instrument. An entity may use forward rate agreements or other derivatives as hedging instruments.

In cases when these simplifying assumptions do not hold, greater ineffectiveness will arise. (The ineffectiveness arising from (a) could be eliminated by designating as the hedged item a portion of the cash flows on the asset that are equivalent to the fixed leg of the swap.)

IE6 It is also assumed that Entity A tests effectiveness on a monthly basis.

IE7 The fair value of an equivalent non-prepayable asset of CU20 million, ignoring changes in value that are not attributable to interest rate movements, at various times during the period of the hedge is as follows.

	1 Jan 20X1	**31 Jan 20X1**	**1 Feb 20X1**	**28 Feb 20X1**	**31 Mar 20X1**
Fair value (asset) (CU)	20,000,000	20,047,408	20,047,408	20,023,795	Nil

IE8 The fair value of the swap at various times during the period of the hedge is as follows.

	1 Jan 20X1	**31 Jan 20X1**	**1 Feb 20X1**	**28 Feb 20X1**	**31 Mar 20X1**
Fair value (liability) (CU)	Nil	(47,408)	(47,408)	(23,795)	Nil

Accounting treatment

IE9 On 1 January 20X1, Entity A designates as the hedged item an amount of CU20 million of assets in the three-month time period. It designates as the hedged risk the change in the value of the hedged item (ie the CU20 million of assets) that is attributable to changes in LIBOR. It also complies with the other designation requirements set out in paragraphs 88(d) and AG119 of the Standard.

IE10 Entity A designates as the hedging instrument the interest rate swap described in paragraph IE4.

End of month 1 (31 January 20X1)

IE11 On 31 January 20X1 (at the end of month 1) when Entity A tests effectiveness, LIBOR has decreased. Based on historical prepayment experience, Entity A estimates that, as a consequence, prepayments will occur faster than previously estimated. As a result it re-estimates the amount of assets scheduled into this time period (excluding new assets originated during the month) as CU96 million.

IE12 The fair value of the designated interest rate swap with a notional principal of CU20 million is (CU47,408)* (the swap is a liability).

IE13 Entity A computes the change in the fair value of the hedged item taking into account the change in estimated prepayments, as follows.

(a) First, it calculates the percentage of the initial estimate of the assets in the time period that was hedged. This is 20 per cent (CU20 million ÷ CU100 million).

(b) Second, it applies this percentage (20 per cent) to its revised estimate of the amount in that time period (CU96 million) to calculate the amount that is the hedged item based on its revised estimate. This is CU19.2 million.

* see paragraph IE8

(c) Third, it calculates the change in the fair value of this revised estimate of the hedged item (CU19.2 million) that is attributable to changes in LIBOR. This is CU45,511 (CU47,408[✦] × (CU19.2 million ÷ CU20 million)).

IE14 Entity A makes the following accounting entries relating to this time period:

Dr	Cash	CU172,097	
Cr	Profit or loss (interest income)[*]		CU172,097

To recognise the interest received on the hedged amount (CU19.2 million).

Dr	Profit or loss (interest expense)	CU179,268	
Cr	Profit or loss (interest income)		CU179,268
Cr	Cash		Nil

To recognise the interest received and paid on the swap designated as the hedging instrument.

Dr	Profit or loss (loss)	CU47,408	
Cr	Derivative liability		CU47,408

To recognise the change in the fair value of the swap.

Dr	Separate line item in the statement of financial position	CU45,511	
Cr	Profit or loss (gain)		CU45,511

To recognise the change in the fair value of the hedged amount.

IE15 The net result on profit or loss (excluding interest income and interest expense) is to recognise a loss of (CU1,897). This represents ineffectiveness in the hedging relationship that arises from the change in estimated prepayment dates.

Beginning of month 2

IE16 On 1 February 20X1 Entity A sells a proportion of the assets in the various time periods. Entity A calculates that it has sold 8 1/3 per cent of the entire portfolio of assets. Because the assets were allocated into time periods by allocating a percentage of the assets (rather than individual assets) into each time period, Entity A determines that it cannot ascertain into which specific time periods the sold assets were scheduled. Hence it uses a systematic and rational basis of allocation. Based on the fact that it sold a representative selection of the assets in the portfolio, Entity A allocates the sale proportionately over all time periods.

IE17 On this basis, Entity A computes that it has sold 8 1/3 per cent of the assets allocated to the three-month time period, ie CU8 million (8 1/3 per cent of CU96 million). The proceeds received are CU8,018,400, equal to the fair value of the assets.[**] On derecognition of the assets, Entity A also removes from the separate line item in the statement of financial position an amount that represents the change in the fair value of the hedged assets that it has now sold. This is 8 1/3 per cent of the total line item balance of CU45,511, ie CU3,793.

✦ ie CU20,047,408 – CU20,000,000. See paragraph IE7

* This example does not show how amounts of interest income and interest expense are calculated.

** The amount realised on sale of the asset is the fair value of a prepayable asset, which is less than the fair value of the equivalent non-prepayable asset shown in paragraph IE7.

IE18 Entity A makes the following accounting entries to recognise the sale of the asset and the removal of part of the balance in the separate line item in the statement of financial position.

Dr	Cash	CU8,018,400	
Cr	Asset		CU8,000,000
Cr	Separate line item in the statement of financial position		CU3,793
Cr	Profit or loss (gain)		CU14,607

To recognise the sale of the asset at fair value and to recognise a gain on sale.

Because the change in the amount of the assets is not attributable to a change in the hedged interest rate no ineffectiveness arises.

IE19 Entity A now has CU88 million of assets and CU80 million of liabilities in this time period. Hence the net amount Entity A wants to hedge is now CU8 million and, accordingly, it designates CU8 million as the hedged amount.

IE20 Entity A decides to adjust the hedging instrument by designating only a proportion of the original swap as the hedging instrument. Accordingly, it designates as the hedging instrument CU8 million or 40 per cent of the notional amount of the original swap with a remaining life of two months and a fair value of CU18,963.[✦] It also complies with the other designation requirements in paragraphs 88(a) and AG119 of the Standard. The CU12 million of the notional amount of the swap that is no longer designated as the hedging instrument is either classified as held for trading with changes in fair value recognised in profit or loss, or is designated as the hedging instrument in a different hedge.[*]

IE21 As at 1 February 20X1 and after accounting for the sale of assets, the separate line item in the statement of financial position is CU41,718 (CU45,511 – CU3,793), which represents the cumulative change in fair value of CU17.6[†] million of assets. However, as at 1 February 20X1, Entity A is hedging only CU8 million of assets that have a cumulative change in fair value of CU18,963.[★] The remaining separate line item in the statement of financial position of CU22,755[++]relates to an amount of assets that Entity A still holds but is no longer hedging. Accordingly Entity A amortises this amount over the remaining life of the time period, ie it amortises CU22,755 over two months.

IE22 Entity A determines that it is not practicable to use a method of amortisation based on a recalculated effective yield and hence uses a straight-line method.

[✦] CU47,408 × 40 per cent

[*] The entity could instead enter into an offsetting swap with a notional principal of CU12 million to adjust its position and designate as the hedging instrument all CU20 million of the existing swap and all CU12 million of the new offsetting swap.

[†] CU19.2 million - (8 1/3% × CU19.2 million)

[★] CU41,718 × (CU8 million ÷ CU17.6 million)

[++] CU41,718 – CU18,963

End of month 2 (28 February 20X1)

IE23 On 28 February 20X1 when Entity A next tests effectiveness, LIBOR is unchanged. Entity A does not revise its prepayment expectations. The fair value of the designated interest rate swap with a notional principal of CU8 million is (CU9,518)[⊙] (the swap is a liability). Also, Entity A calculates the fair value of the CU8 million of the hedged assets as at 28 February 20x1 as CU8,009,518[⌘].

IE24 Entity A makes the following accounting entries relating to the hedge in this time period:

Dr	Cash	CU71,707	
Cr	Profit or loss (interest income)		CU71,707

To recognise the interest received on the hedged amount (CU8 million).

Dr	Profit or loss (interest expense)	CU71,707	
Cr	Profit or loss (interest income)		CU62,115
Cr	Cash		CU9,592

To recognise the interest received and paid on the portion of the swap designated as the hedging instrument (CU8 million).

Dr	Derivative liability	CU9,445	
Cr	Profit or loss (gain)		CU9,445

To recognise the change in the fair value of the portion of the swap designated as the hedging instrument (CU8 million)
(CU9,518 – CU18,963).

Dr	Profit or loss (loss)	CU9,445	
Cr	Separate line item in the statement of financial position		CU9,445

To recognise the change in the fair value of the hedged amount
(CU8,009,518–CU8,018,963).

IE25 The net effect on profit or loss (excluding interest income and interest expense) is nil reflecting that the hedge is fully effective.

IE26 Entity A makes the following accounting entry to amortise the line item balance for this time period:

Dr	Profit or loss (loss)	CU11,378	
Cr	Separate line item in the statement of financial position		CU11,378[*]

To recognise the amortisation charge for the period.

⊙ CU23,795 [see paragraph IE8] × (CU8 million ÷ CU20 million)

⌘ CU20,023,795 [see paragraph IE7] × (CU8 million ÷ CU20 million)

* CU22,755 ÷ 2

End of month 3

IE27 During the third month there is no further change in the amount of assets or liabilities in the three-month time period. On 31 March 20X1 the assets and the swap mature and all balances are recognised in profit or loss.

IE28 Entity A makes the following accounting entries relating to this time period:

Dr	Cash	CU8,071,707	
Cr	Asset (statement of financial position)		CU8,000,000
Cr	Profit or loss (interest income)		CU71,707

To recognise the interest and cash received on maturity of the hedged amount (CU8 million).

Dr	Profit or loss (interest expense)	CU71,707	
Cr	Profit or loss (interest income)		CU62,115
Cr	Cash		CU9,592

To recognise the interest received and paid on the portion of the swap designated as the hedging instrument (CU8 million).

Dr	Derivative liability	CU9,518	
Cr	Profit or loss (gain)		CU9,518

To recognise the expiry of the portion of the swap designated as the hedging instrument (CU8 million).

Dr	Profit or loss (loss)	CU9,518	
Cr	Separate line item in the statement of financial position		CU9,518

To remove the remaining line item balance on expiry of the time period.

IE29 The net effect on profit or loss (excluding interest income and interest expense) is nil reflecting that the hedge is fully effective.

IE30 Entity A makes the following accounting entry to amortise the line item balance for this time period:

Dr	Profit or loss (loss)	CU11,377	
Cr	Separate line item in the statement of financial position		CU11,377*

To recognise the amortisation charge for the period.

* CU22,755 ÷ 2

Summary

IE31 The tables below summarise:

(a) changes in the separate line item in the statement of financial position;
(b) the fair value of the derivative;
(c) the profit or loss effect of the hedge for the entire three-month period of the hedge; and
(d) interest income and interest expense relating to the amount designated as hedged.

Description	1 Jan 20X1	31 Jan 20X1	1 Feb 20X1	28 Feb 20X1	31 Mar 20X1
	CU	CU	CU	CU	CU
Amount of asset hedged	**20,000,000**	**19,200,000**	**8,000,000**	**8,000,000**	**8,000,000**

(a) Changes in the separate line item in the statement of financial position

Brought forward:					
Balance to be amortised	Nil	Nil	Nil	22,755	11,377
Remaining balance	Nil	Nil	45,511	18,963	9,518
Less: Adjustment on sale of asset	Nil	Nil	(3,793)	Nil	Nil
Adjustment for change in fair value of the hedged asset	Nil	45,511	Nil	(9,445)	(9,518)
Amortisation	Nil	Nil	Nil	(11,378)	(11,377)
Carried forward:					
Balance to be amortised	**Nil**	**Nil**	**22,755**	**11,377**	**Nil**
Remaining balance	**Nil**	**45,511**	**18,963**	**9,518**	**Nil**

(b) The fair value of the derivative

	1 Jan 20X1	31 Jan 20X1	1 Feb 20X1	28 Feb 20X1	31 Mar 20X1
CU20,000,000	Nil	47,408	-	-	-
CU12,000,000	Nil	-	28,445	No longer designated as the hedging instrument.	
CU8,000,000	Nil	-	18,963	9,518	Nil
Total	**Nil**	**47,408**	**47,408**	**9,518**	**Nil**

(c) Profit or loss effect of the hedge

	1 Jan 20X1	31 Jan 20X1	1 Feb 20X1	28 Feb 20X1	31 Mar 20X1
Change in line item: asset	Nil	45,511	N/A	(9,445)	(9,518)
Change in derivative fair value	Nil	(47,408)	N/A	9,445	9,518
Net effect	**Nil**	**(1,897)**	**N/A**	**Nil**	**Nil**
Amortisation	**Nil**	**Nil**	**N/A**	**(11,378)**	**(11,377)**

In addition, there is a gain on sale of assets of CU14,607 at 1 February 20X1.

(d) Interest income and interest expense relating to the amount designated as hedged

Profit or loss recognised for the amount hedged	1 Jan 20X1	31 Jan 20X1	1 Feb 20X1	28 Feb 20X1	31 Mar 20X1
Interest income					
- on the asset	Nil	172,097	N/A	71,707	71,707
- on the swap	Nil	179,268	N/A	62,115	62,115
Interest expense					
- on the swap	Nil	(179,268)	N/A	(71,707)	(71,707)

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HKAS 40
Revised ~~July 2019~~August 2020

Hong Kong Accounting Standard 40

Investment Property

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Gains and Losses on Remeasurement to Fair Value

B63 Some commentators argued that there should be either a requirement or an option to recognise changes in the fair value of investment property in equity, on the grounds that:

(a) the market for property is not liquid enough and market values are uncertain and variable. Investment property is not as liquid as financial instruments and IAS 39 allows an option for available-for-sale investments;[∀]

(b) until performance reporting issues are resolved more generally, it is premature to require recognition of fair value changes in the income statement;

(c) recognition of unrealised gains and losses in the income statement increases volatility and does not enhance transparency, because revaluation changes will blur the assessment of an entity's operating performance. It may also cause a presumption that the unrealised gains are available for distribution as dividends;

(d) recognition in equity is more consistent with the historical cost and modified historical cost conventions that are a basis for much of today's accounting. For example, it is consistent with IASC's treatment of revaluations of property, plant and equipment under IAS 16 and with the option available for certain financial instruments under IAS 39;[β]

(e) for properties financed by debt, changes in the fair value of the properties resulting from interest rate changes should not be recognised in the income statement, since the corresponding changes in the fair value of the debt are not recognised under IAS 39;

(f) under paragraphs 92 and 93 of the *Framework*,[#] income should be recognised only when it can be measured with sufficient certainty. For example, IAS 11 *Construction Contracts*[α] requires certain conditions before an entity can use the percentage-of-completion method. These conditions are not normally met for investment property; and

(g) results from operations should be distinguished from changes in values. For example, under IAS 21, unrealised exchange differences on a foreign entity[*] are recognised in equity.

B64 Some commentators suggested that increases should be recognised in equity and decreases should be recognised in profit or loss. This is similar to the revaluation model that forms the allowed alternative treatment[†]in IAS 16 (except for the lack of depreciation).

B65 As proposed in E64, the Board concluded that, in a fair value model, changes in the fair value of investment property should be recognised in the income statement as part of profit or loss for the period. The arguments for this approach include the following:

(a) the conceptual case for the fair value model is built largely on the view that this provides the most relevant and transparent view of the financial performance of investment property. Given this, it would be inconsistent to permit or require recognition in equity;

(b) recognition of fair value changes in equity would create a mismatch because net rental income would be recognised in the income statement, whereas the related consumption of the service potential (recognised as depreciation under IAS 16) would be recognised in equity. Similarly, maintenance expenditure would be recognised as an expense while related increases in fair value would be recognised in equity;

(c) using this approach, there is no need to resolve some difficult and controversial issues that would arise if changes in the fair value of investment property were recognised in equity. These issues include the following:

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

[β] IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39. This paragraph refers to maters relevant when IAS 40 was issued.

[#] The reference to the *Framework* is to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the ~~IASB~~Board in 2001 and in effect when the Standard was developed. ~~In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*. Paragraphs 92 and 93 are now paragraphs 4.47 and 4.48 of the *Conceptual Framework*.~~

[α] IFRS 15 *Revenue from Contracts with Customers*, issued in May 2014, replaced IAS 11 *Construction Contracts*.

[*] In IAS 21 *The Effects of Changes in Foreign Exchange Rates*, as revised by the IASB in 2003, the term 'foreign entity' was replaced by 'foreign operation'.

[†] IAS 16 *Property, Plant and Equipment* as revised by the IASB in 2003 eliminated all references to 'benchmark' treatment and 'allowed alternative' treatments.

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(c) relatively long and continuous production cycles, with volatility in both the production and market environment, mean that the accounting period often does not depict a full cycle. Therefore, period-end measurement (as opposed to time of transaction) assumes greater significance in deriving a measure of current period financial performance or position. The less significant current year harvest is in relation to total biological transformation, the greater the significance of period-end measures of asset change (growth and degeneration). In relatively high turnover, short production cycle, highly controlled agricultural systems (for example, broiler chicken or mushroom production) in which the majority of biological transformation and harvesting occurs within a year, the relationship between cost and future economic benefits appears more stable. This apparent stability does not alter the relationship between current market value and future economic benefits, but it makes the difference in measurement method less significant; and

(d) different sources of replacement animals and plants (home-grown or purchased) give rise to different costs in a historical cost approach. Similar assets should give rise to similar expectations with regard to future benefits. Considerably enhanced comparability and understandability result when similar assets are measured and reported using the same basis.

B17 Those who oppose measuring biological assets at fair value believe there is superior reliability in cost measurement because historical cost is the result of arm’s length transactions, and therefore provides evidence of an open-market value at that point in time, and is independently verifiable. More importantly, they believe fair value is sometimes not reliably measurable and that users of financial statements may be misled by presentation of numbers that are indicated as being fair value but are based on subjective and unverifiable assumptions. Information regarding fair value can be provided other than in a single number in the financial statements. They believe the scope of the Standard is too broad. They also argue that:

(a) market prices are often volatile and cyclical and not appropriate as a basis of measurement;

(b) it may be onerous to require fair valuation at each balance sheet date, especially if interim reports are required;

(c) the historical cost convention is well established and commonly used. The use of any other basis should be accompanied by a change in the IASC *Framework for the Preparation and Presentation of Financial Statements*[*] (the ‘*Framework*’). For consistency with other International Accounting Standards and other activities, biological assets should be measured at their cost;

(d) cost measurement provides more objective and consistent measurement;

(e) active markets may not exist for some biological assets in some countries. In such cases, fair value cannot be measured reliably, especially during the period of growth in the case of a biological asset that has a long growth period (for example, trees in a plantation forest);

(f) fair value measurement results in recognition of unrealised gains and losses and contradicts principles in International Accounting Standards on recognition of revenue; and

(g) market prices at a balance sheet date may not bear a close relationship to the prices at which assets will be sold, and many biological assets are not held for sale.

B18 The *Framework* is neutral with respect to the choice of measurement basis, identifying that a number of different bases are employed to different degrees and in varying combinations, though noting that historical cost is most commonly adopted. The alternatives specifically identified are historical cost, current cost, realisable value, and present value. Precedents for fair value measurement exist in other International Accounting Standards.

B19 The Board concluded that the Standard should require a fair value model for biological assets related to agricultural activity because of the unique nature and characteristics of agricultural activity. However, the Board also concluded that, in some cases, fair value cannot be measured reliably. Some respondents to the questionnaire, as well as some commentators on

[*] References to the *Framework* in this Basis for Conclusions are to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, ~~which was~~ adopted by the ~~IASB~~Board in 2001 and in effect when the Standard was developed.~~In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.~~

HKFRS 1 (Revised)
Revised ~~July 2019~~August 2020

Effective for annual periods
beginning on or after 1 July 2009

Hong Kong Financial Reporting Standards 1 (Revised)

First-time Adoption of Hong Kong Financial Reporting Standards

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

D15A If a first-time adopter accounts for such an investment using the equity method procedures as described in HKAS 28:

(a) the first-time adopter applies the exemption for past business combinations (Appendix C) to the acquisition of the investment.

(b) if the entity becomes a first-time adopter for its separate financial statements earlier than for its consolidated financial statements, and

(i) later than its parent, the entity shall apply paragraph D16 in its separate financial statements.

(ii) later than its subsidiary, the entity shall apply paragraph D17 in its separate financial statements.

Assets and liabilities of subsidiaries, associates and joint ventures

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

(a) the carrying amounts that would be included in the parent's consolidated financial statements, based on the parent's date of transition to HKFRSs, if no adjustments were made for consolidation procedures and for the effects of the business combination in which the parent acquired the subsidiary (this election is not available to a subsidiary of an investment entity, as defined in HKFRS 10, that is required to be measured at fair value through profit or loss); or

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

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

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

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

D17 However, if an entity becomes a first-time adopter later than its subsidiary (or associate or joint venture) the entity shall, in its consolidated financial statements, measure the assets and liabilities of the subsidiary (or associate or joint venture) at the same carrying amounts as in the financial statements of the subsidiary (or associate or joint venture), after adjusting for consolidation and equity accounting adjustments and for the effects of the business combination in which the entity acquired the subsidiary. Notwithstanding this requirement, a non-investment entity parent shall not apply the exception to consolidation that is used by any investment entity subsidiaries. Similarly, if a parent becomes a first-time adopter for its separate financial statements earlier or later than for its consolidated financial statements, it shall measure its assets and liabilities at the same amounts in both financial statements, except for consolidation adjustments.

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

First-time Adoption of Hong Kong Financial Reporting Standards

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Basic concepts

Useful information for users

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

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

(a) readily understandable by users.

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

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

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

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

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

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

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

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

Comparability

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

(a) within an entity over time;

(b) between different first-time adopters; and

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

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

[*] References to the *Framework* *in this Basis for Conclusions* are to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the ~~IASB~~ Board in 2001 and in effect when the Standard was developed. ~~In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.~~

analytical models to make the best use of information presented using IFRSs. The required disclosures relate to both:

(a) the most recent information published in accordance with previous GAAP, so that users have the most up-to-date information; and

(b) the date of transition to IFRSs. This is an important focus of attention for users, preparers and auditors because the opening IFRS balance sheet is the starting point for accounting in accordance with IFRSs.

BC92 Paragraph 24(a) and (b) of the IFRS requires reconciliations of equity and total comprehensive income. The Board concluded that users would also find it helpful to have information about the other adjustments that affect the opening IFRS balance sheet but do not appear in these reconciliations. Because a reconciliation could be voluminous, the IFRS requires disclosure of narrative information about these adjustments, as well as about adjustments to the cash flow statement (paragraph 25 of the IFRS).

BC92A The Board decided to require a first-time adopter to include in its first IFRS financial statements a reconciliation of total comprehensive income (or, if an entity did not report such a total, profit or loss) in accordance with previous GAAP to total comprehensive income in accordance with IFRSs for the latest period reported in accordance with previous GAAP.

BC92B The Board observed that the amendments to IAS 1 in 2007 regarding the presentation of income and expense might result in users having to change their analytical models to include both income and expense that are recognised in profit or loss and those recognised outside profit or loss. Accordingly, the Board concluded that it would be helpful to those users to provide information on the effect and implication of the transition to IFRSs on all items of income and expense, not only those recognised in profit or loss.

BC92C The Board acknowledged that GAAP in other jurisdictions might not have a notion of total comprehensive income. Accordingly, it decided that an entity should reconcile to total comprehensive income in accordance with IFRSs from the previous GAAP equivalent of total comprehensive income. The previous GAAP equivalent might be profit or loss.

BC93 Paragraph 26 of the IFRS states that the reconciliations should distinguish changes in accounting policies from the correction of errors. Some respondents to ED 1 argued that complying with this requirement could be difficult or costly. However, the Board concluded that both components are important and their disclosure should be required because:

(a) information about changes in accounting policies helps explain the transition to IFRSs.

(b) information about errors helps users assess the reliability of financial information. Furthermore, a failure to disclose the effect of material errors would obscure the 'results of the stewardship of management, or the accountability of management for the resources entrusted to it' (*Framework*, paragraph 14[*]).

BC94 For impairment losses (and reversals) recognised in preparing the opening IFRS balance sheet, paragraph 24(c) of the IFRS requires the disclosures that IAS 36 would require if those impairment losses (and reversals) were recognised during the period beginning with the date of transition to IFRSs. The rationale for this requirement is that there is inevitably subjectivity about impairment losses. This disclosure provides transparency about impairment losses recognised on transition to IFRSs. These losses might otherwise receive less attention than impairment losses recognised in earlier or later periods.

~~[*] superseded by Chapter 1 of the *Conceptual Framework*.~~

HKFRS 2

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Effective for annual periods
beginning on or after 1 January 2005

Hong Kong Financial Reporting Standard 2

Share-based Payment

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among group entities.

(b) the revised definitions in Appendix A of the following terms:

- cash-settled share-based payment transaction,
- equity-settled share-based payment transaction,
- share-based payment arrangement, and
- share-based payment transaction.

If the information necessary for retrospective application is not available, an entity shall reflect in its separate or individual financial statements the amounts previously recognised in the group's consolidated financial statements. Earlier application is permitted. If an entity applies the amendments for a period beginning before 1 January 2010, it shall disclose that fact.

63A HKFRS 10 *Consolidated Financial Statements* and HKFRS 11, issued in June 2011, amended paragraph 5 and Appendix A. An entity shall apply those amendments when it applies HKFRS 10 and HKFRS 11.

63B *Annual Improvements to HKFRSs 2010–2012 Cycle*, issued in January 2014, amended paragraphs 15 and 19. In Appendix A, the definitions of 'vesting conditions' and 'market condition' were amended and the definitions of 'performance condition' and 'service condition' were added. An entity shall prospectively apply that amendment to share-based payment transactions for which the grant date is on or after 1 July 2014. Earlier application is permitted. If an entity applies that amendment for an earlier period it shall disclose that fact.

63C HKFRS 9, as issued in September 2014, amended paragraph 6. An entity shall apply that amendment when it applies HKFRS 9.

63D *Classification and Measurement of Share-based Payment Transactions* (Amendments to HKFRS 2), issued in August 2016, amended paragraphs 19, 30–31, 33, 52 and 63 and added paragraphs 33A–33H, 59A–59B, 63D and B44A–B44C and their related headings. An entity shall apply those amendments for annual periods beginning on or after 1 January 2018. Earlier application is permitted. If an entity applies the amendments for an earlier period, it shall disclose that fact.

63E *Amendments to References to the Conceptual Framework in HKFRS Standards*, issued in 2018, amended the footnote to the definition of an equity instrument in Appendix A. An entity shall apply that amendment for annual periods beginning on or after 1 January 2020. Earlier application is permitted if at the same time an entity also applies all other amendments made by *Amendments to References to the Conceptual Framework in HKFRS Standards*. An entity shall apply the amendment to HKFRS 2 retrospectively, subject to the transitional provisions in paragraphs 53–59 of this Standard, in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. However, if an entity determines that retrospective application would be impracticable or would involve undue cost or effort, it shall apply the amendment to HKFRS 2 by reference to paragraphs 23–28, 50–53 and 54F of HKAS 8.

Withdrawal of Interpretations

64 *Group Cash-settled Share-based Payment Transactions* issued in July 2009 supersedes HK(IFRIC)-Int 8 *Scope of HKFRS 2* and HK(IFRIC)-Int 11 *HKFRS 2—Group and Treasury Share Transactions*. The amendments made by that document incorporated the previous requirements set out in HK(IFRIC)-Int 8 and HK(IFRIC)-Int 11 as follows:

(a) amended paragraph 2 and added paragraph 13A in respect of the accounting for transactions in which the entity cannot identify specifically some or all of the goods or services received. Those requirements were effective for annual periods beginning on or after 1 May 2006.

(b) added paragraphs B46, B48, B49, B51–B53, B55, B59 and B61 in Appendix B in respect of the accounting for transactions among group entities. Those requirements were effective for annual periods beginning on or after 1 March 2007.

Those requirements were applied retrospectively in accordance with the requirements of HKAS 8, subject to the transitional provisions of HKFRS 2.

Appendix A
Defined terms

This appendix is an integral part of the HKFRS.

cash-settled share-based payment transaction

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

employees and others providing similar services

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

equity instrument

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

equity instrument granted

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

equity-settled share-based payment transaction

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

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

or

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

fair value

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

* The ~~*Framework*~~ *Conceptual Framework for Financial Reporting* issued in 2018 defines a liability as a present obligation of the entity ~~arising from~~ to transfer an economic resource as a result of past events~~, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits (i.e. an outflow of cash or other assets of the entity)~~.

HKFRS 2 BC
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(c) there is no cost to the entity, because no cash or other assets are given up; the shareholders bear the cost, in the form of dilution of their ownership interests, not the entity.

(d) the recognition of an expense is inconsistent with the definition of an expense in the conceptual frameworks used by accounting standard-setters, including the IASB's *Framework for the Preparation and Presentation of Financial Statements.*[*]

(e) the cost borne by the shareholders is recognised in the dilution of earnings per share (EPS); if the transaction is recognised in the entity's accounts, the resulting charge to the income statement would mean that EPS is 'hit twice'.

(f) requiring the recognition of a charge would have adverse economic consequences, because it would discourage entities from introducing or continuing employee share plans.

'The entity is not a party to the transaction'

BC34 Some argue that the effect of employee share plans is that the existing shareholders transfer some of their ownership interests to the employees and that the entity is not a party to this transaction.

BC35 The Board did not accept this argument. Entities, not shareholders, set up employee share plans and entities, not shareholders, issue share options to their employees. Even if that were not the case, e.g. if shareholders transferred shares or share options direct to the employees, this would not mean that the entity is not a party to the transaction. The equity instruments are issued in return for services rendered by the employees and the entity, not the shareholders, receives those services. Therefore, the Board concluded that the entity should account for the services received in return for the equity instruments issued. The Board noted that this is no different from other situations in which equity instruments are issued. For example, if an entity issues warrants for cash, the entity recognises the cash received in return for the warrants issued. Although the effect of an issue, and subsequent exercise, of warrants might be described as a transfer of ownership interests from the existing shareholders to the warrant holders, the entity nevertheless is a party to the transaction because it receives resources (cash) for the issue of warrants and further resources (cash) for the issue of shares upon exercise of the warrants. Similarly, with employee share options, the entity receives resources (employee services) for the issue of the options and further resources (cash) for the issue of shares on the exercise of options.

'The employees do not provide services'

BC36 Some who argue that the entity is not a party to the transaction counter the points made above with the argument that employees do not provide services for the options, because the employees are paid in cash (or other assets) for their services.

BC37 Again, the Board was not convinced by this argument. If it were true that employees do not provide services for their share options, this would mean that entities are issuing valuable share options and getting nothing in return. Employees do not pay cash for the share options they receive. Hence, if they do not provide services for the options, the employees are providing nothing in return. If this were true, by issuing such options the entity's directors would be in breach of their fiduciary duties to their shareholders.

[*] References to the *Framework* in this Basis for Conclusions are to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the ~~IASB~~Board in 2001 and in effect when the Standard was developed. ~~In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.~~

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

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

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

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

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

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

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

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

Dr Services received
Cr Cash paid

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

[#] ~~now paragraph 4.25 of the *Conceptual Framework*~~

[✧] ~~now paragraph 4.4 and 4.5 of the *Conceptual Framework*~~

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

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

'Adverse economic consequences'

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

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

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

Measurement of equity-settled share-based payment transactions

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

(a) which measurement basis should be applied?

(b) when should that measurement basis be applied?

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

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

~~* now paragraphs 4.4 and 4.22 of the *Conceptual Framework*~~

> received numerous requests from individual and institutional investors, financial analysts and many others urging the Board to mandate the expensing of the compensation cost relating to employee stock options…While a number of major companies have voluntarily opted to reflect these costs as an expense in reporting their earnings, other companies continue to show these costs in the footnotes to their financial statements. In addition, a move to require an expense treatment would be consistent with the FASB's commitment to work toward convergence between U.S. and international accounting standards. In taking all of these factors into consideration, the Board concluded that it was critical that it now revisit this important subject. (FASB News Release, 12 March 2003)

BC285 During the Board's redeliberations of the proposals in ED 2, the Board worked with the FASB to achieve convergence of international and US standards, to the extent possible, bearing in mind that the FASB was at an earlier stage in its project—the FASB was developing an Exposure Draft to revise SFAS 123 whereas the IASB was finalising its IFRS. The Board concluded that, although convergence is an important objective, it would not be appropriate to delay the issue of the IFRS, because of the pressing need for a standard on share-based payment, as explained in paragraphs BC2-BC5. In any event, at the time the IASB concluded its deliberations, a substantial amount of convergence had been achieved. For example, the FASB agreed with the IASB that all share-based payment transactions should be recognised in the financial statements, measured on a fair value measurement basis, including transactions in which share options are granted to employees. Hence, the FASB agreed that the disclosure alternative in SFAS 123 should be eliminated.

BC286 The IASB and FASB also agreed that, once both boards have issued final standards on share-based payment, the two boards will consider undertaking a convergence project, with the objective of eliminating any remaining areas of divergence between international and US standards on this topic.

Recognition versus disclosure

BC287 A basic accounting concept is that disclosure of financial information is not an adequate substitute for recognition in the financial statements. For example, the *Framework* states:

> Items that meet the recognition criteria should be recognised in the balance sheet or income statement. The failure to recognise such items is not rectified by disclosure of the accounting policies used nor by notes or explanatory material. (paragraph 82)*

BC288 A key aspect of the recognition criteria is that the item can be measured with reliability. This issue is discussed further below. Therefore, this discussion focuses on the 'recognition versus disclosure' issue in principle, not on measurement reliability. Once it has been determined that an item meets the criteria for recognition in the financial statements, failing to recognise it is inconsistent with the basic concept that disclosure is not an adequate substitute for recognition.

BC289 Some disagree with this concept, arguing that it makes no difference whether information is recognised in the financial statements or disclosed in the notes. Either way, users of financial statements have the information they require to make economic decisions. Hence, they believe that note disclosure of expenses arising from particular employee share-based payment transactions (i.e. those involving awards of share options to employees), rather than recognition in the income statement, is acceptable.

* ~~now paragraph 4.37 of the *Conceptual Framework*~~

BC377 Consequently the Board decided to amend paragraphs 30–31, and 33 and added paragraphs 33A–33D to clarify the effect that market and non-market vesting conditions and non-vesting conditions have on the measurement of the liability incurred in a cash-settled share-based payment transaction.

BC378 The Board observed that if an employee does not receive the payment because of a failure to satisfy any condition, this should result in remeasuring the liability to zero. The amendments make clear that the cumulative amount ultimately recognised for goods or services received as consideration for a cash-settled share-based payment will be equal to the amount of cash (or other assets) that is paid.

BC379 Furthermore, the Board amended paragraph IG19 and added IG Example 12A to the Guidance on Implementing IFRS 2 to illustrate the impact of a performance condition on the measurement of a cash-settled share-based payment transaction.

BC380 Respondents to the November 2014 ED questioned the meaning of 'best available estimate', as that notion was used in the proposal, for estimating the fair value of a cash-settled share-based payment. The Board noted that the term 'best available estimate' is already used in IFRS 2 and is not a new notion. This term is also used in paragraph 20 of IFRS 2 for estimating the number of equity instruments expected to vest of an equity-settled share-based payment. The Board further observed that analysing such a notion would potentially involve examining similar notions in other Standards and observed that such notions would be better examined as part of a broader project.

BC381 Respondents to the November 2014 ED suggested that the Board should add an explicit requirement for the disclosure of a contingent liability when vesting is not probable (and thus no liability is recognised, as illustrated in Year 1 of Example 12A). The Board observed that adding such a requirement is not necessary because the general requirement in paragraph 50 of IFRS 2 already requires entities to

> …disclose information that enables users of the financial statements to understand the effect of share-based payment transactions on the entity's profit or loss for the period and on its financial position.

BC382 Some respondents to the November 2014 ED suggested that the Board should add other examples to the Guidance on Implementing IFRS 2 to illustrate the effects of vesting and non-vesting conditions on the measurement of cash-settled awards. The Board did not think this was necessary because of the existing examples in the implementation guidance that illustrate the effects of market and non-market vesting conditions and of non-vesting conditions on equity-settled awards. These examples also serve to illustrate the effects of such conditions on cash-settled awards because the amendments require consistent treatment for both types of awards.

<u>Amended quotation from the *Conceptual Framework*</u>

<u>BC383 In Appendix A, the footnote to the definition of an equity instrument quoted the definition of a liability from the *Conceptual Framework for Financial Reporting* issued in 2010. Following the issue of the revised *Conceptual Framework for Financial Reporting* in 2018 (2018 *Conceptual Framework*), *Amendments to References to the Conceptual Framework in IFRS Standards* amended the footnote to quote the revised definition of a liability from the 2018 *Conceptual Framework*.</u>

<u>BC384 The 2018 *Conceptual Framework* did not address classification of financial instruments with characteristics of both liabilities and equity. In addition, *Amendments to References to the Conceptual Framework in IFRS Standards* did not amend the guidance on classification of financial instruments in IFRS 2. Therefore the Board does not expect the amendment to the footnote in IFRS 2 to have a significant effect on the application of this Standard.</u>

HKFRS 2 IG

Revised ~~September 2018~~August 2020

Guidance on Implementing
Hong Kong Financial Reporting Standard 2

Share-based Payment

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

… continued
IG Example 11

Application of requirements

For transactions with employees, IFRS 2 requires the transaction amount to be measured by reference to the fair value of the equity instruments granted (IFRS 2, paragraph 11). To apply this requirement, it is necessary first to determine the type of equity instrument granted to the employees. Although the plan is described as an employee share purchase plan (ESPP), some ESPPs include option features and are therefore, in effect, share option plans. For example, an ESPP might include a 'lookback feature', whereby the employee is able to purchase shares at a discount, and choose whether the discount is applied to the entity's share price at the date of grant or its share price at the date of purchase. Or an ESPP might specify the purchase price, and then allow the employees a significant period of time to decide whether to participate in the plan. Another example of an option feature is an ESPP that permits the participating employees to cancel their participation before or at the end of a specified period and obtain a refund of amounts previously paid into the plan.

However, in this example, the plan includes no option features. The discount is applied to the share price at the purchase date, and the employees are not permitted to withdraw from the plan.

Another factor to consider is the effect of post-vesting transfer restrictions, if any. Paragraph B3 of IFRS 2 states that, if shares are subject to restrictions on transfer after vesting date, that factor should be taken into account when estimating the fair value of those shares, but only to the extent that the post-vesting restrictions affect the price that a knowledgeable, willing market participant would pay for that share. For example, if the shares are actively traded in a deep and liquid market, post-vesting transfer restrictions may have little, if any, effect on the price that a knowledgeable, willing market participant would pay for those shares.

In this example, the shares are vested when purchased, but cannot be sold for five years after the date of purchase. Therefore, the entity should consider the valuation effect of the five-year post-vesting transfer restriction. This entails using a valuation technique to estimate what the price of the restricted share would have been on the purchase date in an arm's length transaction between knowledgeable, willing parties. Suppose that, in this example, the entity estimates that the fair value of each restricted share is CU28. In this case, the fair value of the equity instruments granted is CU4 per share (being the fair value of the restricted share of CU28 less the purchase price of CU24). Because 64,000 shares were purchased, the total fair value of the equity instruments granted is CU256,000.

In this example, there is no vesting period. Therefore, in accordance with paragraph 14 of IFRS 2, the entity should recognise an expense of CU256,000 immediately.

However, in some cases, the expense relating to an ESPP might not be material. IAS 8 *Accounting Policies, Changes in Accounting ~~Policies~~ Estimates and Errors* states that the accounting policies in IFRSs need not be applied when the effect of applying them is immaterial (IAS 8, paragraph 8). ~~IAS 8 also~~ IAS 1 *Presentation of Financial Statements* states that ~~an omission or misstatement of an item~~information is material if omitting, misstating or obscuring it could reasonably be expected to~~, individually or collectively,~~ influence ~~the economic~~ decisions that the primary users of general purpose financial statements make on the basis of ~~the~~ financial statements, which provide financial information about a specific reporting entity. Materiality depends on the ~~size and~~ nature or magnitude of ~~the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor (IAS 8, paragraph 5)~~ information, or both. An entity assesses whether information, either individually or in combination with other information, is material in the context of its financial statements taken as a whole (IAS 1, paragraph 7). Therefore, in this example, the entity should consider whether the expense of CU256,000 is material.

Accounting for a modification of a share-based payment transaction that changes its classification from cash-settled to equity-settled

IG19B The following example illustrates the application of the requirements in paragraph~~s~~ B44A of IFRS 2 to a modification of the terms and conditions of a cash-settled share-based payment transaction that becomes an equity-settled share-based payment transaction.

IG Example 12C

Background

On 1 January 20X1 an entity grants 100 share appreciation rights (SARs) that will be settled in cash to each of 100 employees on the condition that employees will remain employed for the next four years.

On 31 December 20X1 the entity estimates that the fair value of each SAR is CU10 and consequently, the total fair value of the cash-settled award is CU100,000. On 31 December 20X2 the estimated fair value of each SAR is CU12 and consequently, the total fair value of the cash-settled award is CU120,000.

On 31 December 20X2 the entity cancels the SARs and, in their place, grants 100 share options to each employee on the condition that each employee remains in its employ for the next two years. Therefore the original vesting period is not changed. On this date the fair value of each share option is CU13.20 and consequently, the total fair value of the new grant is CU132,000. All of the employees are expected to and ultimately do provide the required service.

For simplicity, this example assumes that none of the employees' compensation qualifies for capitalisation as part of the cost of an asset.

Application of requirements

At the modification date (31 December 20X2), the entity applies paragraph B44A. Accordingly:

(a) from the date of the modification, the share options are measured by reference to their modification-date fair value and, at the modification date, the share options are recognised in equity to the extent to which the employees have rendered services;

(b) the liability for the SARs is derecognised at the modification date; and

(c) the difference between the carrying amount of the liability derecognised and the equity amount recognised at the modification date is recognised immediately in profit or loss.

At the modification date (31 December 20X2), the entity compares the fair value of the equity-settled replacement award for services provided through to the modification date (CU132,000 × 2⁄4 = CU66,000) with the fair value of the cash-settled original award for those services (CU120,000 × 2⁄4 = CU60,000). The difference (CU6,000) is recognised immediately in profit or loss at the date of the modification.

The remainder of the equity-settled share-based payment (measured at its modification-date fair value) is recognised in profit or loss over the remaining two-year vesting period from the date of the modification.

continued…

HKFRS 3 (Revised)
Revised ~~June~~ August 2020

Effective for annual periods
beginning on or after 1 July 2009

Hong Kong Financial Reporting Standard 3 (Revised)

Business Combinations

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

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APPENDICES

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BASIS FOR CONCLUSIONS

ILLUSTRATIVE EXAMPLES

Hong Kong Financial Reporting Standard 3 *Business Combinations* (HKFRS 3) is set out in paragraphs 1 – 68 and Appendices A – C, and E and F. All the paragraphs have equal authority. Paragraphs in **bold type** state the main principles. Terms defined in Appendix A are in *italics* the first time they appear in the HKFRS. HKFRS 3 should be read in the context of its objective and the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Conceptual Framework for Financial Reporting*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

This revised Standard was issued in March 2008. It supersedes HKFRS 3 issued in 2004, as amended in 2005 and 2007.

Hong Kong Financial Reporting Standard 3
Business Combinations

Objective

1 The objective of this HKFRS is to improve the relevance, reliability and comparability of the information that a reporting entity provides in its financial statements about a *business combination* and its effects. To accomplish that, this HKFRS establishes principles and requirements for how the *acquirer*:

(a) recognises and measures in its financial statements the *identifiable* assets acquired, the liabilities assumed and any *non-controlling interest* in the *acquiree*;

(b) recognises and measures the *goodwill* acquired in the business combination or a gain from a bargain purchase; and

(c) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination.

Scope

2 This HKFRS applies to a transaction or other event that meets the definition of a business combination. This HKFRS does not apply to:

(a) the accounting for the formation of a joint arrangement in the financial statements of the joint arrangement itself.

(b) the acquisition of an asset or a group of assets that does not constitute a *business*. In such cases the acquirer shall identify and recognise the individual identifiable assets acquired (including those assets that meet the definition of, and recognition criteria for, *intangible assets* in HKAS 38 *Intangible Assets*) and liabilities assumed. The cost of the group shall be allocated to the individual identifiable assets and liabilities on the basis of their relative *fair values* at the date of purchase. Such a transaction or event does not give rise to goodwill.

(c) a combination of entities or businesses under common control (paragraphs B1 – B4 provide related application guidance).

2A The requirements of this Standard do not apply to the acquisition by an investment entity, as defined in HKFRS 10 *Consolidated Financial Statements*, of an investment in a subsidiary that is required to be measured at fair value through profit or loss.

Identifying a business combination

3 An entity shall determine whether a transaction or other event is a business combination by applying the definition in this HKFRS, which requires that the assets acquired and liabilities assumed constitute a business. If the assets acquired are not a business, the reporting entity shall account for the transaction or other event as an asset acquisition. Paragraphs B5 – ~~B12~~ B12D provide guidance on identifying a business combination and the definition of a business.

The acquisition method

4 An entity shall account for each business combination by applying the acquisition method.

5 Applying the acquisition method requires:

(a) identifying the acquirer;

(b) determining the *acquisition date*;

(c) recognising and measuring the identifiable assets acquired, the liabilities assumed

and any non-controlling interest in the acquiree; and

(d) recognising and measuring goodwill or a gain from a bargain purchase.

Identifying the acquirer

6 For each business combination, one of the combining entities shall be identified as the acquirer.

7 The guidance in HKFRS 10 shall be used to identify the acquirer—the entity that obtains *control* of another entity, i.e. the acquiree. If a business combination has occurred but applying the guidance in HKFRS 10 does not clearly indicate which of the combining entities is the acquirer, the factors in paragraphs B14–B18 shall be considered in making that determination.

Determining the acquisition date

8 The acquirer shall identify the acquisition date, which is the date on which it obtains control of the acquiree.

9 The date on which the acquirer obtains control of the acquiree is generally the date on which the acquirer legally transfers the consideration, acquires the assets and assumes the liabilities of the acquiree—the closing date. However, the acquirer might obtain control on a date that is either earlier or later than the closing date. For example, the acquisition date precedes the closing date if a written agreement provides that the acquirer obtains control of the acquiree on a date before the closing date. An acquirer shall consider all pertinent facts and circumstances in identifying the acquisition date.

Recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree

Recognition principle

10 As of the acquisition date, the acquirer shall recognise, separately from goodwill, the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree. Recognition of identifiable assets acquired and liabilities assumed is subject to the conditions specified in paragraphs 11 and 12.

Recognition conditions

11 To qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must meet the definitions of assets and liabilities in the *Framework for the Preparation and Presentation of Financial Statements*[*] at the acquisition date. For example, costs the acquirer expects but is not obliged to incur in the future to effect its plan to exit an activity of an acquiree or to terminate the employment of or relocate an acquiree's employees are not liabilities at the acquisition date. Therefore, the acquirer does not recognise those costs as part of applying the acquisition method. Instead, the acquirer recognises those costs in its post-combination financial statements in accordance with other HKFRSs.

12 In addition, to qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must be part of what the acquirer and the acquiree (or its former *owners*) exchanged in the business combination transaction rather than the result of separate transactions. The acquirer shall apply the guidance in paragraphs 51–53 to determine which assets acquired or liabilities assumed are part of the exchange for the acquiree and which, if any, are the result of separate transactions to be accounted for in accordance with their nature and the applicable HKFRSs.

* ~~*Framework for the Preparation and Presentation of Financial Statements* was replaced by the *Conceptual Framework for Financial Reporting* in October 2010.~~For this Standard, acquirers are required to apply the definitions of an asset and a liability and supporting guidance in the *Framework for the Preparation and Presentation of Financial Statements* rather than the *Conceptual Framework for Financial Reporting* issued in 2018.

64H [Deleted]

64I *Annual Improvements to HKFRSs 2010–2012 Cycle*, issued in January 2014, amended paragraphs 40 and 58 and added paragraph 67A and its related heading. An entity shall apply that amendment prospectively to business combinations for which the acquisition date is on or after 1 July 2014. Earlier application is permitted. An entity may apply the amendment earlier provided that HKFRS 9 and HKAS 37 (both as amended by *Annual Improvements to HKFRSs 2010–2012 Cycle*) have also been applied. If an entity applies that amendment earlier it shall disclose that fact.

64J *Annual Improvements Cycle 2011–2013* issued in January 2014 amended paragraph 2(a). An entity shall apply that amendment prospectively for annual periods beginning on or after 1 July 2014. Earlier application is permitted. If an entity applies that amendment for an earlier period it shall disclose that fact.

64K HKFRS 15 *Revenue from Contracts with Customers*, issued in July 2014, amended paragraph 56. An entity shall apply that amendment when it applies HKFRS 15.

64L HKFRS 9, as issued in September 2014, amended paragraphs 16, 42, 53, 56, 58 and B41 and deleted paragraphs 64A, 64D and 64H. An entity shall apply those amendments when it applies HKFRS 9.

64M HKFRS 16, issued in May 2016, amended paragraphs 14, 17, B32 and B42, deleted paragraphs B28–B30 and their related heading and added paragraphs 28A–28B and their related heading. An entity shall apply those amendments when it applies HKFRS 16.

64N *[This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]*

64O *Annual Improvements to HKFRS Standards 2015–2017 Cycle*, issued in February 2018, added paragraph 42A. An entity shall apply those amendments to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 January 2019. Earlier application is permitted. If an entity applies those amendments earlier, it shall disclose that fact.

64P *Definition of a Business*, issued in January 2019, added paragraphs B7A–B7C, B8A and B12A–B12D, amended the definition of the term 'business' in Appendix A, amended paragraphs 3, B7–B9, B11 and B12 and deleted paragraph B10. An entity shall apply these amendments to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 January 2020 and to asset acquisitions that occur on or after the beginning of that period. Earlier application of these amendments is permitted. If an entity applies these amendments for an earlier period, it shall disclose that fact.

Transition

65 Assets and liabilities that arose from business combinations whose acquisition dates preceded the application of this HKFRS shall not be adjusted upon application of this HKFRS.

65A Contingent consideration balances arising from business combinations whose acquisition dates preceded the date when an entity first applied this HKFRS as issued in 2008 shall not be adjusted upon first application of this HKFRS. Paragraphs 65B–65E shall be applied in the subsequent accounting for those balances. Paragraphs 65B–65E shall not apply to the accounting for contingent consideration balances arising from business combinations with acquisition dates on or after the date when the entity first applied this HKFRS as issued in 2008. In paragraphs 65B–65E business combination refers exclusively to business combinations whose acquisition date preceded the application of this HKFRS as issued in 2008.

65B If a business combination agreement provides for an adjustment to the cost of the combination contingent on future events, the acquirer shall include the amount of that adjustment in the cost of the combination at the acquisition date if the adjustment is probable and can be measured reliably.

65C A business combination agreement may allow for adjustments to the cost of the combination that are contingent on one or more future events. The adjustment might, for example, be contingent on a specified level of profit being maintained or achieved in future periods, or on the market price of the instruments issued being maintained. It is usually possible to estimate the amount of any such adjustment at the time of initially accounting for the combination without impairing the reliability of the information, even though some uncertainty exists. If the future events do not occur or the estimate needs to be revised, the cost of the business combination shall be adjusted accordingly.

65D However, when a business combination agreement provides for such an adjustment, that adjustment is not included in the cost of the combination at the time of initially accounting for the combination if it either is not probable or cannot be measured reliably. If that adjustment subsequently becomes probable and can be measured reliably, the additional consideration shall be treated as an adjustment to the cost of the combination.

65E In some circumstances, the acquirer may be required to make a subsequent payment to the seller as compensation for a reduction in the value of the assets given, equity instruments issued or liabilities incurred or assumed by the acquirer in exchange for control of the acquiree. This is the case, for example, when the acquirer guarantees the market price of equity or debt instruments issued as part of the cost of the business combination and is required to issue additional equity or debt instruments to restore the originally determined cost. In such cases, no increase in the cost of the business combination is recognised. In the case of equity instruments, the fair value of the additional payment is offset by an equal reduction in the value attributed to the instruments initially issued. In the case of debt instruments, the additional payment is regarded as a reduction in the premium or an increase in the discount on the initial issue.

66 An entity, such as a mutual entity, that has not yet applied HKFRS 3 and had one or more business combinations that were accounted for using the purchase method shall apply the transition provisions in paragraphs B68 and B69.

Income taxes

67 For business combinations in which the acquisition date was before this HKFRS is applied, the acquirer shall apply the requirements of paragraph 68 of HKAS 12, as amended by this HKFRS, prospectively. That is to say, the acquirer shall not adjust the accounting for prior business combinations for previously recognised changes in recognised deferred tax assets. However, from the date when this HKFRS is applied, the acquirer shall recognise, as an adjustment to profit or loss (or, if HKAS 12 requires, outside profit or loss), changes in recognised deferred tax assets.

Reference to HKFRS 9

67A If an entity applies this Standard but does not yet apply HKFRS 9, any reference to HKFRS 9 should be read as a reference to HKAS 39.

Withdrawal of HKFRS 3 (issued 2004)

68 This HKFRS supersedes HKFRS 3 *Business Combinations* issued in 2004 as amended in 2005 and 2007.

Appendix A
Defined terms

This appendix is an integral part of the HKFRS.

acquiree
The business or businesses that the **acquirer** obtains control of in a **business combination**.

acquirer
The entity that obtains control of the **acquiree**.

acquisition date
The date on which the **acquirer** obtains control of the **acquiree**.

business
An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing goods or services to customers, generating investment income (such as dividends or interest) or generating other income from ordinary activities ~~a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants~~.

business combination
A transaction or other event in which an **acquirer** obtains control of one or more **businesses**. Transactions sometimes referred to as 'true mergers' or 'mergers of equals' are also **business combinations** as that term is used in this HKFRS.

contingent consideration
Usually, an obligation of the **acquirer** to transfer additional assets or **equity interests** to the former owners of an **acquiree** as part of the exchange for control of the acquiree if specified future events occur or conditions are met. However, contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met.

equity interests
For the purposes of this HKFRS, *equity interests* is used broadly to mean ownership interests of investor-owned entities and owner, member or participant interests of **mutual entities**.

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

goodwill
An asset representing the future economic benefits arising from other assets acquired in a **business combination** that are not individually identified and separately recognised.

identifiable
An asset is *identifiable* if it either:

(a) is separable, ie capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so; or

(b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

(c) all of the combining entities transfer their net assets, or the owners of those entities transfer their equity interests, to a newly formed entity (sometimes referred to as a roll-up or put-together transaction); or

(d) a group of former owners of one of the combining entities obtains control of the combined entity.

Definition of a business (application of paragraph 3)

B7 A business consists of inputs and processes applied to those inputs that have the ability to ~~create~~ contribute to the creation of outputs. ~~Although businesses usually have outputs, outputs are not required for an integrated set to qualify as a business.~~ The three elements of a business are defined as follows (see paragraphs B8–B12D for guidance on the elements of a business):

(a) **Input:** Any economic resource that creates outputs, or has the ability to ~~create,~~ contribute to the creation of outputs when one or more processes are applied to it. Examples include non-current assets (including intangible assets or rights to use non-current assets), intellectual property, the ability to obtain access to necessary materials or rights and employees.

(b) **Process:** Any system, standard, protocol, convention or rule that when applied to an input or inputs, creates outputs or has the ability to ~~create~~contribute to the creation of outputs. Examples include strategic management processes, operational processes and resource management processes. These processes typically are documented, but the intellectual capacity of an organised workforce having the necessary skills and experience following rules and conventions may provide the necessary processes that are capable of being applied to inputs to create outputs. (Accounting, billing, payroll and other administrative systems typically are not processes used to create outputs.)

(c) **Output:** The result of inputs and processes applied to those inputs that provide ~~or have the ability to provide a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants~~ goods or services to customers, generate investment income (such as dividends or interest) or generate other income from ordinary activities.

Optional test to identify concentration of fair value

B7A Paragraph B7B sets out an optional test (the concentration test) to permit a simplified assessment of whether an acquired set of activities and assets is not a business. An entity may elect to apply, or not apply, the test. An entity may make such an election separately for each transaction or other event. The concentration test has the following consequences:

(a) if the concentration test is met, the set of activities and assets is determined not to be a business and no further assessment is needed.

(b) if the concentration test is not met, or if the entity elects not to apply the test, the entity shall then perform the assessment set out in paragraphs B8–B12D.

B7B The concentration test is met if substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets. For the concentration test:

(a) gross assets acquired shall exclude cash and cash equivalents, deferred tax assets, and goodwill resulting from the effects of deferred tax liabilities.

(b) the fair value of the gross assets acquired shall include any consideration transferred (plus the fair value of any non-controlling interest and the fair value of any previously held interest) in excess of the fair value of net identifiable assets acquired. The fair value of the gross assets acquired may normally be determined as the total obtained by adding the fair value of the consideration transferred (plus the fair value of any non-controlling interest and the fair value of any previously held interest) to the fair value of the liabilities assumed (other than deferred tax liabilities), and then excluding the items identified in subparagraph (a). However, if the fair value of the gross assets acquired is more than that total, a more precise calculation may sometimes be needed.

(c) a single identifiable asset shall include any asset or group of assets that would be recognised and measured as a single identifiable asset in a business combination.

(d) if a tangible asset is attached to, and cannot be physically removed and used separately from, another tangible asset (or from an underlying asset subject to a lease, as defined in HKFRS 16 *Leases*), without incurring significant cost, or significant diminution in utility or fair value to either asset (for example, land and buildings), those assets shall be considered a single identifiable asset.

(e) when assessing whether assets are similar, an entity shall consider the nature of each single identifiable asset and the risks associated with managing and creating outputs from the assets (that is, the risk characteristics).

(f) the following shall not be considered similar assets:

(i) a tangible asset and an intangible asset;

(ii) tangible assets in different classes (for example, inventory, manufacturing equipment and automobiles) unless they are considered a single identifiable asset in accordance with the criterion in subparagraph (d);

(iii) identifiable intangible assets in different classes (for example, brand names, licences and intangible assets under development);

(iv) a financial asset and a non-financial asset;

(v) financial assets in different classes (for example, accounts receivable and investments in equity instruments); and

(vi) identifiable assets that are within the same class of asset but have significantly different risk characteristics.

B7C The requirements in paragraph B7B do not modify the guidance on similar assets in HKAS 38 *Intangible Assets*; nor do they modify the meaning of the term 'class' in HKAS 16 *Property, Plant and Equipment*, HKAS 38 and HKFRS 7 *Financial Instruments: Disclosures*.

Elements of a business

B8 Although businesses usually have outputs, outputs are not required for an integrated set of activities and assets to qualify as a business. To be capable of being conducted and managed for the ~~purposes defined~~ purpose identified in the definition of a business, an integrated set of activities and assets requires two essential elements—inputs and processes applied to those inputs~~, which together are or will be used to create outputs~~. ~~However, a~~ A business need not include all of the inputs or processes that the seller used in operating that business ~~if market participants are capable of acquiring the business and continuing to produce outputs, for example, by integrating the business with their own inputs and processes~~. However, to be considered a business, an integrated set of activities and assets must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create output. Paragraphs B12–B12D specify how to assess whether a process is substantive.

B8A If an acquired set of activities and assets has outputs, continuation of revenue does not on its own indicate that both an input and a substantive process have been acquired.

B9 The nature of the elements of a business varies by industry and by the structure of an entity's operations (activities), including the entity's stage of development. Established businesses often have many different types of inputs, processes and outputs, whereas new businesses often have few inputs and processes and sometimes only a single output (product). Nearly all businesses also have liabilities, but a business need not have liabilities. Furthermore, an acquired set of activities and assets that is not a business might have liabilities.

B10 ~~An integrated set of activities and assets in the development stage might not have outputs. If not, the acquirer should consider other factors to determine whether the set is a business. Those factors include, but are not limited to, whether the set:~~

~~(a) has begun planned principal activities;~~

~~(b) has employees, intellectual property and other inputs and processes that could be applied to those inputs;~~

~~(c) is pursuing a plan to produce outputs; and~~

~~(d) will be able to obtain access to customers that will purchase the outputs.~~

~~Not all of those factors need to be present for a particular integrated set of activities and assets in the development stage to qualify as a business.~~[Deleted]

B11 Determining whether a particular set of activities and assets ~~and activities~~ is a business ~~should~~ shall be based on whether the integrated set is capable of being conducted and managed as a business by a market participant. Thus, in evaluating whether a particular set is a business, it is not relevant whether a seller operated the set as a business or whether the acquirer intends to operate the set as a business.

Assessing whether an acquired process is substantive

B12 ~~In the absence of evidence to the contrary, a particular set of assets and activities in which goodwill is present shall be presumed to be a business. However, a business need not have goodwill.~~ Paragraphs B12A–B12D explain how to assess whether an acquired process is substantive if the acquired set of activities and assets does not have outputs (paragraph B12B) and if it does have outputs (paragraph B12C).

B12A An example of an acquired set of activities and assets that does not have outputs at the acquisition date is an early-stage entity that has not started generating revenue. Moreover, if an acquired set of activities and assets was generating revenue at the acquisition date, it is considered to have outputs at that date, even if subsequently it will no longer generate revenue from external customers, for example because it will be integrated by the acquirer.

B12B If a set of activities and assets does not have outputs at the acquisition date, an acquired process (or group of processes) shall be considered substantive only if:

(a) it is critical to the ability to develop or convert an acquired input or inputs into outputs; and

(b) the inputs acquired include both an organised workforce that has the necessary skills, knowledge, or experience to perform that process (or group of processes) and other inputs that the organised workforce could develop or convert into outputs. Those other inputs could include:

(i) intellectual property that could be used to develop a good or service;

(ii) other economic resources that could be developed to create outputs; or

(iii) rights to obtain access to necessary materials or rights that enable the creation of future outputs.

Examples of the inputs mentioned in subparagraphs (b)(i)–(iii) include technology, in-process research and development projects, real estate and mineral interests.

B12C If a set of activities and assets has outputs at the acquisition date, an acquired process (or group of processes) shall be considered substantive if, when applied to an acquired input or inputs, it:

(a) is critical to the ability to continue producing outputs, and the inputs acquired include an organised workforce with the necessary skills, knowledge, or experience to perform that process (or group of processes); or

(b) significantly contributes to the ability to continue producing outputs and:

(i) is considered unique or scarce; or

(ii) cannot be replaced without significant cost, effort, or delay in the ability to continue producing outputs.

B12D The following additional discussion supports both paragraphs B12B and B12C:

(a) an acquired contract is an input and not a substantive process. Nevertheless, an acquired contract, for example, a contract for outsourced property management or outsourced asset management, may give access to an organised workforce. An entity shall assess whether an organised workforce accessed through such a contract performs a substantive process that the entity controls, and thus has acquired. Factors to be considered in making that assessment include the duration of the contract and its renewal terms.

(b) difficulties in replacing an acquired organised workforce may indicate that the acquired organised workforce performs a process that is critical to the ability to create outputs.

(c) a process (or group of processes) is not critical if, for example, it is ancillary or minor within the context of all the processes required to create outputs.

Identifying the acquirer (application of paragraphs 6 and 7)

B13 The guidance in HKFRS 10 *Consolidated Financial Statements* shall be used to identify the acquirer – the entity that obtains control of the acquiree. If a business combination has occurred but applying the guidance in HKFRS 10 does not clearly indicate which of the combining entities is the acquirer, the factors in paragraphs B14-B18 shall be considered in making that determination.

B14 In a business combination effected primarily by transferring cash or other assets or by incurring liabilities, the acquirer is usually the entity that transfers the cash or other assets or incurs the liabilities.

B15 In a business combination effected primarily by exchanging equity interests, the acquirer is usually the entity that issues its equity interests. However, in some business combinations, commonly called 'reverse acquisitions', the issuing entity is the acquiree. Paragraphs B19-B27 provide guidance on accounting for reverse acquisitions. Other pertinent facts and circumstances shall also be considered in identifying the acquirer in a business combination effected by exchanging equity interests, including:

(a) *the relative voting rights in the combined entity after the business combination* – The acquirer is usually the combining entity whose owners as a group retain or receive the largest portion of the voting rights in the combined entity. In determining which group of owners retains or receives the largest portion of the voting rights, an entity shall consider the existence of any unusual or special voting arrangements and options, warrants or convertible securities.

(b) *the existence of a large minority voting interest in the combined entity if no other owner or organised group of owners has a significant voting interest* – The acquirer is usually the combining entity whose single owner or organised group of owners holds the largest minority voting interest in the combined entity.

(c) *the composition of the governing body of the combined entity* – The acquirer is usually the combining entity whose owners have the ability to elect or appoint or to remove a majority of the members of the governing body of the combined entity.

(d) *the composition of the senior management of the combined entity* – The acquirer is usually the combining entity whose (former) management dominates the management of the combined entity.

(e) *the terms of the exchange of equity interests* – The acquirer is usually the combining entity that pays a premium over the pre-combination fair value of the equity interests of the other combining entity or entities.

Appendix ~~F~~E
Reference to the Conceptual Framework
(Amendments to HKFRS 3 *Business Combinations*)

The following sets out amendments required for this Standard resulting from amendments to HKFRS 3 that are not yet effective. Once effective, the amendments set out below will be incorporated into the text of this Standard and this appendix will be deleted.

Paragraph 11 is amended and the footnote to *Framework for the Preparation and Presentation of Financial Statements* in paragraph 11 is deleted. Paragraphs 14, 21, 22 and 23 are amended and paragraphs 21A, 21B, 21C, 23A and 64Q are added. A heading is added above paragraph 21A and the headings below paragraph 21 and above paragraph 22 are amended. New text is underlined and deleted text is struck through. Paragraph 10 is unamended but is included for ease of reference.

The acquisition method

...

Recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree

Recognition principle

10 **As of the acquisition date, the acquirer shall recognise, separately from goodwill, the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree. Recognition of identifiable assets acquired and liabilities assumed is subject to the conditions specified in paragraphs 11 and 12.**

Recognition conditions

11 To qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must meet the definitions of assets and liabilities in the ~~*Framework for the Preparation and Presentation of Financial Statements**~~ *Conceptual Framework for Financial Reporting* at the acquisition date. For example, costs the acquirer expects but is not obliged to incur in the future to effect its plan to exit an activity of an acquiree or to terminate the employment of or relocate an acquiree's employees are not liabilities at the acquisition date. Therefore, the acquirer does not recognise those costs as part of applying the acquisition method. Instead, the acquirer recognises those costs in its post-combination financial statements in accordance with other HKFRSs.

~~*~~ ~~For this Standard, acquirers are required to apply the definitions of an asset and a liability and supporting guidance in the *Framework for the Preparation and Presentation of Financial Statements* rather than the *Conceptual Framework for Financial Reporting* issued in 2018.~~

...

14 Paragraphs B31–B40 provide guidance on recognising intangible assets. Paragraphs ~~22~~21A–28B specify the types of identifiable assets and liabilities that include items for which this HKFRS provides limited exceptions to the recognition principle and conditions.

...

Exceptions to the recognition or measurement principles

21 This HKFRS provides limited exceptions to its recognition and measurement principles. Paragraphs ~~22~~21A–31A specify both the particular items for which exceptions are provided and the nature of those exceptions. The acquirer shall account for those items by applying the requirements in paragraphs ~~22~~21A–31A, which will result in some items being:

(a) recognised either by applying recognition conditions in addition to those in paragraphs 11 and 12 or by applying the requirements of other HKFRSs, with results that differ from applying the recognition principle and conditions.

(b) measured at an amount other than their acquisition-date fair values.

~~Exception~~ Exceptions to the recognition principle

Liabilities and contingent liabilities within the scope of HKAS 37 or HK(IFRIC)-Int 21

21A Paragraph 21B applies to liabilities and contingent liabilities that would be within the scope of HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets* or HK(IFRIC)-Int 21 *Levies* if they were incurred separately rather than assumed in a business combination.

21B The *Conceptual Framework for Financial Reporting* defines a liability as 'a present obligation of the entity to transfer an economic resource as a result of past events'. For a provision or contingent liability that would be within the scope of HKAS 37, the acquirer shall apply paragraphs 15–22 of HKAS 37 to determine whether at the acquisition date a present obligation exists as a result of past events. For a levy that would be within the scope of HK(IFRIC)-Int 21, the acquirer shall apply HK(IFRIC)-Int 21 to determine whether the obligating event that gives rise to a liability to pay the levy has occurred by the acquisition date.

21C A present obligation identified in accordance with paragraph 21B might meet the definition of a contingent liability set out in paragraph 22(b). If so, paragraph 23 applies to that contingent liability.

Contingent liabilities and contingent assets

22 HKAS 37 ~~*Provisions, Contingent Liabilities and Contingent Assets*~~ defines a contingent liability as:

(a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or

(b) a present obligation that arises from past events but is not recognised because:

(i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

(ii) the amount of the obligation cannot be measured with sufficient reliability.

23 ~~The requirements in HKAS 37 do not apply in determining which contingent liabilities to recognise as of the acquisition date. Instead, the~~ The acquirer shall recognise as of the acquisition date a contingent liability assumed in a business combination if it is a present obligation that arises from past events and its fair value can be measured reliably. Therefore, contrary to paragraphs 14(b), 23, 27, 29 and 30 of HKAS 37, the acquirer recognises a contingent liability assumed in a business combination at the acquisition date even if it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation. Paragraph 56 of this HKFRS provides guidance on the subsequent accounting for contingent liabilities.

23A HKAS 37 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’. The acquirer shall not recognise a contingent asset at the acquisition date.

...

Effective date and transition

Effective date

...

64Q *Reference to the Conceptual Framework*, issued in June 2020, amended paragraphs 11, 14, 21, 22 and 23 and added paragraphs 21A, 21B, 21C and 23A. An entity shall apply those amendments to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 January 2022. Earlier application is permitted if at the same time or earlier an entity also applies all the amendments made by *Amendments to References to the Conceptual Framework in HKFRS Standards*, issued in June 2018.

Basis for Conclusions on

Hong Kong Financial Reporting Standard 3 (Revised)

Business Combinations

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

Disclosure requirements of IFRS 3	**BC411**
Disclosure requirements of the revised standards	**BC419**
Disclosure of information about post-combination revenue and profit or loss of the acquiree	**BC423**
EFFECTIVE DATE AND TRANSITION	**BC429**
Effective date and transition for combinations of mutual entities or by contract alone	**BC433**
Transition requirements for contingent consideration from a business combination that occurred before the effective date of IFRS 3 (as revised in 2008)	**BC434A**
Effective date and transition for clarifications of the accounting for contingent consideration that arises from business combinations	**BC434D**
Scope exceptions for joint ventures	**BC434E**
Previously held interest in a joint operation (amendments issued in December 2017)	**BC434F**
BENEFITS AND COSTS	**BC435**
DISSENTING OPINIONS ON IFRS 3	

APPENDICES

A Amendments to the Basis for Conclusions on other IFRSs

~~**B** Definition of a Business (Amendments to the Basis for Conclusions on IFRS 3 *Business Combinations*)~~

~~C~~B **Reference to the Conceptual Framework (Amendments to the Basis for Conclusions on IFRS 3 *Business Combinations*)**

of businesses would require further research and deliberation of additional issues and delay the implementation of the revised standards' improvements to practice. The boards therefore did not extend the scope of the revised standards to acquisitions of all asset groups. Paragraph 2(b) of the revised IFRS 3 describes the typical accounting for an asset acquisition.

BC21 SFAS 141(R) amends FASB Interpretation No. 46 (revised December 2003) *Consolidation of Variable Interest Entities* (FASB Interpretation 46(R)) to clarify that the initial consolidation of a variable interest entity that is a business is a business combination. Therefore, the assets, liabilities and non-controlling interests of the variable interest entity should be measured in accordance with the requirements of SFAS 141(R). Previously, FASB Interpretation 46(R) required assets, liabilities and non-controlling interests of variable interest entities that are businesses to be measured at fair value. The FASB concluded that variable interest entities that are businesses should be afforded the same exceptions to fair value measurement and recognition that are provided for assets and liabilities of acquired businesses. The FASB also decided that upon the initial consolidation of a variable interest entity that is not a business, the assets (other than goodwill), liabilities and non-controlling interests should be recognised and measured in accordance with the requirements of SFAS 141(R), rather than at fair value as previously required by FASB Interpretation 46(R). The FASB reached that decision for the same reasons described above, ie if SFAS 141(R) allows an exception to fair value measurement for a particular asset or liability, it would be inconsistent to require the same type of asset or liability to be measured at fair value. Except for that provision, the FASB did not reconsider the requirements in FASB Interpretation 46(R) for the initial consolidation of a variable interest entity that is not a business.

Clarifying the definition of a business

BC21A Following a Post-implementation Review (PIR) of IFRS 3, the Board noted that many stakeholders had concerns about how to interpret and apply the definition of a business. Stakeholders indicated that these concerns arose for one or more of the following main reasons:

(a) IFRS 3 requires a fact-driven assessment that adopts the perspective of market participants and does not consider the business rationale, strategic considerations and objectives of the acquirer (see paragraph BC21G);

(b) some sets of activities and assets might have been considered a business from the perspective of particular market participants who could integrate the set in their processes. However, the same sets of activities and assets might not have been considered a business from the perspective of other market participants (see paragraphs BC21H–BC21I);

(c) the definition of a business used the wording 'capable of being conducted and managed for the purpose of providing' a return. That wording did not help in determining whether a transaction includes a business (see paragraphs BC21J–BC21K);

(d) it was difficult to assess:

(i) whether the processes acquired are sufficient to constitute one of the elements required for an acquired set of activities and assets to be a business, and whether any missing processes are so significant that the set is not a business; and

(ii) how to apply the definition of a business if the acquired set of activities and assets does not generate revenue (see paragraphs BC21L–BC21R); and

(e) the definition of a business was broad and IFRS 3 had no guidance identifying when an acquired set of activities and assets is not a business (see paragraphs BC21S–BC21AC).

BC21B To consider those concerns, the Board added to its agenda a project to clarify the definition of a business, with the objective of assisting entities to determine whether a transaction should be accounted for as a business combination or as an asset acquisition. In 2016 the Board published an exposure draft *Definition of a Business and Accounting for Previously Held Interests* (2016 Exposure Draft). The 2016 Exposure Draft attracted 80 comment letters. The Board reviewed those comment letters and consulted the Accounting Standards Advisory Forum (ASAF), the Capital Markets Advisory Committee and the Global Preparers Forum. In 2018 the Board issued *Definition of a Business* (2018 Amendments). In the 2018 Amendments, the Board:

(a) clarified that to be considered a business, an acquired set of activities and assets must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs (see paragraph BC21F);

(b) removed the assessment of whether market participants are capable of replacing any missing inputs or processes and continuing to produce outputs (see paragraphs BC21H–BC21I);

(c) added guidance and illustrative examples to help entities assess whether a substantive process has been acquired (see paragraphs BC21L–BC21R);

(d) narrowed the definitions of a business and of outputs by focusing on goods and services provided to customers and by removing the reference to an ability to reduce costs (see paragraph BC21S);

(e) added an optional concentration test that permits a simplified assessment of whether an acquired set of activities and assets is not a business (see paragraphs BC21T–BC21AC); and

(f) decided that an entity is permitted but not required to apply the amendments to transactions that occurred before the effective date of the amendments. Retrospective application of the amendments to earlier transactions is not required because it is unlikely to provide useful information to users of financial statements, could have been costly and could have been impracticable if hindsight were to be needed. Retrospective application was not prohibited because there may be instances when it would provide useful information and because when it is used it would not deprive users of useful information.

BC21C The 2016 Exposure Draft also dealt with a second topic, accounting for previously held interests. The Board finalised its work on that topic, among others, in 2017 by issuing *Annual Improvements to IFRS Standards 2015–2017 Cycle*.

BC21D IFRS 3 is the result of a joint project between the Board and the FASB and it contained the same definition of a business as the definition in US GAAP. The PIR of IFRS 3 and a PIR of SFAS 141(R) identified similar difficulties in applying the definition of a business. Moreover, the FASB received feedback from many stakeholders that the definition of a business in US GAAP was, in practice, viewed as capturing a broader range of transactions than the identical definition in IFRS 3. Consequently, the FASB amended US GAAP in 2017 by issuing Accounting Standards Update No. 2017-01 *Clarifying the Definition of a Business* (FASB 2017 Amendments). The 2018 Amendments addressed the issues identified during the PIR of IFRS 3 and, though worded differently, are based on conclusions similar to those reached by the FASB. The Board concluded that its 2018 Amendments and the FASB 2017 Amendments could together be expected to lead to more consistency in applying the definition of a business across entities applying US GAAP and entities applying IFRS Standards.

BC21E The 2018 Amendments differ in some respects from the FASB 2017 Amendments. Before finalising the 2018 Amendments, the Board discussed those differences with ASAF. The differences are as follows:

(a) the concentration test set out in paragraphs B7A–B7B of IFRS 3 is optional. The corresponding test in the FASB 2017 Amendments is mandatory. The guidance on how to identify concentration of fair value is substantially the same, but the Board added confirmation of the calculations normally needed (see paragraph B7B(b)) and an illustrative example (Example I).

(b) the Board concluded that an acquired outsourcing contract may give access to an organised workforce that performs a substantive process, even if the acquired set of activities and assets has no outputs. In some cases, that may lead to a conclusion that a business was acquired. In contrast, the FASB concluded that when outputs are not present, a business has been acquired only if the acquired set includes an organised workforce made up of employees.

(c) the Board clarified in paragraph B12D that difficulties in replacing an organised workforce may indicate that the organised workforce performs a process that is critical to the ability to create outputs. The FASB 2017 Amendments do not include this clarification.

(d) the FASB 2017 Amendments include a statement that the presence of more than an insignificant amount of goodwill may be an indicator that an acquired process is substantive. The Board did not include such a statement in the 2018 Amendments (see paragraph BC21R(d)).

(e) the Board clarified in paragraph B7(c) of IFRS 3 that the narrowed definition of outputs includes other income from ordinary activities. An example of such other income is income from contracts outside the scope of IFRS 15 *Revenue from Contracts with Customers*. The FASB expressed a similar view as an observation in its Basis for Conclusions.

(f) the Board aligned the definition of a business with the revised definition of outputs in paragraph B7(c) of IFRS 3. The FASB did not align the two definitions, but its definition of a business refers explicitly to supporting guidance, including guidance on outputs.

Minimum requirements to be a business

BC21F The existence of a process (or processes) is what distinguishes a business from a set of activities and assets that is not a business. Consequently, the Board decided that to be considered a business, an acquired set of activities and assets must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs. The Board incorporated this requirement in paragraph B8. To clarify that a business can exist without including all of the inputs and processes needed to create outputs, the Board replaced the term 'ability to create outputs' with 'ability to contribute to the creation of outputs' in paragraph B7 of IFRS 3.

Market participant's perspective

BC21G Paragraph B11 of IFRS 3 adopts a market participant's perspective in determining whether an acquired set of activities and assets is a business. Some participants in the PIR of IFRS 3 noted that adopting that perspective requires a fact-driven assessment that does not consider the business rationale, strategic considerations and objectives of the acquirer. They expressed concerns that excluding those factors would not result in the most useful information for users of financial statements. Nevertheless, the Board concluded that the assessment should continue to be made from a market participant's perspective and to be driven by facts that indicate the current state and condition of what has been acquired, rather than by considering what the acquirer might intend to do with the acquired set of activities and assets. Basing this determination on facts, rather than on the intentions of the acquirer, helps to prevent similar transactions being accounted for differently. In the Board's view, bringing the business rationale, strategic considerations and objectives of the acquirer into the determination would have made the determination more subjective and thus would have increased diversity in practice. Consequently, the Board did not change paragraph B11 in this regard.

Market participant's ability to replace missing elements

BC21H Before the 2018 Amendments, paragraph B8 of IFRS 3 stated that a business need not include all of the inputs or processes that the seller used in operating that business 'if market participants are capable of acquiring the business and continuing to produce outputs, for example, by integrating the business with their own inputs and processes'. Many participants in the PIR of IFRS 3 stated that it can be challenging to assess whether market participants are capable of performing such an integration, especially if only some market participants are capable of performing such an integration.

BC21I In the light of those comments, the Board decided to base the assessment on what has been acquired in its current state and condition, rather than on whether market participants would be capable of replacing any missing inputs or processes, for example by integrating the acquired activities and assets. Therefore, the Board deleted the reference to such integration. Instead, as discussed in paragraph BC21F, the 2018 Amendments focus on whether acquired inputs and acquired substantive processes together significantly contribute to the ability to create outputs.

The term 'capable of' in the definition of a business

BC21J The definition of a business includes the phrase 'capable of being conducted and managed for the purpose of providing' a return. Many participants in the PIR indicated that this phrase was too broad in scope to be helpful in distinguishing businesses from assets. However, the Board concluded that it was not necessary to change or clarify this phrase because the 2018 Amendments:

(a) removed the assessment of whether market participants are capable of integrating the acquired activities and assets;

(b) clarified that the acquired processes need to be substantive;

(c) narrowed the definition of output; and

(d) added more robust guidance and illustrative examples supporting various aspects of the definition.

BC21K The Board considered whether additional guidance was needed regarding the acquisition of suppliers. In some cases, the acquirer integrates an acquired business with the result that it no longer generates revenue. For example, an entity may acquire a supplier and subsequently consume all the output from the supplier. The acquired inputs and processes are still 'capable of' generating revenue at the acquisition date and so could qualify as a business, if the criteria in paragraph B12C are met. The Board concluded that this outcome was appropriate because the assessment focuses on what the acquirer acquired, not on what the acquirer intends to do with what it acquired. Accordingly, the Board retained the term 'capable of' as the basis for assessment.

Assessing whether an acquired process is substantive

BC21L Many participants in the PIR of IFRS 3 stated that it is difficult to assess:

(a) whether the processes acquired are sufficient to constitute one of the elements required for an acquired set of activities and assets to be a business;

(b) whether any processes missing from that set are so significant that the set is not a business; and

(c) how to apply the definition of a business when the acquired set of assets does not generate revenue.

BC21M To address these concerns, the 2018 Amendments added guidance to help entities to assess whether an acquired process is substantive. That guidance seeks more persuasive evidence when there are no outputs because the existence of outputs already provides some evidence that the acquired set of activities and assets is a business. In particular, if the set has no outputs at the acquisition date, the inputs acquired must include:

(a) an organised workforce that meets specified criteria (see paragraphs BC21N–BC21P); and

(b) other inputs that the organised workforce could develop or convert into outputs (see paragraph BC21Q)

BC21N The Board concluded that the presence of an organised workforce is an indicator of a substantive process. Consequently, the Board decided that, except in limited circumstances, an organised workforce is required in order to conclude that the set of activities and assets is a business. The limited circumstances are when the acquired set both:

(a) has outputs; and

(b) includes a process (or a group of processes) that is unique or scarce, or cannot be replaced without significant cost, effort, or delay in the ability to continue producing outputs. The Board concluded that such processes are usually valuable and that this would often indicate that the processes are substantive, even if no organised workforce is acquired.

BC21O The Board concluded that although an organised workforce is an input to a business, it is not in itself a business. To conclude otherwise would mean that hiring a skilled employee without acquiring any other inputs could be considered to be acquiring a business. The Board decided that such an outcome would be inconsistent with the definition of a business.

BC21P Although the Board concluded that an organised workforce is an input, paragraph B7(b) indicates that the intellectual capacity of an organised workforce having the necessary skills and experience following rules and conventions may provide the necessary processes that are capable of being applied to inputs to create outputs. The Board concluded that this is the case even if the processes are not documented. The Board inserted the phrase 'intellectual capacity' to provide clarity.

BC21Q For an acquired set of activities and assets to be considered a business if the set has no outputs, the Board concluded that the set should include not only a substantive process but also both an organised workforce and other inputs that the acquired organised workforce could develop or convert into outputs. Entities will need to evaluate the nature of those inputs to assess whether that process is substantive. The Board observed that many entities in the development stage will meet this criterion because technology, intellectual property, or other assets are being developed into a good or service. Conversely, if a set is producing outputs at the acquisition date, the set already contains inputs that are being converted into outputs, and, therefore, there is no need to consider specifically the type of inputs to which the acquired process is applied.

BC21R In finalising the 2018 Amendments, the Board also:

(a) specified in paragraph B12D(a) that an acquired contract is not a substantive process, in order to clarify that a contract that provides a continuing revenue stream (eg a lease contract) is not itself a process.

(b) clarified in paragraph B12D(a) that an acquired outsourcing agreement may give access to an organised workforce and that an entity should assess whether an organised workforce accessed through an outsourcing arrangement performs a substantive process that the entity controls, and thus has acquired. The Board added this paragraph because some IFRS Interpretations Committee members observed that IFRS 3 did not provide guidance on whether an outsourced process should be considered in assessing whether a set of activities and assets is a business.

(c) clarified in paragraph B12D(b) that difficulties in replacing an acquired organised workforce may indicate that the organised workforce performs a process that is critical to the ability to create outputs, because the Board expected that it would normally be more difficult to replace a workforce that performs a critical process than to replace a workforce that performs, for example, an ancillary process. The Board provided this indicator because some respondents to the 2016 Exposure Draft commented that the proposed guidance on substantive processes would require too much judgement.

(d) removed the presumption, proposed in the 2016 Exposure Draft, that the presence of more than an insignificant amount of goodwill may be an indicator that an acquired process is substantive. Responses to the 2016 Exposure Draft showed that this proposal created more confusion than clarity. For example, some respondents were unclear whether this proposal referred to 'core goodwill' that is economically present in a business, or to the accounting measurement of goodwill that is determined in accounting for business combinations. Some respondents wondered whether this proposal would, in effect, force entities to apply business combination accounting to measure goodwill in order to assess whether what was acquired was in fact a business.

(e) deleted paragraph B10 of IFRS 3, which described factors to consider when assessing an integrated set of activities and assets in the development stage. The Board deleted that paragraph because the 2018 Amendments provide a more general discussion of acquired sets of activities and assets that do not have outputs.

(f) added illustrative examples in paragraphs IE73–IE123 to assist with the interpretation of what is considered a business. The draft illustrative examples in the 2016 Exposure Draft also included an example on the acquisition of oil and gas operations. To be consistent with the FASB 2017 Amendments, the Board did not include that example in the 2018 Amendments.

Narrowed definition of outputs

BC21S In the 2018 Amendments, the Board narrowed the definition of outputs to focus on goods and services provided to customers, investment returns and other income from ordinary activities and to exclude returns in the form of lower costs, and other economic benefits provided directly to investors or other owners, members, or participants. The Board also amended the definition of a business to make it consistent with the narrowed definition of outputs. The Board made these changes because:

(a) IFRS 15 *Revenue from Contracts with Customers* focuses on goods or services that are an output of an entity's ordinary activities. Nevertheless, because not all businesses have revenue within the scope of IFRS 15, the revised definition also includes outputs that are investment income or other income from ordinary activities.

(b) the previous definition of outputs referred to lower costs and economic benefits provided directly to investors. This reference did not help to distinguish between an asset and a business, because it confused motives for acquiring an asset with the characteristics of the activities and assets acquired. Many asset acquisitions (for example, the purchase of new manufacturing equipment) may be made with the motive of lowering costs but may not involve acquiring a substantive process.

Concentration test

BC21T Many participants in the PIR of IFRS 3 noted that applying the definition of a business involves significant judgements and that IFRS 3 provided little or no guidance that identifies situations in which an acquired set of activities and assets is not a business. To address these concerns, in the 2018 Amendments the Board added a concentration test that is designed to reduce cost and complexity by avoiding the need for a detailed assessment in some circumstances. If substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset, or group of similar identifiable assets, the concentration test is met and the set of activities and assets is considered not to be a business. If the concentration test is met, no further assessment is needed.

BC21U The Board designed the concentration test with the aim of making it easy to understand and—in some straightforward cases that are easy to explain—simple to operate and less costly than applying the detailed assessment otherwise required by paragraphs B8–B12D. To target that aim, the concentration test focuses on a single identifiable asset or a single group of similar identifiable assets. The Board did not expect entities to carry out detailed calculations to apply the test, because detailed calculations would have frustrated the purpose of the test, which is to permit a simplified assessment. In addition, the Board wanted the test to have the same outcome in most circumstances as the detailed assessment and wanted to minimise the risk that the outcome of applying the concentration test could deprive users of financial statements of useful information.

BC21V To confirm that the Board did not expect detailed calculations, paragraph B7B(b) clarifies how the fair value of the gross assets acquired may normally be determined by reference to the fair value of the consideration transferred. In finalising the 2018 Amendments, the Board added an illustrative example showing that calculation (Example I).

BC21W The Board concluded that whether a set of activities and assets includes a substantive process does not depend on how the set is financed. Consequently, the concentration test is based on the gross assets acquired, not on net assets. Thus, the existence of debt (for example, a mortgage loan financing a building) or other liabilities does not alter the conclusion on whether an acquisition is a business combination. In addition, in response to requests from respondents, the Board specified, in finalising the 2018 Amendments, that the gross assets considered in the concentration test exclude cash and cash equivalents acquired, deferred tax assets, and goodwill resulting from the effects of deferred tax liabilities. These exclusions were made because cash acquired, and the tax base of the assets and liabilities acquired, are independent of whether the acquired set of activities and assets includes a substantive process.

BC21X In finalising the 2018 Amendments, the Board made the concentration test optional. This change enables entities to assess whether they have acquired a substantive process when, for example, such an assessment would be more efficient than applying the concentration test, or would result in a conclusion that more faithfully represents the economics of a particular transaction. In line with the purpose of the concentration test, the 2018 Amendments:

(a) specify that the election to carry out that test is available transaction by transaction; and

(b) do not prohibit an entity from carrying out the detailed assessment required by paragraphs B8–B12D if the entity has carried out the concentration test and concluded that the acquired set of activities and assets is not a business. The Board decided that such a prohibition was unnecessary, because if an entity intended to disregard the outcome of the concentration test, it could have elected not to apply it.

BC21Y In making the concentration test optional, the Board considered the accounting consequences that would occur if, when applied to a particular transaction, the concentration test does not achieve the same outcome as the detailed assessment otherwise required by paragraphs B8–B12D. The concentration test identifies some transactions as an asset acquisition. For all other transactions, the entity must go on to perform the detailed assessment. The concentration test never determines that a transaction is a business combination.

BC21Z In theory, the concentration test might sometimes identify a transaction as an asset acquisition when the detailed assessment would identify it as a business combination. That outcome would be a false positive. The Board designed the concentration test to minimise the risk that a false positive could deprive users of financial statements of useful information. A false positive has two consequences:

(a) the entity fails to recognise 'core goodwill' that is economically present in a business combination but is not present in an asset acquisition.[*] Nevertheless, if substantially all of the fair value of the gross assets acquired (including core goodwill) is concentrated in a single identifiable asset (or a group of similar identifiable assets), the fair value of the core goodwill cannot be a substantial part of the total fair value of the gross assets acquired. Thus, information about the value of that core goodwill is unlikely to be material. Moreover, if the fair value of the processes acquired is not significant, the detailed assessment required by paragraphs B8–B12D would be unlikely to conclude that the processes are substantive.

[*] Paragraphs BC313–BC318 describe 'core goodwill'. Those paragraphs also note that, because goodwill is measured as a residual, the carrying amount of goodwill includes several other factors as well as core goodwill.

(b) there are some other differences between the accounting required for a business combination and the accounting required for an asset acquisition, including differences relating to deferred tax, contingent consideration, acquisition-related costs, and gains on bargain purchases. Those differences in accounting requirements are not driven by differences between the economics of a business combination and the economics of an asset acquisition. Therefore, the Board did not expect a false positive to result in a loss of information about the economics of a business combination.

BC21AA The concentration test might not identify an asset acquisition that would be identified by the detailed assessment required by paragraphs B8–B12D. That outcome would be a false negative. An entity is required to carry out the detailed assessment in such a case and is expected to reach the same conclusion as if it had not applied the concentration test. Thus, a false negative has no accounting consequences.

BC21AB In finalising the 2018 Amendments, the Board also clarified some aspects of the guidance on a single identifiable asset and on similar identifiable assets (see paragraphs B7B(c)–(f) and B7C).

BC21AC In finalising the 2018 Amendments, the Board did not:

(a) make the concentration test an indicator, rather than determinative. Such a change would have been inconsistent with the objective of reducing the costs of applying IFRS 3 by providing a test that is designed to be simple in some straightforward cases that are easy to explain.

(b) provide further guidance on the term 'substantially all' because that term is already used in several IFRS Standards.

Method of accounting for business combinations

BC22 Both IAS 22 and APB Opinion 16 permitted use of either the acquisition method or the pooling of interests (pooling) method of accounting for a business combination, although the two methods were not intended as alternatives for the same set of facts and circumstances. ED 3 and the 1999 Exposure Draft proposed, and IFRS 3 and SFAS 141 required, use of the acquisition method to account for all business combinations. The boards did not redeliberate that conclusion during the project that led to the revised standards.

BC23 In developing IFRS 3 and SFAS 141, the IASB and the FASB considered three possible methods of accounting for business combinations–the pooling method, the acquisition method and the fresh start method. In assessing those methods, both boards were mindful of the disadvantages of having more than one method of accounting for business combinations, as evidenced by the experience with IAS 22 and APB Opinion 16. The boards concluded that having more than one method could be justified only if the alternative method (or methods) could be demonstrated to produce information that is more decision-useful and if unambiguous and non-arbitrary boundaries could be established that unequivocally distinguish when one method is to be applied instead of another. The boards also concluded that most business combinations are acquisitions and, for the reasons discussed in paragraphs BC24–BC28, that the acquisition method is the appropriate method for those business combinations. Respondents to ED 3 and the 1999 Exposure Draft generally agreed. Therefore, neither the pooling method nor the fresh start method could be appropriately used for all business combinations.

Reasons for adopting the acquisition method

BC24 Both boards concluded that the acquisition method is the appropriate method of accounting for all business combinations in which one entity obtains control of one or more other businesses[*] because that method is consistent with how the accounting model generally accounts for transactions in which assets are acquired and liabilities are assumed or incurred. Therefore, it produces information that is comparable with other accounting information.

[*] In October 2012 the Board issued *Investment Entities* (Amendments to IFRS 10, IFRS 12 and IAS 27), which removed from the scope of IFRS 3 *Business Combinations* the acquisition by an investment entity, as defined in IFRS 10 *Consolidated Financial Statements*, of an investment in a subsidiary required to be measured at fair value through profit or loss.

BC37 Both boards observed that an important part of decision-useful information is information about cash-generating abilities and cash flows generated. The IASB's *Framework*[*] *for the Preparation and Presentation of Financial Statements* says that 'The economic decisions that are taken by users of financial statements require an evaluation of the ability of an entity to generate cash and cash equivalents and of the timing and certainty of their generation' (paragraph 15).[#] FASB Concepts Statement No. 1 *Objectives of Financial Reporting by Business Enterprises* indicates that '... financial reporting should provide information to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise' (paragraph 37; footnote reference omitted). Neither the cash-generating abilities of the combined entity nor its future cash flows generally are affected by the method used to account for the combination. However, fair values reflect the expected cash flows associated with acquired assets and assumed liabilities. Because the pooling method records the net assets acquired at their carrying amounts rather than at their fair values, the information that the pooling method provides about the cash-generating abilities of those net assets is less useful than that provided by the acquisition method.

BC38 Both boards also concluded that the information provided by the pooling method is less relevant because it has less predictive value and feedback value than the information that is provided by other methods. It is also less complete because it does not reflect assets acquired or liabilities assumed that were not included in the pre-combination financial statements of the combining entities. The pooling method also provides a less faithful representation of the combined entity's performance in periods after the combination. For example, by recording assets and liabilities at the carrying amounts of predecessor entities, post-combination revenues may be overstated (and expenses understated) as the result of embedded gains that were generated by predecessor entities but not recognised by them.

BC39 The *Framework* and FASB Concepts Statement No. 2 *Qualitative Characteristics of Accounting Information* describe comparability as an important characteristic of decision-useful information. Use of different accounting methods for the same set of facts and circumstances makes the resulting information less comparable and thus less useful for making economic decisions. As discussed in paragraphs BC29–BC35, the boards concluded that all business combinations are economically similar. Accordingly, use of the same method to account for all combinations enhances the comparability of the resulting financial reporting information. Both boards observed that the acquisition method, but not the pooling method, could reasonably be applied to all business combinations in which one party to the combination obtains control over the combined entity.

BC40 Opponents of the pooling method generally said that eliminating that method would enhance the comparability of financial statements of entities that grow by means of acquisitions. Both boards agreed.

Inconsistent with historical cost accounting model

BC41 Both boards observed that the pooling method is an exception to the general concept that exchange transactions are accounted for in terms of the fair values of the items exchanged. Because the pooling method records the combination in terms of the pre-combination carrying amounts of the parties to the transaction, it fails to record and thus to hold management accountable for the investment made in the combination.

BC42 Some respondents to the FASB's 1999 Exposure Draft who advocated use of the pooling method asserted that it is consistent with the historical cost model and that eliminating the pooling method would be a step towards adopting a fair value model. They argued that before eliminating the pooling method, the FASB should resolve the broad issue of whether to adopt a fair value model in place of the historical cost model. The FASB disagreed, noting that, regardless of the merits of a fair value model, the pooling method is an aberration that is inconsistent with the historical cost model.

[*] ~~In this Basis for Conclusions references~~ References to the *Framework* in this Basis for Conclusions are to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the IASB in 2001 and in effect when the Standard was developed. ~~In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.~~

[#] ~~superseded by Chapter 1 of the *Conceptual Framework*.~~

An asset or a liability at the acquisition date

BC113 In determining whether an item should be recognised at the acquisition date as part of the business combination, the boards decided that the appropriate first step is to apply the definitions of assets and liabilities in the IASB's *Framework* or FASB Concepts Statement No. 6 *Elements of Financial Statements*, respectively.

BC114 The boards observed that in accordance with both IFRS 3 and SFAS 141, and their predecessors and the related interpretative guidance, particular items were recognised **as if** they were assets acquired or liabilities assumed at the acquisition date even though they did not meet the definition of an asset or a liability. That practice was related to the previous emphasis on measuring the cost of (or investment in) the acquiree rather than the acquisition-date fair values of the assets acquired and liabilities assumed. For example, as discussed in paragraphs BC365–BC370, some expenses for services received in connection with a business combination were capitalised as part of the cost of the acquiree (and recognised as part of goodwill) **as if** they were an asset at the acquisition date. In addition, some future costs that an acquirer expected to incur often were viewed as a cost of the acquiree and recognised **as if** they were a liability at the acquisition date–expected restructuring costs were an example. The boards concluded that the representational faithfulness, consistency and understandability of financial reporting would be improved by eliminating such practices.

BC114A IFRS 3 contains references to the definitions of an asset and a liability in the *Framework for the Preparation and Presentation of Financial Statements* (*Framework*). It requires those definitions to be used when deciding whether to recognise assets and liabilities as part of a business combination. In developing the revised *Conceptual Framework for Financial Reporting*, issued in 2018 (2018 *Conceptual Framework*), the IASB considered whether it should replace those references with references to the revised definitions in the 2018 *Conceptual Framework*. In some cases, applying the revised definitions could change which assets and liabilities qualify for recognition in a business combination. In some such cases, the post-acquisition accounting required by other IFRS Standards could then lead to immediate derecognition of assets or liabilities recognised in a business combination, resulting in so-called *Day 2 gains or losses* that do not depict an economic gain or loss.

BC114B Although the IASB intended to replace all references to the *Framework* with references to the 2018 *Conceptual Framework*, the IASB did not intend to make significant changes to the requirements of IFRS Standards containing those references. Consequently, the IASB decided to retain the reference to the *Framework* in paragraph 11 of IFRS 3 until it completes an analysis of the possible consequences of referring in that paragraph to the revised definitions of an asset and a liability. Once that analysis is complete, the IASB intends to amend IFRS 3 to replace the reference to the *Framework* in a way that avoids unintended consequences, such as *Day 2 gains or losses*.

Part of the business combination

BC115 The second condition for recognising an asset acquired or a liability assumed or incurred in a business combination is that the asset or liability must be part of the business combination transaction rather than an asset or a liability resulting from a separate transaction. Making that distinction requires an acquirer to identify the components of a transaction in which it obtains control over an acquiree. The objective of the condition and the guidance on identifying the components of a business combination is to ensure that each component is accounted for in accordance with its economic substance.

BC116 The boards decided to provide application guidance to help address concerns about the difficulty of determining whether a part of the consideration transferred is for the acquiree or is for another purpose. The boards observed that parties directly involved in the negotiations of an impending business combination may take on the characteristics of related parties. Therefore, they may be willing to enter into other agreements or include as part of the business combination agreement some arrangements that are designed primarily for the benefit of the acquirer or the combined entity, for example, to achieve more favourable financial reporting outcomes after the business combination. Because of those concerns the boards decided to develop a principle for determining whether a particular transaction or arrangement entered into by the parties to the combination is part of what the acquirer and acquiree exchange in the business combination or is a separate transaction.

BC117 The boards concluded that a transaction that is designed primarily for the economic benefit of the acquirer or the combined entity (rather than the acquiree or its former owners before the business combination) is not part of the exchange for the acquiree. Those transactions should be accounted for separately from the business combination. The boards acknowledge that judgement may be required to determine whether part of the consideration paid or the assets acquired and liabilities assumed stems from a separate transaction. Accordingly, the 2005 Exposure Draft included both a general principle and implementation guidance for applying that principle, including several examples.

BC118 Respondents' comments on the proposed guidance on identifying the components of a business combination transaction were mixed. For example, some respondents said that the general principle was clear and provided adequate guidance; others said that the proposed principle was not clear. Several respondents said that the focus on determining whether a transaction benefits the acquiree or the acquirer was not clear because a transaction or event that benefits the acquiree would also benefit the combined entity because the acquiree is part of the combined entity.

BC119 The boards agreed with respondents that the proposed principle for distinguishing between components of a business combination needed improvement. Accordingly, they revised the principle to focus on whether a transaction is entered into by or on behalf of the acquirer or **primarily** for the benefit of the acquirer or the combined entity, rather than **primarily** for the benefit of the acquiree or its former owners **before the combination** (paragraph 52 of the revised IFRS 3).

BC120 The boards also concluded that the focus of the principle should be on identifying whether a business combination includes separate transactions that should be accounted for separately in accordance with their economic substance rather than solely on assessing whether a transaction is part of the exchange for the acquiree (paragraph 51 of the revised IFRS 3). Focusing solely on whether assets or liabilities are part of the exchange for the acquiree might not result in all transactions being accounted for in accordance with their economic substance. For example, if an acquirer asks the acquiree to pay some or all of the acquisition-related costs on its behalf and the acquiree has paid those costs before the acquisition date, at the acquisition date the acquiree will show no liability for those costs. Therefore, some might think that the principle as stated in the 2005 Exposure Draft does not apply to the transactions giving rise to the acquisition-related costs. The boards concluded that focusing instead on whether a transaction is separate from the business combination will more clearly convey the intention of the principle and thus will provide users with more relevant information about the financial effects of transactions and events entered into by the acquirer. The acquirer's financial statements will reflect the financial effects of all transactions for which the acquirer is responsible in accordance with their economic substance.

BC121 To help in applying the principle, paragraph 52 of the revised IFRS 3 includes three examples of transactions that are separate from the transaction in which an acquirer obtains control over an acquiree, and Appendix B provides additional application guidance.

BC122 The first example in paragraph 52 is directed at ensuring that a transaction that in effect settles a pre-existing relationship between the acquirer and the acquiree is excluded from the accounting for the business combination. Assume, for example, that a potential acquiree has an asset (receivable) for an unresolved claim against the potential acquirer. The acquirer and the acquiree's owners agree to settle that claim as part of an agreement to sell the acquiree to the acquirer. The boards concluded that if the acquirer makes a lump sum payment to the seller-owner, part of that payment is to settle the claim and is not part of the consideration transferred to acquire the business. Thus, the portion of the payment that relates to the claim settlement should be excluded from the accounting for the business combination and accounted for separately. In effect, the acquiree relinquished its claim (receivable) against the acquirer by transferring it (as a dividend) to the acquiree's owner. Thus, at the acquisition date the acquiree has no receivable (asset) to be acquired as part of the combination, and the acquirer would account for its settlement payment separately. The FASB observed that the conclusion that a transaction that settles a pre-existing relationship is not part of applying the acquisition method is consistent with the conclusion in EITF Issue No. 04-1 *Accounting for Preexisting Relationships between the Parties to a Business Combination*, which is incorporated into SFAS 141(R) and therefore superseded.

BC123 The second and third examples are also directed at ensuring that payments that are not part of the consideration transferred for the acquiree are excluded from the business combination accounting. The boards concluded that the payments for such transactions or arrangements should be accounted for separately in accordance with the applicable requirements for those transactions. Paragraph BC370 also discusses potential abuses related to the third example–payments to reimburse the acquiree or its former owners for paying the acquirer's costs incurred in connection with the business combination.

development assets acquired in a business combination to be recognised regardless of whether they have an alternative future use.

BC151 Relatively few respondents to the 2005 Exposure Draft commented on the proposed accounting for research and development assets. Those who did so generally disagreed with those proposals (they also generally applied US GAAP rather than IFRSs), citing either or both of the following concerns as support for their view:

(a) In-process research and development may not meet the definition of an asset in the FASB's Concepts Statement 6 because its low likelihood of success does not represent **probable** future economic benefits.

(b) The fair value of in-process research and development may not be measurable with sufficient reliability for recognition in financial statements.

The boards rejected both of those views for the reasons explained in the following paragraphs.

BC152 The boards agreed with respondents that the likelihood that an individual research and development project will result in a profitable product is often low. However, the boards also noted that the use of the word *probable* in the FASB's Concepts Statement 6 refers only to something that is not certain. The definition does not use that term as a recognition criterion that specifies the degree of probability of the inflow or outflow of future economic benefits that must be present for an item to qualify for recognition. Therefore, the boards concluded that in-process research and development acquired in a business combination will generally satisfy the definition of an asset because the observable exchange at the acquisition date provides evidence that the parties to the exchange expect future economic benefits to result from that research and development. Uncertainty about the outcome of an individual project is reflected in measuring its fair value.

BC153 The boards also agreed that determining the fair value of in-process research and development requires the use of estimates and judgement, and the resulting amount will generally not be as reliable as the fair values of other assets for which quoted prices in active markets are available. However, the boards observed that use of estimates and judgement, by itself, does not mean that information is unreliable; reliability does not require precision or certainty. For example, paragraph 86 of the IASB's *Framework*[*] says that 'In many cases, cost or value must be estimated; the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.' The boards also noted that the requirement to measure the fair value of in-process research and development assets acquired in a business combination is not new–not even in US GAAP. In accordance with FASB Interpretation 4, that amount was measured but immediately written off. Moreover, respondents to the 2005 Exposure Draft that apply IFRSs generally did not mention any problems with complying with the provisions of IFRS 3 on research and development assets, which are the same as those in the revised standards.

BC154 In developing the 2005 Exposure Draft, the FASB also considered whether it could make further improvements by extending the recognition provisions of SFAS 141(R) for research and development assets to purchases of in-process research and development assets outside a business combination. At that time, the FASB decided not to do so because the additional time needed to deliberate the related issues would have unduly delayed the revised standards.

BC155 Some respondents to the 2005 Exposure Draft objected to the resulting inconsistent US GAAP requirements for research and development assets acquired in a business combination and those acquired in another type of transaction. The FASB agreed with respondents that inconsistent accounting for research and development assets depending on how they are acquired is undesirable. Therefore, the FASB expects to reconsider the accounting for research and development assets acquired by means other than in a business combination separately from its project on business combinations.

[*] ~~now paragraph 4.41 of the *Conceptual Framework*~~

acquirer's asset is the transaction in which it obtained the controlling interest in the acquiree.

Asset definition in the IASB's Framework

BC322 Paragraph 53 of the IASB's *Framework*[‡] explains that 'The future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity.'

BC323 The IASB concluded that core goodwill represents resources from which future economic benefits are expected to flow to the entity. In considering whether core goodwill represents a resource **controlled** by the entity, the IASB considered the assertion that core goodwill arises, at least in part, through factors such as a well-trained workforce, loyal customers and so on, and that these factors cannot be regarded as controlled by the entity because the workforce could leave and the customers could go elsewhere. However, the IASB, like the FASB, concluded that control of core goodwill is provided by means of the acquirer's power to direct the policies and management of the acquiree. Therefore, both the IASB and the FASB concluded that core goodwill meets the conceptual definition of an asset.

Relevance of information about goodwill

BC324 In developing SFAS 141, the FASB also considered the relevance of information about goodwill. Although the IASB's Basis for Conclusions on IFRS 3 did not explicitly discuss the relevance of information about goodwill, the FASB's analysis of that issue was available to the IASB members as they developed IFRS 3, and they saw no reason not to accept that analysis.

BC325 More specifically, in developing SFAS 141, the FASB considered the views of users as reported by the AICPA Special Committee[*] and as expressed by the Financial Accounting Policy Committee (FAPC) of the Association for Investment Management and Research (AIMR) in its 1993 position paper *Financial Reporting in the 1990s and Beyond*. The FASB observed that users have mixed views about whether goodwill should be recognised as an asset. Some are troubled by the lack of comparability between internally generated goodwill and acquired goodwill that results under present standards, but others do not appear to be particularly bothered by it. However, users appear to be reluctant to give up information about goodwill acquired in a business combination. In the view of the AICPA Special Committee, users want to retain the option of being able to use that information. Similarly, the FAPC said that goodwill should be recognised in financial statements.

BC326 The FASB also considered the growing use of 'economic value added' (EVA)[†] and similar measures, which are increasingly being employed as means of assessing performance. The FASB observed that such measures commonly incorporate goodwill, and in business combinations accounted for by the pooling method, an adjustment was commonly made to incorporate a measure of the goodwill that was not recognised under that method. As a result, the aggregate amount of goodwill is included in the base that is subject to a capital charge that is part of the EVA measure and management is held accountable for the total investment in the acquiree.

[‡] ~~now paragraph 4.8 of the *Conceptual Framework*~~

[*] AICPA Special Committee on Financial Reporting, *Improving Business Reporting–A Customer Focus* (New York: AICPA, 1994).

[†] EVA was developed by the consulting firm of Stern Stewart & Company (and is a registered trademark of Stern Stewart) as a financial performance measure that improves management's ability to make decisions that enhance shareholder value.

Appendix ~~C~~B

Reference to the Conceptual Framework (Amendments to the Basis for Conclusions on IFRS 3 *Business Combinations*)

This appendix contains amendments to Basis for Conclusions on IFRS 3 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.

Paragraphs BC114A–BC114B are amended and paragraphs BC114C–BC114D are added. Paragraph BC125 and the heading above it are deleted. Paragraphs BC264A-BE264E and a heading above paragraph BC264A are added. A heading below paragraph BC264 and a heading above paragraph BC265 are amended. The heading above paragraph BC276 is amended and paragraphs BC276A–BC276B are added. Paragraphs BC434G–BC434H are added and a heading is added above paragraph BC434G. New text is underlined and deleted text is struck through.

Applying the acquisition method

...

Recognising and measuring the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree

Recognition

...

Conditions for recognition

...

An asset or a liability at the acquisition date

...

BC114A Paragraph 11 of IFRS 3 ~~contains references~~ referred to the definitions of an asset and a liability in the *Framework for the Preparation and Presentation of Financial Statements* (*Framework*). It ~~requires~~ required those definitions to be used when deciding whether to recognise assets and liabilities as part of a business combination. In developing the revised *Conceptual Framework for Financial Reporting*, issued in 2018 (2018 *Conceptual Framework*), the IASB considered whether it should replace ~~those references~~ that reference with ~~references~~ a reference to the revised definitions in the 2018 *Conceptual Framework*. In some cases, applying the revised definitions could change which assets and liabilities qualify for recognition in a business combination. In some such cases, the post-acquisition accounting required by other IFRS Standards could then lead to immediate derecognition of assets or liabilities recognised in a business combination, resulting in so-called *Day 2 gains or losses* that do not depict an economic gain or loss.

BC114B Although the IASB intended to replace all references to the *Framework* with references to the 2018 *Conceptual Framework*, the IASB did not intend to make significant changes to the requirements of IFRS Standards containing those references. Consequently, the IASB decided to retain the reference to the *Framework* in paragraph 11 of IFRS 3 until it ~~completes~~ had completed an analysis of the possible consequences of referring in that paragraph to the revised definitions of an asset and a liability. ~~Once that analysis is complete, the IASB intends to amend IFRS 3 to replace the reference to the *Framework* in a way that avoids unintended consequences, such as *Day 2 gains or losses*.~~

BC114C The IASB's analysis led it to conclude that the problem of *Day 2 gains or losses* would be significant in practice only for liabilities that an acquirer accounts for after the acquisition date by applying IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* or IFRIC 21 *Levies*. To avoid the problem, the IASB decided to add a further exception to the recognition principle in IFRS 3. The reasons for making this exception are explained in paragraphs BC264A–BC264E. The IASB noted that adding this exception to the recognition principle would not only avoid *Day 2 gains or losses*; it would also avoid any changes to the assets and liabilities recognised in a business combination ahead of any future amendments to align IAS 37 and IFRIC 21 with the 2018 *Conceptual Framework*.

BC114D The IASB replaced the reference to the *Framework* and added the exception to its recognition principle in May 2020. At the same time, the IASB made two other amendments to clarify aspects of IFRS 3 that it concluded would not be affected by replacing the reference to the *Framework*:

(a) the IASB added paragraph 23A to IFRS 3 to clarify the requirements for contingent assets—that is, possible assets whose existence is uncertain. IFRS 3 prohibits the recognition of contingent assets acquired in a business combination. This prohibition can be inferred from the recognition principle and is confirmed in paragraph BC276 of this Basis for Conclusions. However, the prohibition was not stated explicitly in IFRS 3 itself, and questions arose as to how it would be affected by replacing the reference to the *Framework*. The IASB concluded it would be unaffected—the 2018 *Conceptual Framework* specifies criteria for recognising assets and liabilities, and paragraph 5.14 says that these criteria might not be met if it is uncertain whether an asset exists. The IASB added paragraph 23A to IFRS 3 to make its requirements for contingent assets explicit and clarify that replacing the reference to the *Framework* does not change them.

(b) the IASB deleted paragraph BC125 from this Basis for Conclusions. In applying any IFRS Standard, an entity should apply only the recognition criteria specified in that Standard. However, paragraph BC125 referred to the *Framework* in a way that could be read to mean that, in applying IFRS 3, an acquirer of a business should apply both the recognition criteria specified in IFRS 3 and other recognition criteria discussed in the *Framework*. The IASB deleted paragraph BC125 because of its potential to cause misunderstanding. The IASB does not usually amend the basis for its previous conclusions, but decided that, in this instance, the importance of reducing the risk of misunderstanding warranted the deletion.

...

~~**IFRS 3's criterion on reliability of measurement**~~

BC125 [Deleted]*

* See paragraph BC114D(b).

...

Exceptions to the recognition or measurement principle

...

~~Exception~~ Exceptions to the recognition principle

Liabilities and contingent liabilities within the scope of IAS 37 or IFRIC 21 (paragraphs 21A–21C)

BC264A Paragraph 11 of IFRS 3 specifies that, to qualify for recognition at the acquisition date, the identifiable assets acquired and liabilities assumed must meet the definitions of assets and liabilities in the 2018 *Conceptual Framework*. Paragraph 54 of IFRS 3 specifies that after the acquisition date, an entity generally accounts for those assets and liabilities in accordance with other applicable IFRS Standards for those items.

BC264B As a result of applying the definition of a liability in the 2018 *Conceptual Framework*, an acquirer might recognise at the acquisition date a liability to pay a levy that it would not recognise subsequently when applying IFRIC 21 *Levies*. This difference arises because an entity might recognise a liability earlier applying the 2018 *Conceptual Framework*. Applying IFRIC 21, an entity recognises a liability to pay a levy only when it conducts the activity that triggers the payment of the levy, whereas applying the 2018 *Conceptual Framework*, an entity recognises a liability when it conducts an earlier activity if:

(a) conducting that earlier activity means the entity may have to pay a levy it would not otherwise have had to pay; and

(b) the entity has no practical ability to avoid the later activity that will trigger payment of the levy.

BC264C If an acquirer recognised a liability to pay a levy at the acquisition date when applying the 2018 *Conceptual Framework* and derecognised the liability immediately afterwards when applying IFRIC 21, it would recognise a so-called *Day 2 gain*. This recognised gain would not depict an economic gain, so would not faithfully represent any aspect of the entity's financial performance.

BC264D The IASB noted that IFRIC 21 is an interpretation of IAS 37, and so concluded that the problem of *Day 2 gains* could arise not only for levies within the scope of IFRIC 21 but also for other obligations within the scope of IAS 37. To avoid this problem, the IASB added paragraph 21B to IFRS 3. This paragraph makes an exception from the requirements of paragraph 11 for liabilities and contingent liabilities that would be within the scope of IAS 37 or IFRIC 21 if incurred separately, rather than assumed in a business combination. The exception requires an entity to apply criteria in IAS 37 or IFRIC 21 respectively to determine whether a present obligation exists at the acquisition date. The exception refers to IFRIC 21 as well as IAS 37 because, although IFRIC 21 is an interpretation of IAS 37, it also applies to levies whose timing and amount are certain and so are outside the scope of IAS 37.

BC264E A present obligation identified applying the exception in paragraph 21B of IFRS 3 might meet the definition of a contingent liability. This will be the case if it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or if the amount of the obligation cannot be measured with sufficient reliability. The IASB added paragraph 21C to IFRS 3 to clarify that, if the present obligation identified applying paragraph 21B meets the definition of a contingent liability, paragraph 23 of IFRS 3 also applies to that contingent liability.

Assets and liabilities arising from contingencies (paragraphs 22–23A)

...

The IASB's conclusions on contingent liabilities and contingent assets

...

BC276A In May 2020 the IASB added paragraph 23A to IFRS 3 to clarify the requirements for contingent assets. This amendment is explained further in paragraph BC114D(a).

BC276B The requirements for recognising contingent liabilities and contingent assets include both applications of and exceptions to the recognition principle. The IASB located all these requirements in the section headed 'exceptions to the recognition principle' because it concluded the requirements are clearest if they are all located together.

...

Effective date and transition

...

Amendments issued in May 2020

BC434G *Reference to the Conceptual Framework*, issued in May 2020, updated paragraph 11 of IFRS 3, replacing a reference to the *Framework* with a reference to the 2018 *Conceptual Framework*. It made further amendments to avoid unintended consequences of updating the reference.

BC434H Paragraph 64Q of IFRS 3 requires an entity to apply these amendments prospectively. It also permits an entity to apply the amendments before their effective date, without disclosing that it has done so. The IASB concluded that no significant benefits would be gained from requiring either retrospective application or disclosure of early application. The IASB reached this conclusion because it did not expect the amendments to change significantly the population of assets and liabilities recognised in a business combination.

Illustrative Examples and Comparison with SFAS 141(R)

Hong Kong Financial Reporting Standard 3 (Revised)

Business Combinations

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

Contents

from paragraph

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FOOTNOTE X: ACQUISITIONS

APPENDI~~CES~~X

~~**A**~~ **Amendments to guidance on other IFRSs**

~~**B Definition of a Business (Amendments to the Illustrative Examples accompanying IFRS 3 *Business Combinations*)**~~

COMPARISON OF IFRS 3 (AS REVISED IN 2008) AND SFAS 141(R)

TABLE OF CONCORDANCE

B67(a) The fair value of the acquired identifiable intangible assets of CU3,300 is provisional pending receipt of the final valuations for those assets.

B64(j) B67(c) IAS 37.84, 85 A contingent liability of CU1,000 has been recognised for expected warranty claims on products sold by TC during the last three years. We expect that the majority of this expenditure will be incurred in 20X3 and that all will be incurred by the end of 20X4. The potential undiscounted amount of all future payments that AC could be required to make under the warranty arrangements is estimated to be between CU500 and CU1,500. As of 31 December 20X2, there has been no change since 30 June 20X2 in the amount recognised for the liability or any change in the range of outcomes or assumptions used to develop the estimates.

B64(o) The fair value of the non-controlling interest in TC, an unlisted company, was estimated by applying a market approach and an income approach. The fair value measurements are based on significant inputs that are not observable in the market and thus represent a fair value measurement categorised within Level 3 of the fair value hierarchy as described in IFRS 13. Key assumptions include the following:

(a) a discount rate range of 20–25 per cent;

(b) a terminal value based on a range of terminal EBITDA multiples between 3 and 5 times (or, if appropriate, based on long–term sustainable growth rates ranging from 3 to 6 per cent);

(c) financial multiples of companies deemed to be similar to TC; and

(d) adjustments because of the lack of control or lack of marketability that market participants would consider when measuring the fair value of the non-controlling interest in TC.

B64(p)(ii) AC recognised a gain of CU500 as a result of measuring at fair value its 15 per cent equity interest in TC held before the business combination. The gain is included in other income in AC's statement of comprehensive income for the year ending 31 December 20X2.

B64(q)(i) The revenue included in the consolidated statement of comprehensive income since 30 June 20X2 contributed by TC was CU4,090. TC also contributed profit of CU1,710 over the same period.

B64(q)(ii) Had TC been consolidated from 1 January 20X2 the consolidated statement of comprehensive income would have included revenue of CU27,670 and profit of CU12,870.

Definition of a business

IE73 The examples in paragraphs IE74–IE123 illustrate application of the guidance in paragraphs B7–B12D on the definition of a business.

Example A—acquisition of real estate

Scenario 1—Background

IE74 An entity (Purchaser) purchases a portfolio of 10 single-family homes that each have an in-place lease. The fair value of the consideration paid is equal to the aggregate fair value of the 10 single-family homes acquired. Each single-family home includes the land, building and property improvements. Each home has a different floor area and interior design. The 10 single-family homes are located in the same area and the classes of customers (eg tenants) are similar. The risks associated with operating in the real estate market of the homes acquired are not significantly different. No employees, other assets, processes or other activities are transferred.

Scenario 1—Application of requirements

IE75 Purchaser elects to apply the optional concentration test set out in paragraph B7B and concludes that:

(a) each single-family home is considered a single identifiable asset in accordance with paragraph B7B for the following reasons:

(i) the building and property improvements are attached to the land and cannot be removed without incurring significant cost; and

(ii) the building and the in-place lease are considered a single identifiable asset, because they would be recognised and measured as a single identifiable asset in a business combination (see paragraph B42).

(b) the group of 10 single-family homes is a group of similar identifiable assets because the assets (all single-family homes) are similar in nature and the risks associated with managing and creating outputs are not significantly different. This is because the types of homes and classes of customers are not significantly different.

(c) consequently, substantially all of the fair value of the gross assets acquired is concentrated in a group of similar identifiable assets.

IE76 Therefore, Purchaser concludes that the acquired set of activities and assets is not a business.

Scenario 2—Background

IE77 Assume the same facts as in Scenario 1 except that Purchaser also purchases a multi-tenant corporate office park with six 10-storey office buildings that are fully leased. The additional set of activities and assets acquired includes the land, buildings, leases and contracts for outsourced cleaning, security and maintenance. No employees, other assets, other processes or other activities are transferred. The aggregate fair value associated with the office park is similar to the aggregate fair value associated with the 10 single-family homes. The processes performed through the contracts for outsourced cleaning and security are ancillary or minor within the context of all the processes required to create outputs.

Scenario 2—Application of requirements

IE78 Purchaser elects to apply the optional concentration test set out in paragraph B7B and concludes that the single-family homes and the office park are not similar identifiable assets, because the single-family homes and the office park differ significantly in the risks associated with operating the assets, obtaining tenants and managing tenants. In particular, the scale of operations and risks associated with the two classes of customers are significantly different. Consequently, the fair value of the gross assets acquired is not substantially all concentrated in a group of similar identifiable assets, because the fair value of the office park is similar to the aggregate fair value of the 10 single-family homes. Thus Purchaser assesses whether the set meets the minimum requirements to be considered a business in accordance with paragraphs B8–B12D.

IE79 The set of activities and assets has outputs because it generates revenue through the in-place leases. Consequently, Purchaser applies the criteria in paragraph B12C to determine whether any processes acquired are substantive.

IE80 Purchaser concludes that the criterion in paragraph B12C(a) is not met because:

(a) the set does not include an organised workforce; and

(b) Purchaser considers that the processes performed by the outsourced cleaning, security and maintenance personnel (the only processes acquired) are ancillary or minor within the context of all the processes required to create outputs (see paragraph B12D(c)) and, therefore, are not critical to the ability to continue producing outputs.

IE81 After considering the only processes acquired, those performed by the outsourced cleaning, security and maintenance personnel, Purchaser also concludes that the criteria in paragraph B12C(b) are not met. Either of the following reasons justifies that conclusion:

(a) the processes do not significantly contribute to the ability to continue producing outputs.

(b) the processes are readily accessible in the marketplace. Thus, they are not unique or scarce. In addition, they could be replaced without significant cost, effort, or delay in the ability to continue producing outputs.

IE82 Because none of the criteria in paragraph B12C is met, Purchaser concludes that the acquired set of activities and assets is not a business.

Scenario 3—Background

IE83 Assume the same facts as in Scenario 2, except that the acquired set of activities and assets also includes the employees responsible for leasing, tenant management, and managing and supervising all operational processes.

Scenario 3—Application of requirements

IE84 Purchaser elects not to apply the optional concentration test set out in paragraph B7B and therefore assesses whether the set meets the minimum requirements to be considered a business in accordance with paragraphs B8–B12D.

IE85 The acquired set of activities and assets has outputs because it generates revenue through the in-place leases. Consequently, Purchaser applies the criteria in paragraph B12C.

IE86 Purchaser concludes that the criterion in paragraph B12C(a) is met because the set includes an organised workforce with the necessary skills, knowledge or experience to perform processes (ie leasing, tenant management, and managing and supervising the operational processes) that are substantive because they are critical to the ability to continue producing outputs when applied to the acquired inputs (ie the land, buildings and in-place leases). Furthermore, Purchaser concludes that the criterion in paragraph B8 is met because those substantive processes and inputs together significantly contribute to the ability to create output. Consequently, Purchaser concludes that the acquired set of activities and assets is a business.

Example B—acquisition of a drug candidate

Scenario 1—Background

IE87 An entity (Purchaser) purchases a legal entity that contains:

(a) the rights to an in-process research and development project that is developing a compound to treat diabetes and is in its final testing phase (Project 1). Project 1 includes the historical know-how, formula protocols, designs and procedures expected to be needed to complete the final testing phase.

(b) a contract that provides outsourced clinical trials. The contract is priced at current market rates and a number of vendors in the marketplace could provide the same services. Therefore, the fair value associated with this contract is nil. Purchaser has no option to renew the contract.

No employees, other assets, other processes or other activities are transferred.

Scenario 1—Application of requirements

IE88 Purchaser elects to apply the optional concentration test set out in paragraph B7B and concludes that:

(a) Project 1 is a single identifiable asset because it would be recognised and measured as a single identifiable intangible asset in a business combination.

(b) because the acquired contract has a fair value of nil, substantially all of the fair value of the gross assets acquired is concentrated in Project 1.

IE89 Consequently, Purchaser concludes that the acquired set of activities and assets is not a business.

Scenario 2—Background

IE90 Assume the same facts as in Scenario 1 except that the acquired set of activities and assets also includes another in-process research and development project that is developing a compound to treat Alzheimer's disease and is in its final testing phase (Project 2). Project 2 includes the historical know-how, formula protocols, designs, and procedures expected to be needed to complete the final phase of testing. The fair value associated with Project 2 is similar to the fair value associated with Project 1. No employees, other assets, processes or other activities are transferred.

Scenario 2—Application of requirements

IE91 Purchaser elects to apply the optional concentration test set out in paragraph B7B and concludes that:

(a) Project 1 and Project 2 are identifiable intangible assets that would each be recognised and measured as a separate identifiable asset in a business combination.

(b) Project 1 and Project 2 are not similar identifiable assets because significantly different risks are associated with managing and creating outputs from each asset. Each project has significantly different risks associated with developing, completing and marketing the compound to customers. The compounds are intended to treat significantly different medical conditions, and each project has a significantly different potential customer base.

(c) consequently, the fair value of the gross assets acquired is not substantially all concentrated in a single identifiable asset or group of similar identifiable assets. Therefore, Purchaser assesses whether the set meets the minimum requirements to be considered a business in accordance with paragraphs B8–B12D.

IE92 The acquired set of activities and assets does not have outputs because it has not started generating revenue. Thus, Purchaser applies the criteria in paragraph B12B. Purchaser concludes that those criteria are not met for the following reasons:

(a) the set does not include an organised workforce; and

(b) although the contract that provides outsourced clinical trials might give access to an organised workforce that has the necessary skills, knowledge or experience to perform processes needed to carry out the clinical trials, that organised workforce cannot develop or convert the inputs acquired by Purchaser into outputs. Successful clinical trials are a pre-condition for producing output, but carrying out those trials will not develop or convert the acquired inputs into outputs.

Consequently, Purchaser concludes that the acquired set of activities and assets is not a business.

Example C—acquisition of a biotech entity

Background

IE93 An entity (Purchaser) purchases a legal entity (Entity Biotech). Entity Biotech's operations include: research and development activities on several drug compounds that it is developing (in-process research and development projects); senior management and scientists who have the necessary skills, knowledge, or experience to perform research and development activities; and tangible assets (including a corporate headquarters, a research lab, and lab equipment). Entity Biotech does not yet have a marketable product and has not yet generated revenue. Each of the assets acquired has a similar fair value.

Application of requirements

IE94 It is evident that the fair value of the gross assets acquired is not substantially all concentrated in a single identifiable asset or group of similar identifiable assets. Thus, the optional concentration test set out in paragraph B7B would not be met. Consequently, Purchaser assesses whether the set meets the minimum requirements to be considered a business in accordance with paragraphs B8–B12D.

IE95 Purchaser first assesses whether it has acquired any processes. No process is documented. Nevertheless, the acquired organised workforce has proprietary knowledge of Biotech's ongoing projects and experience with them. Applying paragraph B7(b), Purchaser concludes that the intellectual capacity of the acquired organised workforce having the necessary skills and experience following rules and conventions provides the necessary processes that are capable of being applied to inputs to create outputs.

IE96 Purchaser next assesses whether the acquired processes are substantive. The set of activities and assets does not have outputs. Thus, Purchaser applies the criteria in paragraph B12B. Purchaser concludes that those criteria are met because:

(a) the acquired processes are critical to the ability to develop or convert the acquired inputs into outputs; and

(b) the inputs acquired include both:

(i) an organised workforce that has the necessary skills, knowledge, or experience to perform the acquired processes; and

(ii) other inputs that the organised workforce could develop or convert into outputs. Those inputs include the in-process research and development projects.

IE97 Finally, applying the criteria in paragraph B8, Purchaser concludes that the acquired substantive processes and the acquired inputs together significantly contribute to the ability to create output. Consequently, Purchaser concludes that the acquired set of activities and assets is a business.

Example D—acquisition of a television station

Background

IE98 An entity (Purchaser) purchases broadcasting assets from another entity (Seller). The acquired set of activities and assets includes only the communications licence, the broadcasting equipment and an office building. Each of the assets acquired has a similar fair value. Purchaser does not purchase the processes needed to broadcast programmes and it does not acquire any employees, other assets, other processes or other activities. Before the acquisition date, Seller stopped broadcasting using the set of activities and assets acquired by Purchaser.

Application of requirements

IE99 Purchaser elects to apply the optional concentration test set out in paragraph B7B and concludes that:

(a) the broadcasting equipment and building are not a single identifiable asset because the equipment is not attached to the building and can be removed without significant cost or diminution in utility or fair value of either asset.

(b) the licence is an intangible asset, whereas the broadcasting equipment and building are tangible assets in different classes. Consequently, in accordance with paragraph B7B(f), the assets are not considered similar to each other.

(c) each of the single identifiable assets has similar fair value. Thus, the fair value of the gross assets acquired is not substantially all concentrated in a single identifiable asset or group of similar identifiable assets.

Consequently, Purchaser assesses whether the set of activities and assets meets the minimum requirements to be considered a business in accordance with paragraphs B8–B12D.

IE100 The set of activities and assets does not have outputs, because Seller has stopped broadcasting. Thus, Purchaser applies the criteria in paragraph B12B. The set does not include an organised workforce, so it does not meet those criteria. Consequently, Purchaser concludes that the acquired set of activities and assets is not a business.

Example E—acquisition of a closed manufacturing facility

Background

IE101 An entity (Purchaser) purchases a closed manufacturing facility—the land and the building—as well as the related equipment. The fair value of the equipment and the fair value of the facility are similar. To comply with local laws, Purchaser must take over the employees who worked in the facility. No other assets, processes or other activities are transferred. The acquired set of activities and assets stopped producing outputs before the acquisition date.

Application of requirements

IE102 Purchaser elects to apply the optional concentration test set out in paragraph B7B and concludes that:

(a) the equipment and the facility are not a single identifiable asset because the equipment could be removed from the facility without significant cost or diminution in utility or fair value of either the equipment or the facility—the equipment is not attached to the facility and can be used in many other types of manufacturing facilities.

(b) the equipment and facility are not similar identifiable assets because they are in different classes of tangible assets.

(c) the fair values of the equipment and the facility are similar. Therefore, the fair value of the gross assets acquired is not substantially all concentrated in a single identifiable asset or group of similar identifiable assets.

Consequently, Purchaser assesses whether the set of activities and assets meets the minimum requirements to be considered a business in accordance with paragraphs B8–B12D.

IE103 The acquired set of activities and assets does not have outputs at the acquisition date because it stopped producing outputs before then. Consequently, Purchaser applies the criteria in paragraph B12B. The set includes an organised workforce that has the necessary skills, knowledge or experience to use the equipment, but it does not include another acquired input (such as intellectual property or inventories) that the organised workforce could develop or convert into outputs. The facility and the equipment cannot be developed or converted into outputs. Consequently, Purchaser concludes that the acquired set of activities and assets is not a business.

Example F—licence of distribution rights

Background

IE104 An entity (Purchaser) purchases from another entity (Seller) the exclusive sublicence to distribute Product X in a specified jurisdiction. Seller has the licence to distribute Product X worldwide. As part of this transaction, Purchaser also purchases the existing customer contracts in the jurisdiction and takes over a supply contract to purchase Product X from the producer at market rates. None of the identifiable assets acquired has a fair value that constitutes substantially all of the fair value of the gross assets acquired. No employees, other assets, processes, distribution capabilities or other activities are transferred.

Application of requirements

IE105 Purchaser elects to apply the optional concentration test set out in paragraph B7B and concludes that:

(a) the identifiable assets that could be recognised in a business combination include the sublicence to distribute Product X, customer contracts and the supply contract;

(b) the sublicence and customer contracts are in different classes of intangible assets, so they are not similar identifiable assets; and

(c) consequently, the fair value of the gross assets acquired is not substantially all concentrated in a single identifiable asset or group of similar identifiable assets.

Consequently, Purchaser assesses whether the set of activities and assets meets the minimum requirements to be considered a business in accordance with paragraphs B8–B12D.

IE106 The set of activities and assets has outputs because at the acquisition date the licence was generating revenue from customers in the jurisdiction specified in the sublicence. Consequently, Purchaser applies the criteria in paragraph B12C. As explained in paragraph B12D(a), acquired contracts are an input and not a substantive process. Purchaser considers next whether the acquired supply contract provides access to an organised workforce that performs a substantive process. Because the supply contract is not providing a service that applies a process to another acquired input, Purchaser concludes that the substance of the supply contract is only that of buying Product X, without acquiring the organised workforce, processes and other inputs needed to produce Product X. Furthermore, the acquired sublicence is an input, not a process. Purchaser concludes that the set is not a business because it does not include an organised workforce and Purchaser has acquired no substantive process that could meet the criteria in paragraph B12C.

Example G—acquisition of brands

Background

IE107 Assume the same facts as in Example F, except that Purchaser purchases the worldwide rights to Product X, including all related intellectual property. The acquired set of activities and assets includes all customer contracts and customer relationships, finished goods inventories, marketing materials, customer incentive programmes, raw material supply contracts, specialised equipment specific to manufacturing Product X and documented manufacturing processes and protocols to produce Product X. No employees, other assets, other processes or other activities are transferred. None of the identifiable assets acquired has a fair value that constitutes substantially all of the fair value of the gross assets acquired.

Application of requirements

IE108 As noted in paragraphs IE105 and IE107, the fair value of the gross assets acquired is not substantially all concentrated in a single identifiable asset or group of similar identifiable assets. Thus, the optional concentration test set out in paragraph B7B would not be met. Consequently, Purchaser assesses whether the set of activities and assets meets the minimum requirements to be considered a business in accordance with paragraphs B8–B12D.

IE109 The set of activities and assets has outputs, so Purchaser applies the criteria in paragraph B12C. The set does not include an organised workforce and, therefore, does not meet the criterion in paragraph B12C(a). However, Purchaser concludes that the acquired manufacturing processes are substantive because, when applied to acquired inputs, such as the intellectual property, raw material supply contracts and specialised equipment, those processes significantly contribute to the ability to continue producing outputs and because they are unique to Product X. Consequently, the criterion in paragraph B12C(b) is met. Furthermore, Purchaser concludes that the criterion in paragraph B8 is met because those substantive processes and inputs together significantly contribute to the ability to create output. As a result, Purchaser concludes that the acquired set of activities and assets is a business.

Example H—acquisition of loan portfolio

Scenario 1—Background

IE110 An entity (Purchaser) purchases a loan portfolio from another entity (Seller). The portfolio consists of residential mortgage loans with terms, sizes and risk ratings that are not significantly different. No employees, other assets, processes or other activities are transferred.

Scenario 1—Application of requirements

IE111 Purchaser elects to apply the optional concentration test set out in paragraph B7B and concludes that:

(a) the assets (residential mortgage loans) are similar in nature;

(b) the risks associated with managing and creating outputs are not significantly different because the terms, sizes and risk ratings of the loans are not significantly different;

(c) the acquired loans are similar assets; and

(d) consequently, substantially all of the fair value of the gross assets acquired is concentrated in a group of similar identifiable assets.

Consequently, Purchaser concludes that the acquired set of activities and assets is not a business.

Scenario 2—Background

IE112 Assume the same facts as in Scenario 1 except that the portfolio of loans consists of commercial loans with terms, sizes and risk ratings that are significantly different. None of the acquired loans, and no group of loans with similar terms, sizes and risk ratings, has a fair value that constitutes substantially all of the fair value of the acquired portfolio. No employees, other assets, processes or other activities are transferred.

Scenario 2—Application of requirements

IE113 Purchaser elects to apply the optional concentration test set out in paragraph B7B and concludes that:

(a) the assets (commercial loans) are similar in nature;

(b) the risks associated with managing and creating outputs from the loans are significantly different because the terms, sizes and risk ratings of the loans are significantly different;

(c) the acquired loans are not similar identifiable assets; and

(d) consequently, the fair value of the gross assets acquired is not substantially all concentrated in a group of similar identifiable assets.

Consequently, Purchaser assesses whether the set meets the minimum requirements to be considered a business in accordance with paragraphs B8–B12D.

IE114 The portfolio of loans has outputs because it generates interest income. Consequently, Purchaser applies the criteria in paragraph B12C. Acquired contracts are not a substantive process, as explained in paragraph B12D(a). Moreover, the acquired set of activities and assets does not include an organised workforce and there are no acquired processes that could meet the criteria in paragraph B12C(b). Consequently, Purchaser concludes that the acquired set of activities and assets is not a business.

Scenario 3—Background

IE115 Assume the same facts as in Scenario 2 but Purchaser also takes over the employees of Seller (such as brokers, vendors, and risk managers) who managed the credit risk of the portfolio and the relationship with the borrowers. The consideration transferred to Seller is significantly higher than the fair value of the acquired portfolio of loans.

Scenario 3—Application of requirements

IE116 As noted in paragraph IE113, the fair value of the gross assets acquired is not substantially all concentrated in a group of similar identifiable assets. Thus, the optional concentration test set out in paragraph B7B would not be met. Consequently, Purchaser assesses whether the set meets the minimum requirements to be considered a business in accordance with paragraphs B8–B12D.

IE117 The portfolio of loans has outputs because it generates interest income. Consequently, Purchaser applies the criteria in paragraph B12C and concludes that the criterion in paragraph B12C(a) is met because the set includes an organised workforce with the necessary skills, knowledge or experience to perform processes (customer relationship management and credit risk management) critical to the ability to continue producing outputs. Furthermore, Purchaser concludes that the criterion in paragraph B8 is met because those substantive processes and the acquired inputs (the portfolio of loans) together significantly contribute to the ability to create output. Consequently, Purchaser concludes that the acquired set is a business.

Example I—determining the fair value of the gross assets acquired

Background

IE118 An entity (Purchaser) holds a 20% interest in another entity (Entity A). At a subsequent date (the acquisition date), Purchaser acquires a further 50% interest in Entity A and obtains control of it. Entity A's assets and liabilities on the acquisition date are the following:

(a) a building with a fair value of CU500;

(b) an identifiable intangible asset with a fair value of CU400;

(c) cash and cash equivalents with a fair value of CU100;

(d) financial liabilities with a fair value of CU700; and

(e) deferred tax liabilities of CU160 arising from temporary differences associated with the building and the intangible asset.

IE119 Purchaser pays CU200 for the additional 50% interest in Entity A. Purchaser determines that at the acquisition date the fair value of Entity A is CU400, that the fair value of the non-controlling interest in Entity A is CU120 (30% x CU400) and that the fair value of the previously held interest is CU80 (20% x CU400).

Application of requirements

IE120 To perform the optional concentration test set out in paragraph B7B, Purchaser needs to determine the fair value of the gross assets acquired. Applying paragraph B7B, Purchaser determines that the fair value of the gross assets acquired is CU1,000, calculated as follows:

(a) the fair value of the building (CU500); plus

(b) the fair value of the identifiable intangible asset (CU400); plus

(c) the excess (CU100) of:

(i) the sum (CU400) of the consideration transferred (CU200), plus the fair value of the non-controlling interest (CU120), plus the fair value of the previously held interest (CU80); over

(ii) the fair value of the net identifiable assets acquired (CU300 = CU500 + CU400 + CU100 – CU700).

IE121 The excess referred to in paragraph IE120(c) is determined in a manner similar to the initial measurement of goodwill in accordance with paragraph 32 of IFRS 3. Including this amount in determining the fair value of the gross assets acquired means that the concentration test is based on an amount that is affected by the value of any substantive processes acquired.

IE122 The fair value of gross assets acquired is determined after making the following exclusions specified in paragraph B7B(a) of IFRS 3 for items that are independent of whether any substantive process was acquired:

(a) the fair value of the gross assets acquired does not include the fair value of the cash and cash equivalents acquired (CU100) and does not include deferred tax assets (nil in this example); and

(b) for the calculation specified in paragraph IE120(c)(ii), the deferred tax liability is not deducted in determining the fair value of the net assets acquired (CU300) and does not need to be determined. As a result, the excess (CU100) calculated by applying paragraph IE120(c) does not include goodwill resulting from the effects of deferred tax liabilities.

IE123 The fair value of the gross assets acquired (CU1,000) may also be determined as follows:

(a) the total (CU1,100) obtained by adding:

(i) the amount paid (CU200) (plus the fair value of the non-controlling interest (CU120) plus the fair value of the previously held interest (CU80)); to

(ii) the fair value of the liabilities assumed (other than deferred tax liabilities) (CU700); less

(b) the cash and cash equivalents acquired (CU100); less

(c) deferred tax assets acquired (nil in this example). In practice, it would be necessary to determine the amount of deferred tax assets to be excluded only if including the deferred tax assets could lead to the concentration test not being met.

Appendix ~~A~~
Amendments to guidance on other IFRSs

The following amendments to guidance on other IFRSs are necessary in order to ensure consistency with IFRS 3 (as revised in 2008) and the related amendments to other IFRSs. In the amended paragraphs, new text is underlined and deleted text is struck through.

* * *

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

HKFRS 4 BC
Revised ~~July 2019~~August 2020

Basis for Conclusions on
Hong Kong Financial Reporting Standards 4

Insurance Contracts

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(ii) those rights will lapse if the policyholders stop paying premiums.

(e) Acquisition costs should be recognised as an expense when incurred.

(f) The Board will consider two more questions later in phase II:

(i) Should the measurement model unbundle the individual elements of an insurance contract and measure them individually?

(ii) How should an insurer measure its liability to holders of participating contracts?

BC7 In two areas, those tentative conclusions differ from the IASC Steering Committee's recommendations in the DSOP:

(a) the use of a fair value measurement objective rather than entity-specific value. However, that change is not as significant as it might seem because entity-specific value as described in the DSOP is indistinguishable in most respects from estimates of fair value determined using measurement guidance that the Board has tentatively adopted in phase II of its project on business combinations.[*]

(b) the criteria used to determine whether measurement should reflect future premiums and related cash flows (paragraph BC6(d)).

BC8 Since January 2003, constraints on Board and staff resources have prevented the Board from continuing work to determine whether its tentative conclusions for phase II can be developed into a standard that is consistent with the IASB *Framework*[1] and workable in practice. The Board intends to return to phase II of the project in the second quarter of 2004. It plans to focus at that time on both conceptual and practical issues, as in any project. Only after completing its deliberations will the Board proceed with an Exposure Draft of a proposed IFRS. The Board's deliberations in all projects include a consideration of alternatives and whether those alternatives represent conceptually superior approaches to financial reporting issues. Consequently, the Board will examine existing practices throughout the world to ascertain whether any could be deemed to be a superior answer suitable for international adoption.

BC9 As discussed in paragraph BC84, ED 5 proposed a 'sunset clause', which the Board deleted in finalising the IFRS. Although respondents generally opposed the sunset clause, many applauded the Board's signal of its commitment to complete phase II without delay.

Scope

BC10 Some argued that the IFRS should deal with all aspects of financial reporting by insurers, to ensure that the financial reporting for insurers is internally consistent. They noted that regulatory requirements, and some national accounting requirements, often cover all aspects of an insurer's business. However, for the following reasons,

[*] The Board completed the second phase of its project on business combinations in 2008 by issuing a revised IFRS 3 *Business Combinations* and an amended version of IAS 27 *Consolidated and Separate Financial Statements*. The consolidation requirements in IAS 27 were superseded by IFRS 10 *Consolidated Financial Statements* issued in May 2011. IFRS 13, issued in May 2011, defines fair value and contains the requirements for measuring fair value.

[1] References to the *Framework* in this Basis for Conclusions are to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by ~~IASB~~ the Board in 2001 and in effect when the Standard was developed. ~~In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting.*~~

Dissenting opinions on IFRS 4

DO1 Professor Barth and Messrs Garnett, Gélard, Leisenring, Smith and Yamada dissent from the issue of IFRS 4.

Dissent of Mary E Barth, Robert P Garnett, Gilbert Gélard, James J Leisenring and John T Smith

DO2 Messrs Garnett and Gélard dissent for the reasons given in paragraphs DO3 and DO4 and Mr Garnett also dissents for the reasons given in paragraphs DO5 and DO6. Professor Barth and Messrs Leisenring and Smith dissent for the reasons given in paragraphs DO3-DO8 and Mr Smith also dissents for the reasons given in paragraphs DO9-DO13.

Temporary exemption from paragraphs 10-12 of IAS 8

DO3 Professor Barth and Messrs Garnett, Gélard, Leisenring and Smith dissent because IFRS 4 exempts an entity from applying paragraphs 10-12 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* when accounting for insurance and reinsurance contracts. They believe that all entities should be required to apply these paragraphs. These Board members believe that the requirements in IAS 8 have particular relevance and applicability when an IFRS lacks specificities, as does IFRS 4, which allows the continuation of a variety of measurement bases for insurance and reinsurance contracts. Because of the failure to consider the IASB *Framework*,* continuation of such practices may result in the inappropriate recognition of, or inappropriate failure to recognise, assets, liabilities, equity, income and expense. In these Board members' view, if an entity cannot meet the basic requirements of paragraphs 10-12 of IAS 8, it should not be allowed to describe its financial statements as being in accordance with International Financial Reporting Standards.

DO4 These Board members' concerns are heightened by the delay in completing phase II of the Board's project on accounting for insurance contracts. Although phase II is on the Board's active agenda, it is unlikely that the Board will be able to develop an IFRS on insurance contracts in the near term. Accordingly, it is likely that the exemption from IAS 8 will be in place for some time.

Future investment margins and shadow accounting

DO5 Professor Barth and Messrs Garnett, Leisenring and Smith dissent for the further reason that they would not permit entities to change their accounting policies for insurance and reinsurance contracts to policies that include using future investment margins in the measurement of insurance liabilities. They agree with the view expressed in paragraph BC134 that cash flows from an asset are irrelevant for the measurement of a liability (unless those cash flows affect the cash flows arising from the liability or the credit characteristics of the liability). Therefore, they believe that changing to an accounting policy for insurance contracts that uses future investment margins to measure liabilities arising from insurance contracts reduces the relevance and reliability of an insurer's financial statements. They do not believe that other aspects of an accounting model for insurance contracts can outweigh this reduction.

* References to the *Framework* in this Dissent are to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the ~~IASB~~Board in 2001 and in effect when the Standard was developed. ~~In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.~~

HKFRS 4 Revised IG
Revised ~~July 2019~~August 2020

Revised Guidance on Implementing HKFRS 4

Insurance Contracts

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Disclosure

Purpose of this guidance

IG11 The guidance in paragraphs IG12-IG71 suggests possible ways to apply the disclosure requirements in paragraphs 36-39A of the IFRS. As explained in paragraphs 36 and 38 of the IFRS, the objective of the disclosures is:

(a) to identify and explain the amounts in an insurer's financial statements arising from insurance contracts; and

(b) to enable users of those financial statements to evaluate the nature and extent of risks arising from insurance contracts.

IG12 An insurer decides in the light of its circumstances how much detail it gives to satisfy those requirements, how much emphasis it places on different aspects of the requirements and how it aggregates information to display the overall picture without combining information that has materially different characteristics. It is necessary to strike a balance so that important information is not obscured either by the inclusion of a large amount of insignificant detail or by the aggregation of items that have materially different characteristics. For example:

(a) a large international insurance group that operates in a wide range of regulatory jurisdictions typically provides disclosures that differ in format, content and detail from those provided by a specialised niche insurer operating in one jurisdiction.

(b) many insurance contracts have similar characteristics. When no single contract is individually material, a summary by classes of contracts is appropriate.

(c) information about an individual contract may be material when it is, for example, a significant contributor to an insurer's risk profile.

To satisfy the requirements, an insurer would not typically need to disclose all the information suggested in the guidance. This guidance does not create additional requirements.

IG13 IAS 1 *Presentation of Financial Statements* requires an entity to 'provide additional disclosures when compliance with the specific requirements in IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.'

IG14 For convenience, this Implementation Guidance discusses each disclosure requirement in the IFRS separately. In practice, disclosures would normally be presented as an integrated package and individual disclosures may satisfy more than one requirement. For example, information about the assumptions that have the greatest effect on the measurement of amounts arising from insurance contracts may help to convey information about insurance risk and market risk.

Materiality

IG15 IAS 1 defines materiality and notes that a specific disclosure requirement in an IFRS need not be satisfied if the information is not material. ~~IAS 1 defines materiality as follows:~~

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

IG16 Paragraph 7 of IAS 1 also explains the following:

> Assessing whether information ~~an omission or misstatement~~ could reasonably be expected to influence ~~economic~~ decisions ~~of~~ made by the primary users of a specific reporting entity's general purpose financial statements~~, and so be material,~~ requires an entity to consider ~~consideration of~~ the characteristics of those users while also considering the entity's own circumstances. Many existing and potential investors, lenders and other creditors cannot require reporting entities to provide information directly to them and must rely on general purpose financial statements for much of the financial information they need. Consequently, they are the primary users at whom general purpose financial statements are directed. Financial statements are prepared for users who have a reasonable level of knowledge of business and economic activities and who review and analyse the information diligently. At times, even well-informed and diligent users may seek the aid of an adviser to understand information about complex economic phenomena. ~~The *Framework for the Preparation and Presentation of Financial Statements* states in paragraph 25[*] that 'users are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence.' Therefore, the assessment needs to take into account how users with such attributes could reasonably be expected to be influenced in making economic decisions.~~

Explanation of recognised amounts (paragraphs 36 and 37 of the IFRS)

Accounting policies

IG17 IAS 1 requires disclosure of accounting policies and paragraph 37(a) of the IFRS highlights this requirement. In developing disclosures about accounting policies for insurance contracts, an insurer might conclude that it needs to address the treatment of, for example, some or all of the following, if applicable:

(a) premiums (including the treatment of unearned premiums, renewals and lapses, premiums collected by agents and brokers but not yet passed on and premium taxes or other levies on premiums).

(b) fees or other charges made to policyholders.

(c) acquisition costs (including a description of their nature).

(d) claims incurred (both reported and not reported), claims handling costs (including a description of their nature) and liability adequacy tests (including a description of the cash flows included in the test, whether and how the cash flows are discounted and the treatment of embedded options and guarantees in those tests, see paragraphs 15-19 of the IFRS). An insurer might disclose whether insurance liabilities are discounted and, if they are discounted, explain the methodology used.

(e) the objective of methods used to adjust insurance liabilities for risk and uncertainty (for example, in terms of a level of assurance or level of sufficiency), the nature of those models, and the source of information used in the models.

(f) embedded options and guarantees (including a description of whether (i) the measurement of insurance liabilities reflects the intrinsic value and time value of these items and (ii) their measurement is consistent with observed current market prices).

(g) discretionary participation features (including a clear statement of how the insurer applies paragraphs 34 and 35 of the IFRS in classifying that feature as a liability or as a component of equity) and other features that permit policyholders to share in investment performance.

~~[*] IASC's *Framework for the Preparation and Presentation of Financial Statements* was adopted by the IASB in 2001. In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*. Paragraph 25 was superseded by Chapter 3 of the *Conceptual Framework*.~~

HKFRS 5

Revised ~~July 2019~~August 2020

Effective for annual periods
beginning on or after 1 January 2005

Hong Kong Financial Reporting Standard 5

Non-current Assets Held for Sale and Discontinued Operations

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disposal group	A group of assets to be disposed of, by sale or otherwise, together as a group in a single transaction, and liabilities directly associated with those assets that will be transferred in the transaction. The group includes goodwill acquired in a business combination if the group is a **cash-generating unit** to which goodwill has been allocated in accordance with the requirements of paragraphs 80-87 of HKAS 36 *Impairment of Assets* or if it is an operation within such a cash-generating unit.
fair value	*Fair value* is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See HKFRS 13.)
firm purchase commitment	An agreement with an unrelated party, binding on both parties and usually legally enforceable, that (a) specifies all significant terms, including the price and timing of the transactions, and (b) includes a disincentive for non-performance that is sufficiently large to make performance **highly probable**.
highly probable	Significantly more likely than **probable**.
non-current asset	An asset that does not meet the definition of a **current asset**.
probable	More likely than not.
recoverable amount	The higher of an asset's **fair value** less **costs ~~to sell~~ of disposal** and its **value in use**.
value in use	The present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life.

HKFRS 5 BC
Revised ~~July 2019~~August 2020

Basis for Conclusions on
Hong Kong Financial Reporting Standard 5

Non-current Assets Held for Sale and Discontinued Operations

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(b) the assets and liabilities of a disposal group classified as held for sale separately in the asset and liability sections of the balance sheet. The major classes of those assets and liabilities are separately disclosed either on the face of the balance sheet or in the notes.

BC57 In the Basis for Conclusions on SFAS 144 the FASB noted that information about the nature of both assets and liabilities of a disposal group is useful to users. Separately presenting those items in the balance sheet provides information that is relevant. Separate presentation also distinguishes those assets that are not being depreciated from those that are being depreciated. The Board agreed with the FASB's views.

BC58 Respondents to ED 4 noted that the separate presentation within equity of amounts relating to assets and disposal groups classified as held for sale (such as, for example, unrealised gains and losses on available-for-sale assets* and foreign currency translation adjustments) would also provide useful information. The Board agreed and has added such a requirement to the IFRS.

Timing of classification as, and definition of, discontinued operations

BC59 With the introduction of SFAS 144, the FASB broadened the scope of a discontinued operation from a 'segment of a business' to a 'component of an entity'. A component is widely drawn, the criterion being that it comprises 'operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity'. SFAS 144 states that a component may be a segment, a reporting unit, a subsidiary or an asset group.

BC60 However, at the same time, the FASB specified more restrictive criteria for determining *when* the component is classified as discontinued and hence when its results are presented as discontinued. SFAS 144 requires a component to be classified as discontinued only if it has been disposed of or if it meets the criteria for classification as an asset 'held for sale'.

BC61 The definition of a discontinuing operation in IAS 35 as a 'major line of business' or 'geographical area of operations' is closer to the former, and narrower, US GAAP definition. The trigger in IAS 35 for classifying the operation as discontinuing is the earlier of (a) the entity entering into a binding sale agreement and (b) the board of directors approving and announcing a formal disposal plan. Although IAS 35 refers to IAS 37 for further guidance on what constitutes a plan, the criteria are less restrictive than those in SFAS 144.

BC62 Paragraph 12 of the *Framework*# states that the objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions. Paragraph 15 of the *Framework* goes on to state that the economic decisions that are taken by users of financial statements require an evaluation of the ability of an entity to generate cash and cash equivalents. Separately highlighting the results of discontinued operations provides users with information that is relevant in assessing the ongoing ability of the entity to generate cash flows.

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* IFRS 9 *Financial Instruments* eliminated the category of available-for-sale financial assets. This paragraph refers to matters relevant when IFRS 5 was issued.

\# References to the *Framework* in this Basis for Conclusions are to the IASC's *Framework for the Preparation and Presentation of Financial Statements,* adopted by the ~~IASB~~Board in 2001 and in effect when the Standard was developed.~~ In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*. Paragraphs 12 and 15 were superseded by Chapter 1 of the *Conceptual Framework*.~~

HKFRS 6
Revised ~~February 2010~~August 2020

Effective for annual periods
beginning on or after 1 January 2006

Hong Kong Financial Reporting Standard 6

Exploration for and Evaluation of Mineral Resources

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Measurement of exploration and evaluation assets

Measurement at recognition

8 Exploration and evaluation assets shall be measured at cost.

Elements of cost of exploration and evaluation assets

9 An entity shall determine an accounting policy specifying which expenditures are recognised as exploration and evaluation assets and apply the policy consistently. In making this determination, an entity considers the degree to which the expenditure can be associated with finding specific mineral resources. The following are examples of expenditures that might be included in the initial measurement of exploration and evaluation assets (the list is not exhaustive):

(a) acquisition of rights to explore;

(b) topographical, geological, geochemical and geophysical studies;

(c) exploratory drilling;

(d) trenching;

(e) sampling; and

(f) activities in relation to evaluating the technical feasibility and commercial viability of extracting a mineral resource.

10 Expenditures related to the development of mineral resources shall not be recognised as exploration and evaluation assets. The ~~*Framework*~~ *Conceptual Framework for Financial Reporting* and HKAS 38 *Intangible Assets* provide guidance on the recognition of assets arising from development.

11 In accordance with HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets* an entity recognises any obligations for removal and restoration that are incurred during a particular period as a consequence of having undertaken the exploration for and evaluation of mineral resources.

Measurement after recognition

12 After recognition, an entity shall apply either the cost model or the revaluation model to the exploration and evaluation assets. If the revaluation model is applied (either the model in HKAS 16 *Property, Plant and Equipment* or the model in HKAS 38) it shall be consistent with the classification of the assets (see paragraph 15).

Changes in accounting policies

13 An entity may change its accounting policies for exploration and evaluation expenditures if the change makes the financial statements more relevant to the economic decision-making needs of users and no less reliable, or more reliable and no less relevant to those needs. An entity shall judge relevance and reliability using the criteria in HKAS 8.

14 To justify changing its accounting policies for exploration and evaluation expenditures, an entity shall demonstrate that the change brings its financial statements closer to meeting the criteria in HKAS 8, but the change need not achieve full compliance with those criteria.

Specifying the level at which exploration and evaluation assets are assessed for impairment

21 An entity shall determine an accounting policy for allocating exploration and evaluation assets to cash-generating units or groups of cash-generating units for the purpose of assessing such assets for impairment. Each cash-generating unit or group of units to which an exploration and evaluation asset is allocated shall not be larger than an operating segment determined in accordance with HKFRS 8 *Operating Segments*.

22 The level identified by the entity for the purposes of testing exploration and evaluation assets for impairment may comprise one or more cash-generating units.

Disclosure

23 An entity shall disclose information that identifies and explains the amounts recognised in its financial statements arising from the exploration for and evaluation of mineral resources.

24 To comply with paragraph 23, an entity shall disclose:

(a) its accounting policies for exploration and evaluation expenditures including the recognition of exploration and evaluation assets.

(b) the amounts of assets, liabilities, income and expense and operating and investing cash flows arising from the exploration for and evaluation of mineral resources.

25 An entity shall treat exploration and evaluation assets as a separate class of assets and make the disclosures required by either HKAS 16 or HKAS 38 consistent with how the assets are classified.

Effective date

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

26A *Amendments to References to the Conceptual Framework in HKFRS Standards*, issued in 2018, amended paragraph 10. An entity shall apply that amendment for annual periods beginning on or after 1 January 2020. Earlier application is permitted if at the same time an entity also applies all other amendments made by *Amendments to References to the Conceptual Framework in HKFRS Standards*. An entity shall apply the amendment to HKFRS 6 retrospectively in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. However, if an entity determines that retrospective application would be impracticable or would involve undue cost or effort, it shall apply the amendment to HKFRS 6 by reference to paragraphs 23–28, 50–53 and 54F of HKAS 8.

Transitional provisions

27 If it is impracticable to apply a particular requirement of paragraph 18 to comparative information that relates to annual periods beginning before 1 January 2006, an entity shall disclose that fact. HKAS 8 explains the term ‘impracticable’.

Basis for Conclusions on IFRS 6 *Exploration for and Evaluation of Mineral Resources*

This Basis for Conclusions accompanies, but is not part of, IFRS 6.

Introduction

BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching the conclusions in IFRS 6 *Exploration for and Evaluation of Mineral Resources.* Individual Board members gave greater weight to some factors than to others.

Reasons for issuing the IFRS

BC2 Paragraphs 10-12 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* specify a hierarchy of criteria that an entity should use in developing an accounting policy if no IFRS applies specifically to an item. Without the exemption in IFRS 6, an entity adopting IFRSs in 2005 would have needed to assess whether its accounting policies for the exploration for and evaluation of mineral resources complied with those requirements. In the absence of guidance, there might have been uncertainty about what would be acceptable. Establishing what would be acceptable could have been costly and some entities might have made major changes in 2005 followed by further significant changes once the Board completes its comprehensive review of accounting for extractive activities.

BC3 To avoid unnecessary disruption for both users and preparers at this time, the Board proposed to limit the need for entities to change their existing accounting policies for exploration and evaluation assets. The Board did this by:

(a) creating a temporary exemption from parts of the hierarchy in IAS 8 that specify the criteria an entity uses in developing an accounting policy if no IFRS applies specifically.

(b) limiting the impact of that exemption from the hierarchy by identifying expenditures to be included in and excluded from exploration and evaluation assets and requiring all exploration and evaluation assets to be assessed for impairment.

BC4 The Board published its proposals in January 2004. ED 6 *Exploration for and Evaluation of Mineral Resources* had a comment deadline of 16 April 2004. The Board received 55 comment letters.

BC5 In April 2004 the Board approved a research project to be undertaken by staff from the national standard-setters in Australia, Canada, Norway and South Africa that will address accounting for extractive activities generally. The research project team is assisted by an advisory panel, which includes members from industry (oil and gas and mining sectors), accounting firms, users and securities regulators from around the world.

Scope

BC6 In the Board's view, even though no IFRS has addressed extractive activities directly, all IFRSs (including International Accounting Standards and Interpretations) are applicable to entities engaged in the exploration for and evaluation of mineral resources that make an unreserved statement of compliance with IFRSs in accordance with IAS 1 *Presentation of Financial Statements*. Consequently, each IFRS must be applied by all such entities.

BC7 Some respondents to ED 6 encouraged the Board to develop standards for other stages in the process of exploring for and evaluating mineral resources, including pre-exploration activities (ie activities preceding the exploration for and evaluation of mineral resources) and development activities (ie activities after the technical feasibility and commercial viability of extracting a mineral resource are demonstrable). The Board decided not to do this for two reasons. First, it did not want to prejudge the comprehensive review of the accounting for such activities. Second, the Board concluded that an appropriate accounting policy for pre-exploration activities could be developed from an application of existing IFRSs, from the *Framework*'s[*] definitions of assets and expenses, and by applying the general principles of asset recognition in IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*.

[*] References to the *Framework* in this Basis for Conclusions are to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the Board in 2001 and in effect when the Standard was developed.

Amended reference to the *Conceptual Framework*

BC67 Following the issue of the revised *Conceptual Framework for Financial Reporting* in 2018 (2018 *Conceptual Framework*), the Board issued *Amendments to References to the Conceptual Framework in IFRS Standards*. In IFRS 6, that document replaced a reference in paragraph 10 to the *Framework* with a reference to the 2018 *Conceptual Framework*. The Board does not expect that replacement to have a significant effect on the application of the Standard for the following reasons:

(a) The Board does not expect the application of the revised definition of an asset, together with the revised recognition criteria, to lead to significant changes in practice for entities that applied the *Framework* when developing their accounting policies for recognition of assets arising from development of mineral resources. Although the Board replaced the probability and reliability recognition criteria with recognition criteria based on the qualitative characteristics of useful financial information, the 2018 *Conceptual Framework* specifies low probability of an inflow or outflow of economic benefits and measurement uncertainty as factors to be considered in decisions about recognition.

(b) Entities that apply IAS 38 to develop their accounting policies for recognition of assets arising from development of mineral resources will not be affected by the amendment of the reference to the *Framework* in IFRS 6.

Dissenting opinions on IFRS 6

Dissent of Robert P Garnett, James J Leisenring, Warren J McGregor and John T Smith

DO1 Messrs Garnett, Leisenring, McGregor and Smith dissent from the issue of IFRS 6.

DO2 These four Board members dissent because they would not permit entities the alternative of continuing their existing accounting treatment for exploration and evaluation assets. In particular, they believe that all entities should be required to apply paragraphs 11 and 12 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* when developing an accounting policy for exploration and evaluation assets. These Board members believe that the requirements in IAS 8 have particular relevance and applicability when an IFRS lacks specificities, as is the case for entities recognising exploration and evaluation assets. This is especially true because the IFRS allows the continuation of a variety of measurement bases for these items and, because of the failure to consider the *Framework*[*], may result in the inappropriate recognition of assets. In the view of these Board members, if an entity cannot meet those requirements, it should not be allowed to describe its financial statements as being in accordance with International Financial Reporting Standards.

DO3 Messrs Garnett and McGregor also disagree with the modifications to the requirements of IAS 36 for the purpose of assessing exploration and evaluation assets for impairment contained in paragraphs 18-22 of the IFRS. They think that the requirements of IAS 36 should be applied in their entirety to exploration and evaluation assets. Failure to do so could result in exploration and evaluation assets continuing to be carried forward when such assets are not known to be recoverable. This could result in the exclusion of relevant information from the financial statements because of the failure to recognise impairment losses on a timely basis and the inclusion of unreliable information because of the inclusion of assets that do not faithfully represent the transactions and other events that they purport to represent.

DO4 The four Board members' concerns are heightened by the absence as yet from the Board's main agenda of a project on accounting for exploration for and evaluation of mineral resources generally. Although a research project has begun, it is unlikely that the Board will be able to develop financial reporting standards in the medium term. Accordingly, it is likely that the concession referred to in paragraph DO2 and, in Messrs Garnett and McGregor's cases, in paragraph DO3, will remain in place for some time.

[*] The reference to the *Framework* is to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the Board in 2001 and in effect when the Standard was developed.

HKFRS 7
Revised ~~November 2019~~August 2020

Effective for annual periods
beginning on or after 1 January 2007

Hong Kong Financial Reporting Standard 7

Financial Instruments: Disclosures

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Hong Kong Financial Reporting Standard 7 *Financial Instruments: Disclosures* (HKFRS 7) is set out in paragraphs 1-45 and Appendices A-~~D~~C. All the paragraphs have equal authority. Paragraphs in **bold type** state the main principles. Terms defined in Appendix A are in *italics* the first time they appear in the Standard. Definitions of other terms are given in the Glossary for Hong Kong Financial Reporting Standards. HKFRS 7 should be read in the context of its objective and the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Conceptual Framework for Financial Reporting*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

(c) on discontinuation of measuring a financial instrument, or a proportion of it, at fair value through profit or loss, that financial instrument's fair value that has become the new carrying amount in accordance with paragraph 6.7.4 of HKFRS 9 and the related nominal or principal amount (except for providing comparative information in accordance with HKAS 1, an entity does not need to continue this disclosure in subsequent periods).

Uncertainty arising from interest rate benchmark reform

24H For hedging relationships to which an entity applies the exceptions set out in paragraphs 6.8.4–6.8.12 of HKFRS 9 or paragraphs 102D–102N of HKAS 39, an entity shall disclose:

(a) the significant interest rate benchmarks to which the entity's hedging relationships are exposed;

(b) the extent of the risk exposure the entity manages that is directly affected by the interest rate benchmark reform;

(c) how the entity is managing the process to transition to alternative benchmark rates;

(d) a description of significant assumptions or judgements the entity made in applying these paragraphs (for example, assumptions or judgements about when the uncertainty arising from interest rate benchmark reform is no longer present with respect to the timing and the amount of the interest rate benchmark-based cash flows); and

(e) the nominal amount of the hedging instruments in those hedging relationships.

Fair value

25 Except as set out in paragraph 29, for each class of financial assets and financial liabilities (see paragraph 6), an entity shall disclose the fair value of that class of assets and liabilities in a way that permits it to be compared with its carrying amount.

26 In disclosing fair values, an entity shall group financial assets and financial liabilities into classes, but shall offset them only to the extent that their carrying amounts are offset in the statement of financial position.

27-27B [Deleted]

28 In some cases, an entity does not recognise a gain or loss on initial recognition of a financial asset or financial liability because the fair value is neither evidenced by a quoted price in an active market for an identical asset or liability (ie a Level 1 input) nor based on a valuation technique that uses only data from observable markets (see paragraph B5.1.2A of HKFRS 9). In such cases, the entity shall disclose by class of financial asset or financial liability:

(a) its accounting policy for recognising in profit or loss the difference between the fair value at initial recognition and the transaction price to reflect a change in factors (including time) that market participants would take into account when pricing the asset or liability (see paragraph B5.1.2A(b) of HKFRS 9).

44S–44W [Deleted]

44X *Investment Entities* (Amendments to HKFRS 10, HKFRS 12 and HKAS 27 (2011)), issued in December 2012, amended paragraph 3. An entity shall apply that amendment for annual periods beginning on or after 1 January 2014. Earlier application of *Investment Entities* is permitted. If an entity applies that amendment earlier it shall also apply all amendments included in *Investment Entities* at the same time.

44Y [Deleted]

44Z HKFRS 9, as issued in September 2014, amended paragraphs 2–5, 8–11, 14, 20, 28–30, 36, 42C–42E, Appendix A and paragraphs B1, B5, B9, B10, B22 and B27, deleted paragraphs 12, 12A, 16, 22–24, 37, 44E, 44F, 44H–44J, 44N, 44S–44W, 44Y, B4 and Appendix D and added paragraphs 5A, 10A, 11A, 11B, 12B–12D, 16A, 20A, 21A–21D, 22A–22C, 23A–23F, 24A–24G, 35A–35N, 42I–42S, 44ZA and B8A–B8J. An entity shall apply those amendments when it applies HKFRS 9. Those amendments need not be applied to comparative information provided for periods before the date of initial application of HKFRS 9.

44ZA In accordance with paragraph 7.1.2 of HKFRS 9, for annual reporting periods prior to 1 January 2018, an entity may elect to early apply only the requirements for the presentation of gains and losses on financial liabilities designated as at fair value through profit or loss in paragraphs 5.7.1(c), 5.7.7–5.7.9, 7.2.14 and B5.7.5–B5.7.20 of HKFRS 9 without applying the other requirements in HKFRS 9. If an entity elects to apply only those paragraphs of HKFRS 9, it shall disclose that fact and provide on an ongoing basis the related disclosures set out in paragraphs 10–11 of this HKFRS (as amended by HKFRS 9 (2010)).

44AA *Annual Improvements to HKFRSs 2012–2014 Cycle*, issued in October 2014, amended paragraphs 44R and B30 and added paragraph B30A. An entity shall apply those amendments retrospectively in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* for annual periods beginning on or after 1 January 2016, except that an entity need not apply the amendments to paragraphs B30 and B30A for any period presented that begins before the annual period for which the entity first applies those amendments. Earlier application of the amendments to paragraphs 44R, B30 and B30A is permitted. If an entity applies those amendments for an earlier period it shall disclose that fact.

44BB *Disclosure Initiative* (Amendments to HKAS 1), issued in January 2015, amended paragraphs 21 and B5. An entity shall apply those amendments for annual periods beginning on or after 1 January 2016. Earlier application of those amendments is permitted.

44CC HKFRS 16 *Leases*, issued in May 2016, amended paragraphs 29 and B11D. An entity shall apply those amendments when it applies HKFRS 16.

44DD *[This paragraph refers to amendments that are not yet effective, and is therefore not included in this edition.]*

44DE *Interest Rate Benchmark Reform*, which amended HKFRS 9, HKAS 39 and HKFRS 7, issued in November 2019, added paragraphs 24H and 44DF. An entity shall apply these amendments when it applies the amendments to HKFRS 9 or HKAS 39.

44DF In the reporting period in which an entity first applies *Interest Rate Benchmark Reform*, issued in November 2019, an entity is not required to present the quantitative information required by paragraph 28(f) of HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

Withdrawal of HKAS 30

45 This HKFRS supersedes HKAS 30 *Disclosures in the Financial Statements of Banks and Similar Financial Institutions*.

HKFRS 7 BC
Revised ~~November 2019~~August 2020

Basis for Conclusions on
Hong Kong Financial Reporting Standard 7

Financial Instruments:

Disclosures

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BC35OO The Board noted that IAS 1 requires an entity to prepare a reconciliation for each component of equity between the carrying amount at the beginning and at the end of the period. Consequently, as a result of IAS 1, an entity would disclose the amounts in relation to the time value of options that would be accumulated in other comprehensive income and the movements in that balance.

BC35PP However, in its 2010 Hedge Accounting Exposure Draft, the Board proposed that an entity should differentiate between transaction related hedged items and time-period related hedged items when providing the reconciliation of the accumulated other comprehensive income. This disaggregation would provide additional information about what cumulative amount in other comprehensive income would become an expense item over time and what amount would be transferred when a particular transaction occurs.

BC35QQ Most respondents agreed with the Board's proposal and consequently, the Board decided to retain the proposal from its 2010 Hedge Accounting Exposure Draft. However, as a consequence of the Board's decision to also allow an alternative accounting treatment for forward elements and foreign currency basis spreads, the Board also required that for the purpose of the IAS 1, amounts recognised in accumulated other comprehensive income that relate to forward elements and foreign currency basis spreads should be reconciled separately from amounts in relation to time value of options.

Hedging credit risk using credit derivatives

BC35RR For situations in which entities hedge credit risk using credit derivatives the Board decided to mitigate accounting mismatches in relation to credit derivatives accounted for at fair value through profit or loss by also using fair value through profit or loss accounting for the hedged credit exposure. Consequently, the Board also considered disclosures to provide transparency when entities apply that accounting.

BC35SS The Board considered that the following information would be useful for understanding the accounting in such situations:

(a) a reconciliation of amounts at the beginning and end of the period for the nominal amount and for the fair value of the credit derivatives;

(b) the gain or loss recognised in profit or loss as a result of changing the accounting for a credit exposure to fair value through profit or loss; and

(c) when an entity discontinues fair value through profit or loss accounting for credit exposures, the fair value that becomes the new deemed cost or amortisable amount (for loan commitments) and the related nominal or principal amount.

Uncertainty arising from interest rate benchmark reform

BC35TT In May 2019 the Board published the Exposure Draft *Interest Rate Benchmark Reform* (2019 Exposure Draft), which proposed exceptions to specific hedge accounting requirements in IFRS 9 and IAS 39 to provide relief in the period before the reform of interest rate benchmarks. The Board issued the final amendments to IFRS 9 and IAS 39 in September 2019. Paragraphs BC6.546–BC6.603 of the Basis for Conclusions on IFRS 9 and paragraphs BC223–BC288 of the Basis for Conclusions on IAS 39 provide the background to these amendments.

BC35UU In the 2019 Exposure Draft, the Board proposed that entities applying the exceptions provide disclosure about the magnitude of the hedging relationships to which the exceptions apply. As explained in paragraph BC44 of the Basis for Conclusions on the 2019 Exposure Draft, the Board noted that IFRS 7 already requires specific disclosures about hedge accounting. The Board proposed that for some specifically identified disclosures, information be provided separately for hedging relationships to which the proposed exceptions apply. Specifically, the Board proposed that an entity provide separately the information required by paragraphs 24A(a), 24A(c)–(d), 24B(a)(i)–(ii), 24B(a)(iv) and 24B(b) of IFRS 7 for hedging relationships affected by interest rate benchmark reform.

BC35VV Most respondents to the 2019 Exposure Draft agreed that information about the magnitude of the hedging relationships to which the proposed exceptions apply would be useful to users of financial statements. However, respondents had mixed views on whether the proposed disclosure requirements struck the right balance between the expected benefits for users of financial statements and the expected cost for preparers. As a result, these respondents suggested simplifying the proposed disclosure requirements.

BC35WW In addition, users of financial statements told the Board that, since the proposed amendments to IFRS 9 and IAS 39 would be mandatory, information about the extent to which an entity's hedging relationships are within the scope of the exceptions would provide useful information. Such information could be provided by requiring entities to disclose the nominal amounts of hedging instruments in hedging relationships in the scope of the amendments, supplemented with an explanation about how the entity is managing the process to transition to alternative benchmark rates. These disclosures would help users of financial statements understand how an entity's hedging relationships are affected by the uncertainty arising from interest rate benchmark reform.

BC35XX On the basis of respondents' comments and feedback from users of financial statements, the Board decided to require entities to provide the disclosures set out in paragraph 24H of IFRS 7 for hedging relationships directly affected by interest rate benchmark reform.

BC35YY Specific to the disclosure requirement in paragraph 24H(d) of IFRS 7, the Board acknowledged that given the objective and specificity of the amendments to IFRS 9 and IAS 39, there may be limited additional assumptions or judgements in the context of applying those exceptions. For example, the exceptions specify the assumptions to make about the interest rate benchmark-based cash flows. Nevertheless, the Board observed that if an entity makes significant assumptions or judgements in applying the exceptions in those amendments (for example, to determine when the uncertainty arising from interest rate benchmark reform is no longer present), that would be useful information for the users of financial statements. Accordingly, the Board decided to require entities to disclose information about any significant assumptions or judgements that the entity makes in applying the exceptions in the amendments.

BC35ZZ The Board noted that the requirement in paragraph 24H(e) of IFRS 7 is intended to provide users of financial statements with information about the quantum of hedging relationships which are directly affected by the uncertainties arising from the reform. That paragraph requires disclosure of the nominal amount of the hedging instruments in a hedging relationship directly affected by the uncertainties arising from the reform so that the information is disclosed on a gross basis rather than on a net basis (that is, offsetting hedging instruments in a liability position against those in an asset position).

BC35AAA Some respondents to the 2019 Exposure Draft raised concerns about the disclosure requirement in paragraph 28(f) of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. This paragraph requires an entity, on the initial application of an IFRS (or amendments to an IFRS), to disclose, for the current period and each prior period presented, the amount of any adjustment for each financial statement line item affected.

BC35BBB These respondents said that requiring such disclosure for the amendments to IFRS 9 and IAS 39 would not provide useful information to users of financial statements and also would be onerous for preparers. This is because it would require an entity to maintain parallel systems in order to determine the amount of the adjustment for each financial statement line item affected. Furthermore, disclosing this information would be inconsistent with the Board's observation in paragraph BC6.550 of IFRS 9 and paragraph BC227 of IAS 39, that discontinuing hedge accounting solely due to uncertainties arising from the reform would not provide useful information to users of financial statements.

BC35CCC The Board agreed with these comments and decided to exempt entities from the requirement in paragraph 28(f) of IAS 8 in the reporting period in which an entity first applies the amendments to IFRS 9 and IAS 39.

Other disclosures—fair value (paragraphs 25-30)[7]

BC36 Many entities use fair value information internally in determining their overall financial position and in making decisions about individual financial instruments. It is also relevant to many decisions made by users of financial statements because, in many circumstances, it reflects the judgement of the financial markets about the present value of expected future cash flows relating to an instrument. Fair value information permits comparisons of financial instruments having substantially the same economic characteristics, regardless of why they are held and when and by whom they were issued or acquired. Fair values provide a neutral basis for assessing management's stewardship by indicating the effects of its decisions to buy, sell or hold financial assets and to incur, maintain or discharge financial liabilities. The Board decided that when an entity does not measure a financial asset or financial liability in its balance sheet at fair value, it should provide fair value information through supplementary disclosures to assist users to compare entities on a consistent basis.

[7] IFRS 13 *Fair Value Measurement*, issued in May 2011, defines fair value and contains requirements for measuring fair value and for disclosing information about fair value measurements. As a consequence paragraphs 27-27B of IFRS 7 have been deleted.

BC37 Disclosure of fair value is not required for investments in unquoted equity instruments[8] and derivatives linked to such equity instruments if their fair value cannot be measured reliably.[9] Similarly, IFRS 4 does not specify the accounting required for contracts containing a discretionary participation feature pending phase II of the Board's project on insurance contracts. Accordingly, disclosure of fair value is not required for contracts containing a discretionary participation feature, if the fair value of that feature cannot be measured reliably. For all other financial assets and financial liabilities, it is reasonable to expect that fair value can be determined with sufficient reliability within constraints of timeliness and cost. Therefore, the Board concluded that there should be no other exception from the requirement to disclose fair value information for financial assets or financial liabilities.

BC38 To provide users of financial statements with a sense of the potential variability of fair value estimates, the Board decided that information about the use of valuation techniques should be disclosed, in particular the sensitivities of fair value estimates to the main valuation assumptions.[10] In forming this conclusion, the Board considered the view that disclosure of sensitivities could be difficult, particularly when there are many assumptions to which the disclosure would apply and these assumptions are interdependent. However, the Board noted that a detailed quantitative disclosure of sensitivity to all assumptions is not required (only those that could result in a significantly different estimate of fair value are required) and that the disclosure does not require the entity to reflect interdependencies between assumptions when making the disclosure. Additionally, the Board considered whether this disclosure might imply that a fair value established by a valuation technique is less reliable than one established by other means. However, the Board noted that fair values estimated by valuation techniques are more subjective than those established from an observable market price, and concluded that users need information to help them assess the extent of this subjectivity.

BC39 Paragraph 28 requires disclosure about the difference that arises if the transaction price differs from the fair value of a financial instrument that is determined in accordance with paragraph B5.4.8 of IFRS 9.[11] Those disclosures relate to matters addressed in the December 2004 amendment to IAS 39 *Transition and Initial Recognition of Financial Assets and Financial Liabilities*. That amendment does not specify how entities should account for those initial differences in subsequent periods. The disclosures required by paragraph 28 inform users about the amount of gain or loss that will be recognised in profit or loss in future periods. The Board noted that the information required to provide these disclosures would be readily available to the entities affected.

BC39A Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157) issued by the US Financial Accounting Standards Board requires disclosures that are based on a three-level fair value hierarchy for the inputs used in valuation techniques to measure fair value. The Board was asked by some users of financial statements to include similar disclosure requirements in IFRS 7 to provide more information about the relative reliability of the inputs to fair value measurements. The Board concluded that such a hierarchy would improve comparability between

8 IFRS 13, issued in May 2011, defines a Level 1 input as a quoted price in an active market for an identical asset or liability. Level 2 inputs include quoted prices for identical assets or liabilities in markets that are not active. As a result IAS 39 and IFRS 9 refer to such equity instruments as 'an equity instrument that does not have a quoted price in an active market for an identical instrument (ie a Level 1 input)'.

9 IFRS 9 changed the measurement requirements for investments in equity instruments.

10 IFRS 13, issued in May 2011, resulted in paragraph 27B(c) of IFRS 7 being deleted.

11 IFRS 13, issued in May 2011, contains the requirements for measuring fair value. As a consequence of issuing that IFRS, paragraph B5.4.8 of IFRS 9 was deleted. However, in 2014 the requirements for amortised cost measurement and impairment were added to IFRS 9 as Sections 5.4 and 5.5. Paragraph B5.4.8 of IFRS 9 now contains requirements related to amortised cost measurement.

HKFRS 8 BC
Revised ~~November 2016~~August 2020

Basis for Conclusions on
Hong Kong Financial Reporting Standard 8

Operating Segments

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Dissenting opinions on IFRS 8

Dissent of Stephen Cooper from the amendment issued in April 2009

DO1 Mr Cooper dissents from the amendment to IFRS 8 *Operating Segments* made by *Improvements to IFRSs* issued in April 2009.

DO2 In his view the changes are unnecessary considering that the provisions in the *Framework*[*] regarding materiality already enable a reporting entity not to disclose segment assets when those assets are small relative to segment profit and not relevant to the understanding of the business. Mr Cooper believes that allowing a reporting entity not to disclose segment assets merely because this is not reported to the chief operating decision maker weakens IFRS 8, and may result in segment assets not being disclosed even when they are important to understanding the performance and financial position of that business.

[*] The reference to the *Framework* is to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the Board in 2001 and in effect when the Standard was amended.

Hong Kong Financial Reporting Standard 9 (2014)

Financial Instruments

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Hong Kong Financial Reporting Standard 9 *Financial Instruments* (HKFRS 9) is set out in paragraphs 1.1–7.3.2 and Appendices A–~~D~~C. All the paragraphs have equal authority. Paragraphs in **bold type** state the main principles. Terms defined in Appendix A are in *italics* the first time they appear in the HKFRS. Definitions of other terms are given in the Glossary for Hong Kong Financial Reporting Standards. HKFRS 9 should be read in the context of its objective and the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Conceptual Framework for Financial Reporting*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

6.7.4 When an entity discontinues measuring the financial instrument that gives rise to the credit risk, or a proportion of that financial instrument, at fair value through profit or loss, that financial instrument's fair value at the date of discontinuation becomes its new carrying amount. Subsequently, the same measurement that was used before designating the financial instrument at fair value through profit or loss shall be applied (including amortisation that results from the new carrying amount). For example, a financial asset that had originally been classified as measured at amortised cost would revert to that measurement and its effective interest rate would be recalculated based on its new gross carrying amount on the date of discontinuing measurement at fair value through profit or loss.

6.8 Temporary exceptions from applying specific hedge accounting requirements

6.8.1 An entity shall apply paragraphs 6.8.4–6.8.12 and paragraphs 7.1.8 and 7.2.26(d) to all hedging relationships directly affected by interest rate benchmark reform. These paragraphs apply only to such hedging relationships. A hedging relationship is directly affected by interest rate benchmark reform only if the reform gives rise to uncertainties about:

(a) the interest rate benchmark (contractually or non-contractually specified) designated as a hedged risk; and/or

(b) the timing or the amount of interest rate benchmark-based cash flows of the hedged item or of the hedging instrument.

6.8.2 For the purpose of applying paragraphs 6.8.4–6.8.12, the term 'interest rate benchmark reform' refers to the market-wide reform of an interest rate benchmark, including the replacement of an interest rate benchmark with an alternative benchmark rate such as that resulting from the recommendations set out in the Financial Stability Board's July 2014 report 'Reforming Major Interest Rate Benchmarks'.[2]

6.8.3 Paragraphs 6.8.4–6.8.12 provide exceptions only to the requirements specified in these paragraphs. An entity shall continue to apply all other hedge accounting requirements to hedging relationships directly affected by interest rate benchmark reform.

Highly probable requirement for cash flow hedges

6.8.4 For the purpose of determining whether a forecast transaction (or a component thereof) is highly probable as required by paragraph 6.3.3, an entity shall assume that the interest rate benchmark on which the hedged cash flows (contractually or non-contractually specified) are based is not altered as a result of interest rate benchmark reform.

Reclassifying the amount accumulated in the cash flow hedge reserve

6.8.5 For the purpose of applying the requirement in paragraph 6.5.12 in order to determine whether the hedged future cash flows are expected to occur, an entity shall assume that the interest rate benchmark on which the hedged cash flows (contractually or non-contractually specified) are based is not altered as a result of interest rate benchmark reform.

[2] The report, 'Reforming Major Interest Rate Benchmarks', is available at http://www.fsb.org/wp-content/uploads/r_140722.pdf.

Assessing the economic relationship between the hedged item and the hedging instrument

6.8.6 For the purpose of applying the requirements in paragraphs 6.4.1(c)(i) and B6.4.4–B6.4.6, an entity shall assume that the interest rate benchmark on which the hedged cash flows and/or the hedged risk (contractually or non-contractually specified) are based, or the interest rate benchmark on which the cash flows of the hedging instrument are based, is not altered as a result of interest rate benchmark reform.

Designating a component of an item as a hedged item

6.8.7 Unless paragraph 6.8.8 applies, for a hedge of a non-contractually specified benchmark component of interest rate risk, an entity shall apply the requirement in paragraphs 6.3.7(a) and B6.3.8—that the risk component shall be separately identifiable—only at the inception of the hedging relationship.

6.8.8 When an entity, consistent with its hedge documentation, frequently resets (ie discontinues and restarts) a hedging relationship because both the hedging instrument and the hedged item frequently change (ie the entity uses a dynamic process in which both the hedged items and the hedging instruments used to manage that exposure do not remain the same for long), the entity shall apply the requirement in paragraphs 6.3.7(a) and B6.3.8—that the risk component is separately identifiable—only when it initially designates a hedged item in that hedging relationship. A hedged item that has been assessed at the time of its initial designation in the hedging relationship, whether it was at the time of the hedge inception or subsequently, is not reassessed at any subsequent redesignation in the same hedging relationship.

End of application

6.8.9 An entity shall prospectively cease applying paragraph 6.8.4 to a hedged item at the earlier of:

(a) when the uncertainty arising from interest rate benchmark reform is no longer present with respect to the timing and the amount of the interest rate benchmark-based cash flows of the hedged item; and

(b) when the hedging relationship that the hedged item is part of is discontinued.

6.8.10 An entity shall prospectively cease applying paragraph 6.8.5 at the earlier of:

(a) when the uncertainty arising from interest rate benchmark reform is no longer present with respect to the timing and the amount of the interest rate benchmark-based future cash flows of the hedged item; and

(b) when the entire amount accumulated in the cash flow hedge reserve with respect to that discontinued hedging relationship has been reclassified to profit or loss.

6.8.11 An entity shall prospectively cease applying paragraph 6.8.6:

(a) to a hedged item, when the uncertainty arising from interest rate benchmark reform is no longer present with respect to the hedged risk or the timing and the amount of the interest rate benchmark-based cash flows of the hedged item; and

(b) to a hedging instrument, when the uncertainty arising from interest rate benchmark reform is no longer present with respect to the timing and the amount of the interest rate benchmark-based cash flows of the hedging instrument.

If the hedging relationship that the hedged item and the hedging instrument are part of is discontinued earlier than the date specified in paragraph 6.8.11(a) or the date specified in paragraph 6.8.11(b), the entity shall prospectively cease applying paragraph 6.8.6 to that hedging relationship at the date of discontinuation.

6.8.12 When designating a group of items as the hedged item, or a combination of financial instruments as the hedging instrument, an entity shall prospectively cease applying paragraphs 6.8.4–6.8.6 to an individual item or financial instrument in accordance with paragraphs 6.8.9, 6.8.10, or 6.8.11, as relevant, when the uncertainty arising from interest rate benchmark reform is no longer present with respect to the hedged risk and/or the timing and the amount of the interest rate benchmark-based cash flows of that item or financial instrument.

Chapter 7 Effective date and transition

7.1 Effective date

7.1.1 An entity shall apply this Standard for annual periods beginning on or after 1 January 2018. Earlier application is permitted. If an entity elects to apply this Standard early, it must disclose that fact and apply all of the requirements in this Standard at the same time (but see also paragraphs 7.1.2, 7.2.21 and 7.3.2). It shall also, at the same time, apply the amendments in Appendix C.

7.1.2 Despite the requirements in paragraph 7.1.1, for annual periods beginning before 1 January 2018, an entity may elect to early apply only the requirements for the presentation of gains and losses on financial liabilities designated as at fair value through profit or loss in paragraphs 5.7.1(c), 5.7.7–5.7.9, 7.2.14 and B5.7.5–B5.7.20 without applying the other requirements in this Standard. If an entity elects to apply only those paragraphs, it shall disclose that fact and provide on an ongoing basis the related disclosures set out in paragraphs 10–11 of HKFRS 7 (as amended by HKFRS 9 (2010)). (See also paragraphs 7.2.2 and 7.2.15.)

7.1.3 *Annual Improvements to HKFRSs 2010–2012 Cycle*, issued in January 2014, amended paragraphs 4.2.1 and 5.7.5 as a consequential amendment derived from the amendment to HKFRS 3. An entity shall apply that amendment prospectively to business combinations to which the amendment to HKFRS 3 applies.

7.1.4 HKFRS 15, issued in July 2014, amended paragraphs 3.1.1, 4.2.1, 5.1.1, 5.2.1, 5.7.6, B3.2.13, B5.7.1, C5 and C42 and deleted paragraph C16 and its related heading. Paragraphs 5.1.3 and 5.7.1A, and a definition to Appendix A, were added. An entity shall apply those amendments when it applies HKFRS 15.

7.1.5 HKFRS 16, issued in May 2016, amended paragraphs 2.1, 5.5.15, B4.3.8, B5.5.34 and B5.5.46. An entity shall apply those amendments when it applies HKFRS 16.

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

7.1.7 *Prepayment Features with Negative Compensation* (Amendments to HKFRS 9), issued in November 2017, added paragraphs 7.2.29–7.2.34 and B4.1.12A and amended paragraphs B4.1.11(b) and B4.1.12(b). An entity shall apply these amendments for annual periods beginning on or after 1 January 2019. Earlier application is permitted. If an entity applies these amendments for an earlier period, it shall disclose that fact.

7.1.8 *Interest Rate Benchmark Reform*, which amended HKFRS 9, HKAS 39 and HKFRS 7, issued in November 2019, added Section 6.8 and amended paragraph 7.2.26. An entity shall apply these amendments for annual periods beginning on or after 1 January 2020. Earlier application is permitted. If an entity applies these amendments for an earlier period, it shall disclose that fact.

7.2 Transition

7.2.1 An entity shall apply this Standard retrospectively, in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, except as specified in paragraphs 7.2.4–7.2.26 and 7.2.28. This Standard shall not be applied to items that have already been derecognised at the date of initial application.

7.2.2 For the purposes of the transition provisions in paragraphs 7.2.1, 7.2.3–7.2.28 and 7.3.2, the date of initial application is the date when an entity first applies those requirements of this Standard and must be the beginning of a reporting period after the issue of this Standard. Depending on the entity's chosen approach to applying HKFRS 9, the transition can involve one or more than one date of initial application for different requirements.

Transition for classification and measurement (Chapters 4 and 5)

7.2.3 At the date of initial application, an entity shall assess whether a financial asset meets the condition in paragraphs 4.1.2(a) or 4.1.2A(a) on the basis of the facts and circumstances that exist at that date. The resulting classification shall be applied retrospectively irrespective of the entity's business model in prior reporting periods.

(a) shall apply the accounting for the time value of options in accordance with paragraph 6.5.15 retrospectively if, in accordance with HKAS 39, only the change in an option's intrinsic value was designated as a hedging instrument in a hedging relationship. This retrospective application applies only to those hedging relationships that existed at the beginning of the earliest comparative period or were designated thereafter.

(b) may apply the accounting for the forward element of forward contracts in accordance with paragraph 6.5.16 retrospectively if, in accordance with HKAS 39, only the change in the spot element of a forward contract was designated as a hedging instrument in a hedging relationship. This retrospective application applies only to those hedging relationships that existed at the beginning of the earliest comparative period or were designated thereafter. In addition, if an entity elects retrospective application of this accounting, it shall be applied to all hedging relationships that qualify for this election (ie on transition this election is not available on a hedging-relationship-by-hedging-relationship basis). The accounting for foreign currency basis spreads (see paragraph 6.5.16) may be applied retrospectively for those hedging relationships that existed at the beginning of the earliest comparative period or were designated thereafter.

(c) shall apply retrospectively the requirement of paragraph 6.5.6 that there is not an expiration or termination of the hedging instrument if:

  (i) as a consequence of laws or regulations, or the introduction of laws or regulations, the parties to the hedging instrument agree that one or more clearing counterparties replace their original counterparty to become the new counterparty to each of the parties; and

  (ii) other changes, if any, to the hedging instrument are limited to those that are necessary to effect such a replacement of the counterparty.

(d) shall apply the requirements in Section 6.8 retrospectively. This retrospective application applies only to those hedging relationships that existed at the beginning of the reporting period in which an entity first applies those requirements or were designated thereafter, and to the amount accumulated in the cash flow hedge reserve that existed at the beginning of the reporting period in which an entity first applies those requirements.

Entities that have applied HKFRS 9 (2009), HKFRS 9 (2010) or HKFRS 9 (2013) early

7.2.27 An entity shall apply the transition requirements in paragraphs 7.2.1–7.2.26 at the relevant date of initial application. An entity shall apply each of the transition provisions in paragraphs 7.2.3–7.2.14A and 7.2.17–7.2.26 only once (ie if an entity chooses an approach of applying HKFRS 9 that involves more than one date of initial application, it cannot apply any of those provisions again if they were already applied at an earlier date). (See paragraphs 7.2.2 and 7.3.2.)

7.2.28 An entity that applied HKFRS 9 (2009), HKFRS 9 (2010) or HKFRS 9 (2013) and subsequently applies this Standard:

(a) shall revoke its previous designation of a financial asset as measured at fair value through profit or loss if that designation was previously made in accordance with the condition in paragraph 4.1.5 but that condition is no longer satisfied as a result of the application of this Standard;

(b) may designate a financial asset as measured at fair value through profit or loss if that designation would not have previously satisfied the condition in paragraph 4.1.5 but that condition is now satisfied as a result of the application of this Standard;

(c) shall revoke its previous designation of a financial liability as measured at fair value through profit or loss if that designation was previously made in accordance with the condition in paragraph 4.2.2(a) but that condition is no longer satisfied as a result of the application of this Standard; and

(d) may designate a financial liability as measured at fair value through profit or loss if that designation would not have previously satisfied the condition in paragraph 4.2.2(a) but that condition is now satisfied as a result of the application of this Standard.

Such a designation and revocation shall be made on the basis of the facts and circumstances that exist at the date of initial application of this Standard. That classification shall be applied retrospectively.

Transition for Prepayment Features with Negative Compensation

7.2.29 An entity shall apply *Prepayment Features with Negative Compensation* (Amendments to HKFRS 9) retrospectively in accordance with HKAS 8, except as specified in paragraphs 7.2.30–7.2.34.

7.2.30 An entity that first applies these amendments at the same time it first applies this Standard shall apply paragraphs 7.2.1–7.2.28 instead of paragraphs 7.2.31–7.2.34.

7.2.31 An entity that first applies these amendments after it first applies this Standard shall apply paragraphs 7.2.32–7.2.34. The entity shall also apply the other transition requirements in this Standard necessary for applying these amendments. For that purpose, references to the date of initial application shall be read as referring to the beginning of the reporting period in which an entity first applies these amendments (date of initial application of these amendments).

7.2.32 With regard to designating a financial asset or financial liability as measured at fair value through profit or loss, an entity:

(a) shall revoke its previous designation of a financial asset as measured at fair value through profit or loss if that designation was previously made in accordance with the condition in paragraph 4.1.5 but that condition is no longer satisfied as a result of the application of these amendments;

(b) may designate a financial asset as measured at fair value through profit or loss if that designation would not have previously satisfied the condition in paragraph 4.1.5 but that condition is now satisfied as a result of the application of these amendments;

(c) shall revoke its previous designation of a financial liability as measured at fair value through profit or loss if that designation was previously made in accordance with the condition in paragraph 4.2.2(a) but that condition is no longer satisfied as a result of the application of these amendments; and

(d) may designate a financial liability as measured at fair value through profit or loss if that designation would not have previously satisfied the condition in paragraph 4.2.2(a) but that condition is now satisfied as a result of the application of these amendments.

Such a designation and revocation shall be made on the basis of the facts and circumstances that exist at the date of initial application of these amendments. That classification shall be applied retrospectively.

7.2.33 An entity is not required to restate prior periods to reflect the application of these amendments. The entity may restate prior periods if, and only if, it is possible without the use of hindsight and the restated financial statements reflect all the requirements in this Standard. If an entity does not restate prior periods, the entity shall recognise any difference between the previous carrying amount and the carrying amount at the beginning of the annual reporting period that includes the date of initial application of these amendments in the opening retained earnings (or other component of equity, as appropriate) of the annual reporting period that includes the date of initial application of these amendments.

7.2.34 In the reporting period that includes the date of initial application of these amendments, the entity shall disclose the following information as at that date of initial application for each class of financial assets and financial liabilities that were affected by these amendments:

(a) the previous measurement category and carrying amount determined immediately before applying these amendments;

(b) the new measurement category and carrying amount determined after applying these amendments;

(c) the carrying amount of any financial assets and financial liabilities in the statement of financial position that were previously designated as measured at fair value through profit or loss but are no longer so designated; and

(d) the reasons for any designation or de-designation of financial assets or financial liabilities as measured at fair value through profit or loss.

7.3 Withdrawal of HK(IFRIC) - Int 9, HKFRS 9 (2009), HKFRS 9 (2010) and HKFRS 9 (2013)

7.3.1 This Standard supersedes HK(IFRIC)-Int 9 *Reassessment of Embedded Derivatives*. The requirements added to HKFRS 9 in November 2010 incorporated the requirements previously set out in paragraphs 5 and 7 of HK(IFRIC)-Int 9. As a consequential amendment, HKFRS 1 *First-time Adoption of Hong Kong Financial Reporting Standards* incorporated the requirements previously set out in paragraph 8 of HK(IFRIC)-Int 9.

7.3.2 This Standard supersedes HKFRS 9 (2009), HKFRS 9 (2010) and HKFRS 9 (2013). However, for annual periods beginning before 1 January 2018, an entity may elect to apply those earlier versions of HKFRS 9 instead of applying this Standard if, and only if, the entity's relevant date of initial application is before 1 February 2015.

lifetime expected credit losses	The **expected credit losses** that result from all possible default events over the expected life of a financial instrument.
loss allowance	The allowance for **expected credit losses** on financial assets measured in accordance with paragraph 4.1.2, lease receivables and **contract assets**, the accumulated impairment amount for financial assets measured in accordance with paragraph 4.1.2A and the provision for expected credit losses on loan commitments and **financial guarantee contracts**.
modification gain or loss	The amount arising from adjusting the **gross carrying amount of a financial asset** to reflect the renegotiated or modified contractual cash flows. The entity recalculates the gross carrying amount of a financial asset as the present value of the estimated future cash payments or receipts through the expected life of the renegotiated or modified financial asset that are discounted at the financial asset's original **effective interest rate** (or the original **credit-adjusted effective interest rate** for **purchased or originated credit-impaired financial assets**) or, when applicable, the revised **effective interest rate** calculated in accordance with paragraph 6.5.10. When estimating the expected cash flows of a financial asset, an entity shall consider all contractual terms of the financial asset (for example, prepayment, call and similar options) but shall not consider the **expected credit losses**, unless the financial asset is a **purchased or originated credit-impaired financial asset**, in which case an entity shall also consider the initial expected credit losses that were considered when calculating the original **credit-adjusted effective interest rate**.
past due	A financial asset is past due when a counterparty has failed to make a payment when that payment was contractually due.
purchased or originated credit-impaired financial asset	Purchased or originated financial asset(s) that are **credit-impaired** on initial recognition.
reclassification date	The first day of the first reporting period following the change in business model that results in an entity reclassifying financial assets.
regular way purchase or sale	A purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned.
transaction costs	Incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability (see paragraph B5.4.8). An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.

The following terms are defined in paragraph 11 of HKAS 32, Appendix A of HKFRS 7, Appendix A of HKFRS 13 or Appendix A of HKFRS 15 and are used in this Standard with the meanings specified in HKAS 32, HKFRS 7, HKFRS 13 or HKFRS 15:

(a) credit risk;[3]

(b) equity instrument;

(c) fair value;

(d) financial asset;

[3] This term (as defined in HKFRS 7) is used in the requirements for presenting the effects of changes in credit risk on liabilities designated as at fair value through profit or loss (see paragraph 5.7.7).

B4.3.12 Paragraph B4.3.11 does not apply to embedded derivatives in contracts acquired in:

(a) a business combination (as defined in HKFRS 3 *Business Combinations*);

(b) a combination of entities or businesses under common control as described in paragraphs B1–B4 of HKFRS 3; or

(c) the formation of a joint venture as defined in HKFRS 11 *Joint Arrangements*

or their possible reassessment at the date of acquisition.[4]

Reclassification of financial assets (Section 4.4)

Reclassification of financial assets

B4.4.1 Paragraph 4.4.1 requires an entity to reclassify financial assets if the entity changes its business model for managing those financial assets. Such changes are expected to be very infrequent. Such changes are determined by the entity's senior management as a result of external or internal changes and must be significant to the entity's operations and demonstrable to external parties. Accordingly, a change in an entity's business model will occur only when an entity either begins or ceases to perform an activity that is significant to its operations; for example, when the entity has acquired, disposed of or terminated a business line. Examples of a change in business model include the following:

(a) An entity has a portfolio of commercial loans that it holds to sell in the short term. The entity acquires a company that manages commercial loans and has a business model that holds the loans in order to collect the contractual cash flows. The portfolio of commercial loans is no longer for sale, and the portfolio is now managed together with the acquired commercial loans and all are held to collect the contractual cash flows.

(b) A financial services firm decides to shut down its retail mortgage business. That business no longer accepts new business and the financial services firm is actively marketing its mortgage loan portfolio for sale.

B4.4.2 A change in the objective of the entity's business model must be effected before the reclassification date. For example, if a financial services firm decides on 15 February to shut down its retail mortgage business and hence must reclassify all affected financial assets on 1 April (ie the first day of the entity's next reporting period), the entity must not accept new retail mortgage business or otherwise engage in activities consistent with its former business model after 15 February.

B4.4.3 The following are not changes in business model:

(a) a change in intention related to particular financial assets (even in circumstances of significant changes in market conditions).

(b) the temporary disappearance of a particular market for financial assets.

(c) a transfer of financial assets between parts of the entity with different business models.

4 HKFRS 3 addresses the acquisition of contracts with embedded derivatives in a business combination.

B6.3.14 For example, an entity issues debt in an environment in which inflation-linked bonds have a volume and term structure that results in a sufficiently liquid market that allows constructing a term structure of zero-coupon real interest rates. This means that for the respective currency, inflation is a relevant factor that is separately considered by the debt markets. In those circumstances the inflation risk component could be determined by discounting the cash flows of the hedged debt instrument using the term structure of zero-coupon real interest rates (ie in a manner similar to how a risk-free (nominal) interest rate component can be determined). Conversely, in many cases an inflation risk component is not separately identifiable and reliably measurable. For example, an entity issues only nominal interest rate debt in an environment with a market for inflation-linked bonds that is not sufficiently liquid to allow a term structure of zero-coupon real interest rates to be constructed. In this case the analysis of the market structure and of the facts and circumstances does not support the entity concluding that inflation is a relevant factor that is separately considered by the debt markets. Hence, the entity cannot overcome the rebuttable presumption that inflation risk that is not contractually specified is not separately identifiable and reliably measurable. Consequently, an inflation risk component would not be eligible for designation as the hedged item. This applies irrespective of any inflation hedging instrument that the entity has actually entered into. In particular, the entity cannot simply impute the terms and conditions of the actual inflation hedging instrument by projecting its terms and conditions onto the nominal interest rate debt.

B6.3.15 A contractually specified inflation risk component of the cash flows of a recognised inflation-linked bond (assuming that there is no requirement to account for an embedded derivative separately) is separately identifiable and reliably measurable, as long as other cash flows of the instrument are not affected by the inflation risk component.

Components of a nominal amount

B6.3.16 There are two types of components of nominal amounts that can be designated as the hedged item in a hedging relationship: a component that is a proportion of an entire item or a layer component. The type of component changes the accounting outcome. An entity shall designate the component for accounting purposes consistently with its risk management objective.

B6.3.17 An example of a component that is a proportion is 50 per cent of the contractual cash flows of a loan.

B6.3.18 A layer component may be specified from a defined, but open, population, or from a defined nominal amount. Examples include:

(a) part of a monetary transaction volume, for example, the next FC10 cash flows from sales denominated in a foreign currency after the first FC20 in March 201X;[5]

(b) a part of a physical volume, for example, the bottom layer, measuring 5 million cubic metres, of the natural gas stored in location XYZ;

(c) a part of a physical or other transaction volume, for example, the first 100 barrels of the oil purchases in June 201X or the first 100 MWh of electricity sales in June 201X; or

(d) a layer from the nominal amount of the hedged item, for example, the last CU80 million of a CU100 million firm commitment, the bottom layer of CU20 million of a CU100 million fixed-rate bond or the top layer of CU30 million from a total amount of CU100 million of fixed-rate debt that can be prepaid at fair value (the defined nominal amount is CU100 million).

[5] In this Standard monetary amounts are denominated in 'currency units' (CU) and 'foreign currency units' (FC).

HKFRS 9 BC
Revised ~~November 2019~~August 2020

Basis for Conclusions on
Hong Kong Financial Reporting Standard 9 (2014)

Financial Instruments

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through to investors the cash flows from the asset? Does the accounting treatment change because Entity A first sold the asset to an SPE?[8]

BCZ3.16 To address these issues, the exposure draft of proposed amendments to IAS 39 in 2002 included guidance to clarify under which conditions pass-through arrangements could be treated as a transfer of the underlying financial asset. The IASB concluded that an entity does not have an asset and a liability, as defined in the *Framework*,[9] when it enters into an arrangement to pass through cash flows from an asset and that arrangement meets specified conditions. In these cases, the entity acts more as an agent of the eventual recipients of the cash flows than as an owner of the asset. Accordingly, to the extent that those conditions are met the arrangement is treated as a transfer and considered for derecognition even though the entity may continue to collect cash flows from the asset. Conversely, to the extent the conditions are not met, the entity acts more as an owner of the asset with the result that the asset should continue to be recognised.

BCZ3.17 Respondents to the exposure draft (2002) were generally supportive of the proposed changes. Some respondents asked for further clarification of the requirements and the interaction with the requirements for consolidation of special purpose entities (in SIC-12 *Consolidation—Special Purpose Entities*). Respondents in the securitisation industry noted that under the proposed guidance many securitisation structures would not qualify for derecognition.

BCZ3.18 Considering these and other comments, the IASB decided to proceed with its proposals to issue guidance on pass-through arrangements and to clarify that guidance in finalising the revised IAS 39 (this guidance is now in IFRS 9).

BCZ3.19 The IASB concluded that the following three conditions must be met for treating a contractual arrangement to pass through cash flows from a financial asset as a transfer of that asset:

(a) The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset. However, the entity is allowed to make short-term advances to the eventual recipient so long as it has the right of full recovery of the amount lent plus accrued interest.

(b) The entity is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows.

(c) The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. In addition, during the short settlement period, the entity is not entitled to reinvest such cash flows except for investments in cash or cash equivalents and where any interest earned from such investments is remitted to the eventual recipients.

BCZ3.20 These conditions followed from the definitions of assets and liabilities in the *Framework*. Condition (a) indicates that the transferor has no liability (because there is no present obligation to pay cash), and conditions (b) and (c) indicate that the transferor has no asset (because the transferor does not control the future economic benefits associated with the transferred asset).

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

[9] References to the *Framework* in this Basis for Conclusions are to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the IASB in 2001 and in effect when parts of the Standard were developed and revised. ~~In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.~~

BC5.84 In developing a model that depicts expected credit losses, the IASB observed that:

(a) when an entity prices a financial instrument, part of the yield, the credit risk premium, compensates the entity for the credit losses initially expected (for example, an entity will typically demand a higher yield for those instruments with higher expected credit losses at the date the instrument is issued). Consequently, no economic loss is suffered at initial recognition simply because the credit risk on a financial instrument is high at that time, because those expected credit losses are implicit in the initial pricing of the instrument.

(b) for most financial instruments, the pricing is not adjusted for changes in expected credit losses in subsequent periods. Consequently, subsequent changes in expected credit losses are economic losses (or gains) of the entity in the period in which they occur.

BC5.85 Expected credit losses, in isolation, are not directly observable. However, because the credit risk premium is a component of the market yield for financial instruments, the indirect measurement of expected credit losses is a daily occurrence in the pricing of such instruments in the market. A number of models exist to assist market participants and regulators in the measurement of expected credit losses. But, because expected credit losses are not directly observable, their measurement is inherently based on judgement and any model that attempts to depict expected credit losses will be subject to measurement uncertainty.

BC5.86 Some interested parties would prefer an impairment model that results in a more conservative, or prudential, depiction of expected credit losses. Those interested parties argue that such a depiction would better meet the needs of both the regulators who are responsible for maintaining financial stability and investors and other users of financial statements. However, to be consistent with the *Conceptual Framework*[*], faithful representation of expected credit losses implies that the depiction of those credit losses is neutral and free from bias. The depiction of expected credit losses in an unbiased way informs the decisions of a broad range of users of financial statements, including regulators and investors and creditors. In the IASB's view, incorporating a degree of conservatism would be arbitrary and would result in a lack of comparability. The risk of an outcome other than the probability-weighted expected outcome is only relevant for particular purposes, such as determining the extent of economic or regulatory capital requirements.

Alternative models considered to depict expected credit losses

The model proposed in the 2009 Impairment Exposure Draft

BC5.87 In November 2009 the IASB published the 2009 Impairment Exposure Draft, which proposed that an entity should measure amortised cost at the expected (credit-adjusted) cash flows discounted at the original credit-adjusted effective interest rate, ie the effective interest rate adjusted for the initial expected credit losses. The IASB was aware that these proposals were a fundamentally new approach to impairment accounting for financial reporting purposes that was much more closely linked to credit risk management concepts. In order to fully understand the consequences of this, the IASB established a panel of credit risk experts (the Expert Advisory Panel (EAP)) to provide input during the comment period.

BC5.88 In the IASB's view, the model in the 2009 Impairment Exposure Draft most faithfully represents expected credit losses and would determine the carrying amount, interest revenue and impairment gains or losses to be recognised through a single, integrated calculation. Thus, an entity would recognise:

(a) the initial expected credit losses over the life of the asset through the credit-adjusted effective interest rate; and

(b) any changes in expected credit losses when those changes occurred.

[*] References to the *Conceptual Framework* in this Basis for Conclusions are to the *Conceptual Framework for Financial Reporting*, issued in 2010 and in effect when parts of the Standard were developed and amended.

(d) Alternative 2 is operationally the least complex of the approaches considered.

BC6.544 The IASB considered that, on balance, the advantages of Alternative 2 outweighed its disadvantages and, overall, that it was superior to all other approaches. Hence, the IASB decided to include Alternative 2 in the final requirements.

BC6.545 In response to feedback received on the 2010 Hedge Accounting Exposure Draft, the IASB also decided to align the accounting for the discontinuation of fair value through profit or loss accounting for loan commitments with that for loans (ie use amortisation unless a higher liability is required by IAS 37, instead of simply reverting to that Standard as contemplated during the IASB's initial deliberations—see paragraphs BC6.479 and BC6.482). The IASB's reasons for also using an amortisation approach for loan commitments were that:

(a) it would prevent an immediate gain from the derecognition of the loan commitment under IAS 37 if the probable threshold is not met when discontinuing fair value through profit or loss accounting. This would reduce concerns about earnings management.

(b) the amortisation of the carrying amount when discontinuing fair value through profit or loss accounting would use the effective interest method. This would require the entity to assume that a loan had been drawn under the loan commitment in order to determine an amortisation profile. The rationale for this alternative is that a credit loss only results from a loan commitment if that loan commitment gets drawn and the resulting loan is not repaid. Hence, an amortisation on an 'as if drawn' basis would be appropriate for the amortisation of the carrying amount.

(c) this accounting also provides operational relief for loan commitments that allow repayments and redraws (for example, a revolving facility). It would avoid the need to capitalise any remaining carrying amount into individual drawings to ensure its amortisation, which would be operationally complex.

Amendments for Interest Rate Benchmark Reform (September 2019)

BC6.546 Interest rate benchmarks such as interbank offered rates (IBORs) play an important role in global financial markets. These interest rate benchmarks index trillions of dollars and other currencies in a wide variety of financial products, from derivatives to residential mortgages. However, cases of attempted market manipulation of some interest rate benchmarks, together with the post-crisis decline in liquidity in interbank unsecured funding markets, have undermined confidence in the reliability and robustness of some interest rate benchmarks. Against this background, the G20 asked the Financial Stability Board (FSB) to undertake a fundamental review of major interest rate benchmarks. Following the review, the FSB published a report setting out its recommended reforms of some major interest rate benchmarks such as IBORs. Public authorities in many jurisdictions have since taken steps to implement those recommendations. In some jurisdictions, there is already clear progress towards the reform of interest rate benchmarks, or the replacement of interest rate benchmarks with alternative, nearly risk-free interest rates that are based, to a greater extent, on transaction data (alternative benchmark rates). This has in turn led to uncertainty about the long-term viability of some interest rate benchmarks. In these amendments, the term 'interest rate benchmark reform' refers to the market-wide reform of an interest rate benchmark including its replacement with an alternative benchmark rate, such as that resulting from the FSB's recommendations set out in its July 2014 report 'Reforming Major Interest Rate Benchmarks' (the reform).*

* The report, 'Reforming Major Interest Rate Benchmarks', is available at http://www.fsb.org/wp-content/uploads/r_140722.pdf.

BC6.547 In 2018 the IASB noted the increasing levels of uncertainty about the long-term viability of some interest rate benchmarks and decided to address as a priority the issues affecting financial reporting in the period before the reform (referred to as pre-replacement issues).

BC6.548 As part of the pre-replacement issues, the IASB considered the implications for specific hedge accounting requirements in IFRS 9 and IAS 39, which require forward-looking analysis. As a result of the reform, contractual cash flows of hedged items and hedging instruments based on an existing interest rate benchmark will likely change when that interest rate benchmark is subject to the reform—in these amendments, contractual cash flows encompass both contractually specified and non-contractually specified cash flows. The same uncertainty arising from the reform regarding the timing and the amount of future cash flows will likely affect the changes in fair value of hedged items and hedging instruments in a fair value hedge of the interest rate benchmark exposure. Until decisions are made about what the alternative benchmark rate is, and when and how the reform will occur, including specifying its effects on particular contracts, uncertainties will exist regarding the timing and the amount of future cash flows of the hedged item and the hedging instrument.

BC6.549 The IASB noted that the hedge accounting requirements in IFRS 9 and IAS 39 provide a clear basis for accounting for such uncertainties. In applying these requirements, the uncertainties about the timing and the amount of future cash flows could affect an entity's ability to meet those specific forward-looking hedge accounting requirements in the period when uncertainty is created by the reform. In some cases, solely due to such uncertainties, entities could be required to discontinue hedge accounting for hedging relationships that would otherwise qualify for hedge accounting. Also, because of the uncertainties arising from the reform, entities may not be able to designate new hedging relationships that would otherwise qualify for hedge accounting applying IFRS 9 and IAS 39. In some cases, discontinuation of hedge accounting would require an entity to recognise gains or losses in profit or loss.

BC6.550 In the IASB's view, discontinuation of hedge accounting solely due to such uncertainties before the reform's economic effects on hedged items and hedging instruments are known would not provide useful information to users of financial statements. Therefore, the IASB decided to publish in May 2019 the Exposure Draft *Interest Rate Benchmark Reform* (2019 Exposure Draft), which proposed exceptions to IFRS 9 and IAS 39 to provide relief during this period of uncertainty.

BC6.551 The 2019 Exposure Draft proposed exceptions to specific hedge accounting requirements such that entities would apply those requirements assuming the interest rate benchmark on which the hedged risk and/or cash flows of the hedged item or of the hedging instrument are based is not altered as a result of the reform. The proposed exceptions applied only to the hedge accounting requirements specified in that Exposure Draft and were not intended to provide relief from all consequences arising from the reform.

BC6.552 Almost all respondents to the 2019 Exposure Draft agreed with the IASB's decision to address pre-replacement issues. Many highlighted the urgency of these issues, especially in some jurisdictions where there is already clear progress towards the reform or replacement of interest rate benchmarks with alternative benchmark rates.

BC6.553 In September 2019 the IASB amended IFRS 9, IAS 39 and IFRS 7 by issuing *Interest Rate Benchmark Reform*, which confirmed with modifications the proposals in the 2019 Exposure Draft. In the amendments issued in September 2019, the IASB added paragraphs 6.8.1–6.8.12 and 7.1.8 to IFRS 9 and amended paragraph 7.2.26 of IFRS 9.

BC6.554 The IASB decided to propose amendments to IAS 39 as well as IFRS 9 because when entities first apply IFRS 9, they are permitted to choose as an accounting policy to continue to apply the hedge accounting requirements of IAS 39. The IASB understands that a significant number of IFRS preparers—financial institutions in particular—have made such an accounting policy choice.

Scope of the exceptions

BC6.555 In the 2019 Exposure Draft, the IASB noted that the hedge accounting issues being addressed arise in the context of interest rate benchmark reform, and, therefore, the proposed exceptions would apply only to hedging relationships of interest rate risk that are affected by the reform. However, some respondents expressed the view that the scope of the exceptions, as set out in the 2019 Exposure Draft, would not include other types of hedging relationships that may be affected by uncertainties arising from the reform such as hedging relationships in which an entity designates cross-currency interest rate swaps to hedge its exposure to both foreign currency and interest rate risk. These respondents asked the IASB to clarify whether the scope of the exceptions was meant to include such hedging relationships.

BC6.556 In its redeliberations on the 2019 Exposure Draft, the IASB clarified that it did not intend to exclude from the scope of the amendments hedging relationships in which interest rate risk is not the only designated hedged risk. The IASB agreed with respondents that other hedging relationships could be directly affected by the reform when the reform gives rise to uncertainties about the timing or the amount of interest rate benchmark-based cash flows of the hedged item or of the hedging instrument. Therefore, the IASB confirmed that the exceptions would apply to the interest rate benchmark-based cash flows in these situations. The IASB noted that many derivatives, designated in hedging relationships in which there is no uncertainty about the timing or the amount of interest rate benchmark-based cash flows, could be indirectly affected by the reform. For example, this would be the case when the valuation of the derivatives is affected by general uncertainty in the market caused by the reform. The IASB confirmed that the exceptions do not apply to these hedging relationships, despite the indirect effect the uncertainties arising from the reform could have on the valuation of derivatives.

BC6.557 Consequently, the IASB clarified the wording in paragraph 6.8.1 of IFRS 9 to refer to all hedging relationships that are directly affected by interest rate benchmark reform. Paragraph 6.8.1 of IFRS 9 explains that a hedging relationship is directly affected by interest rate benchmark reform only if the reform gives rise to uncertainties about the interest rate benchmark (contractually or non-contractually specified) designated as a hedged risk and/or the timing or the amount of interest rate benchmark-based cash flows of the hedged item or of the hedging instrument. The scope of the exceptions does not exclude hedging relationships in which interest rate risk is not the only hedged risk.

Highly probable requirement

BC6.558 The IASB noted that, if an entity designates a forecast transaction as the hedged item in a cash flow hedge, applying paragraph 6.3.3 of IFRS 9, that transaction must be highly probable (highly probable requirement). This requirement is intended to ensure that changes in the fair value of designated hedging instruments are recognised in the cash flow hedge reserve only for those hedged forecast transactions that are highly probable to occur. This requirement is an important discipline in applying hedge accounting to forecast transactions. The IASB noted that the requirements in IFRS 9 provide a clear basis to account for the effects of the reform—that is, if the effects of the reform are such that the hedged cash flows are no longer highly probable, hedge accounting should be discontinued. As set out in paragraph BC6.550, in the IASB's view, discontinuing all affected hedging relationships solely due to such uncertainty would not provide useful information to users of financial statements.

BC6.559 Therefore, the IASB amended IFRS 9 to provide an exception to the highly probable requirement that would provide targeted relief during this period of uncertainty. More specifically, applying the exception, if the hedged future cash flows are based on an interest rate benchmark that is subject to the reform, an entity assumes that the interest rate benchmark on which the hedged cash flows are based is not altered when assessing whether the future cash flows are highly probable. If the hedged future cash flows are based on a highly probable forecast transaction, by applying the exception in paragraph 6.8.4 of IFRS 9 when performing the assessment of the highly probable requirement for that forecast transaction, the entity would assume that the interest rate benchmark on which the hedged cash flows are based will not be altered in the future contract as a result of the reform. For example, for a future issuance of a London Interbank Offered Rate (LIBOR)-referenced debt instrument, the entity would assume that the LIBOR benchmark rate on which the hedged cash flows are based will not be altered as a result of the reform.

BC6.560 The IASB noted that this exception does not necessarily result in an entity determining that the hedged cash flows are highly probable. In the example described in paragraph BC6.559, the entity assumed that the interest rate benchmark in the future contract would not be altered as a result of the reform when determining whether that forecast transaction is highly probable. However, if the entity decides not to issue the debt instrument because of uncertainty arising from the reform or for any other reason, the hedged future cash flows are no longer highly probable (and are no longer expected to occur). The exception would not permit or require the entity to assume otherwise. In this case, the entity would conclude that the LIBOR-based cash flows are no longer highly probable (and are no longer expected to occur).

BC6.561 The IASB also included an exception for discontinued hedging relationships. Applying this exception, any amount remaining in the cash flow hedge reserve when a hedging relationship is discontinued would be reclassified to profit or loss in the same period(s) during which the hedged cash flows affect profit or loss, based on the assumption that the interest rate benchmark on which the hedged cash flows are based is not altered as a result of the reform. If, however, the hedged future cash flows are no longer expected to occur for other reasons, the entity is required to immediately reclassify to profit or loss any amount remaining in the cash flow hedge reserve. In addition, the exception would not exempt entities from reclassifying the amount that is not expected to be recovered into profit or loss as required by paragraph 6.5.11(d)(iii) of IFRS 9.

Assessment of the economic relationship between the hedged item and the hedging instrument

BC6.562 Applying IFRS 9, a hedging relationship qualifies for hedge accounting only if there is an economic relationship between the hedged item and the hedging instrument.

BC6.563 Demonstrating the existence of an economic relationship requires the estimation of future cash flows because the assessment is prospective in nature. Interest rate benchmark reform could affect this assessment for hedging relationships that may extend beyond the timing of the reform. That is because entities would have to consider possible changes to the fair value or future cash flows of hedged items and hedging instruments to assess whether an economic relationship continues to exist between the hedged item and hedging instrument. Consequently, at some point in time, it is possible that entities would not be able to demonstrate the existence of an economic relationship solely because of uncertainties arising from the reform.

BC6.564 The IASB considered the usefulness of the information that would result from the potential discontinuation of hedge accounting for affected hedging relationships and decided to amend the requirements in IFRS 9 to provide an exception for assessing the economic relationship between the hedged item and the hedging instrument for the same reasons discussed in paragraph BC6.550.

BC6.565 Applying this exception, an entity shall assess whether the economic relationship as required by paragraph 6.4.1(c)(i) of IFRS 9 exists based on the assumption that the hedged risk or the interest rate benchmark on which the hedged item or the hedging instrument is based is not altered as a result of the reform. Similarly, if an entity designates a highly probable forecast transaction as the hedged item, the entity shall perform the assessment based on the assumption that the interest rate benchmark on which the hedged cash flows are based will not change as a result of the reform.

BC6.566 The IASB noted that an offset between the hedged item and the hedging instrument is a fundamental principle of the hedge accounting model in IFRS 9 and, therefore, the IASB considered it critical to maintain this principle. The exception addresses only the uncertainties arising from the reform. Therefore, if an entity is unable to demonstrate the existence of an economic relationship between the hedged item and the hedging instrument for other reasons, the entity shall discontinue hedge accounting as required by IFRS 9.

Measurement of ineffectiveness

BC6.567 The IASB noted that the exceptions were not intended to change the requirement that entities measure and recognise hedge ineffectiveness. The IASB considered that the actual results of the hedging relationships would provide useful information to users of financial statements during the period of uncertainty arising from the reform. Therefore, the IASB decided that entities should continue to measure and recognise hedge ineffectiveness as required by IFRS Standards.

BC6.568 The IASB also considered whether any exceptions should be made to the measurement of hedged items or hedging instruments because of the uncertainty arising from the reform. However, the IASB noted that such an exception would be inconsistent with the decision not to change the requirements to measure and recognise hedge ineffectiveness in the financial statements. Therefore, the IASB decided not to provide an exception from the measurement of hedging instruments and hedged items. This means that the fair value of a derivative designated as the hedging instrument should continue to be measured using the assumptions that market participants would use when pricing that derivative as required by IFRS 13 *Fair Value Measurement*.

BC6.569 For a hedged item designated in a fair value hedge, IFRS 9 requires an entity to remeasure the hedged item for changes in fair value attributable to the hedged risk and recognise the gain or loss related to that fair value hedge adjustment in profit or loss. In doing so, the entity uses the assumptions that market participants would use when pricing the hedged item for changes in fair value attributable to the hedged risk. This would include a risk premium for uncertainty inherent in the hedged risk that market participants would consider. For example, to measure changes in fair value attributable to the hedged risk such as the IBOR component of a fixed-rate loan, an entity needs to reflect the uncertainty caused by the reform. When applying a present value technique to calculate the changes in fair value attributable to the designated risk component, such measurement should reflect market participants' assumptions about the uncertainty arising from the reform.

BC6.570 When an entity designates interest rate benchmark-based cash flows as the hedged item in a cash flow hedge, to calculate the change in the value of the hedged item for the purpose of measuring hedge ineffectiveness, the entity may use a derivative that would have terms that match the critical terms of the designated cash flows and the hedged risk (this is commonly referred to as a 'hypothetical derivative'). As the IASB decided that entities should continue to measure and recognise hedge ineffectiveness as required by IFRS Standards, entities should continue to apply assumptions that are consistent with those applied to the hedged risk of the hedged item. For example, if an entity designated interest rate benchmark-based cash flows as the hedged item in a cash flow hedge, the entity would not assume for the purpose of measuring hedge ineffectiveness that the expected replacement of the interest rate benchmark with an alternative benchmark rate will result in zero cash flows after the replacement. The hedging gain or loss on the hedged item should be measured using the interest rate benchmark-based cash flows (that is, the cash flows on which the hypothetical derivative is based) when applying a present value technique, discounted at a market-based discount rate that reflects market participants' assumptions about the uncertainty arising from the reform. The IASB concluded that reflecting market participants' assumptions when measuring hedge ineffectiveness provides useful information to users of financial statements about the effects of the uncertainty arising from the reform on an entity's hedging relationships. Therefore, the IASB decided that no exceptions are needed for the measurement of actual ineffectiveness.

Hedges of risk components

BC6.571 The IASB noted that in accordance with IFRS 9 an entity may designate an item in its entirety or a component of an item as the hedged item in a hedging relationship. For example, an entity that issues a 5-year floating-rate debt instrument that bears interest at 3-month LIBOR + 1%, could designate as the hedged item either the entire debt instrument (that is, all of the cash flows) or only the 3-month LIBOR risk component of the floating-rate debt instrument. Specifically, paragraph 6.3.7(a) of IFRS 9 allows entities to designate only changes in the cash flows or fair value of an item attributable to a specific risk or risks (risk component) provided that the risk component is separately identifiable and reliably measurable.

BC6.572 The IASB observed that an entity's ability to conclude that an interest rate benchmark is a separately identifiable component in accordance with paragraph 6.3.7(a) of IFRS 9 requires a continuous assessment over the duration of the hedging relationship and could be affected by the reform. For example, if the outcome of the reform affects the market structure of an interest rate benchmark, it could affect an entity's assessment of whether a non-contractually specified LIBOR component is separately identifiable and, therefore, an eligible hedged item in a hedging relationship. The IASB considered only risk components that are implicit in the fair value or the cash flows of an item of which they are a part (referred to as non-contractually specified) because the same issue does not arise for risk components that are explicitly specified in the contract.

BC6.573 For the reasons outlined in paragraph BC6.550, the IASB noted that discontinuing hedging relationships due to uncertainty arising from the reform would not provide useful information. Consequently, the IASB decided to propose amending IFRS 9 so that entities would not discontinue hedge accounting solely because the risk component is no longer separately identifiable as a result of the reform. In the 2019 Exposure Draft, the IASB proposed that the separately identifiable requirement for hedges of the benchmark component of interest rate risk be applied only at the inception of those hedging relationships affected by the reform.

BC6.574 The IASB proposed not to extend the relief to allow entities to designate the benchmark component of interest rate risk as the hedged item in a new hedging relationship if the risk component is not separately identifiable at the inception of the hedging relationship. In the IASB's view, allowing hedge accounting for risk components that are not separately identifiable at the inception would be inconsistent with the objective of the exception. The IASB noted that such circumstances are different from allowing continued designation as the hedged item for risk components that had met the requirement at the inception of the hedging relationship.

BC6.575 Furthermore, the IASB did not propose any exception from the requirement that changes in the fair value or cash flows of the risk component must be reliably measurable. As noted in paragraph BC6.566, in the IASB's view, an offset between the hedged item and the hedging instrument is a fundamental principle of the hedge accounting model in IFRS 9 and, therefore, the IASB considered reliable measurement of the hedged item and the hedging instrument to be critical to maintain this principle.

BC6.576 Almost all respondents agreed with the exception proposed in the 2019 Exposure Draft to apply the separately identifiable requirement only at the inception of a hedging relationship. However, some respondents noted that the proposed exception did not provide equivalent relief to hedging relationships that frequently reset (ie discontinue and restart). In those hedging relationships both the hedging instrument and the hedged item frequently change (ie the entity uses a dynamic process in which both the hedged items and the hedging instruments used to manage that exposure do not remain the same for long). As hedging instruments and hedged items are being added or removed from a portfolio, entities are de-designating and redesignating hedging relationships regularly to adjust the exposure. If each redesignation of the hedging relationship is considered to be the inception of a new hedging relationship (even though it is still the same hedging strategy), then the separately identifiable requirement would need to be assessed for all hedged items at each redesignation even if they have been assessed previously. For the same reasons as those noted in paragraph BC6.572, this could affect an entity's ability to conclude that a non-contractually specified risk component remains separately identifiable and, therefore, an eligible hedged item for hedge accounting purposes.

BC6.577 The IASB noted that the exception proposed in the 2019 Exposure Draft has the effect that if a non-contractually specified risk component meets the separately identifiable requirement at the inception of a hedging relationship, then that requirement would not be reassessed subsequently. Hence, providing a similar exception for hedging relationships that frequently reset (ie discontinue and restart) would be consistent with the objective of the exception originally provided in the 2019 Exposure Draft.

BC6.578 Thus, the IASB confirmed the proposal that a risk component is only required to be separately identifiable at the inception of the hedging relationship. In addition, to respond to the feedback described in paragraph BC6.576, the IASB added the exception in paragraph 6.8.8 of IFRS 9 for hedging relationships that, consistent with an entity's hedge documentation, frequently reset (ie discontinue and restart) because both the hedging instrument and the hedged item frequently change. Applying that paragraph, an entity shall determine whether the risk component is separately identifiable only when it initially designates an item as a hedged item in the hedging relationship. The hedged item is not reassessed at any subsequent redesignation in the same hedging relationship.

BC6.579 In reaching its decision for the exception in paragraph 6.8.8 of IFRS 9 the IASB considered an example where an entity uses a dynamic process to manage interest rate risk as discussed in paragraph B6.5.24(b) of IFRS 9 and designates the LIBOR risk component of floating-rate loans as the hedged risk. At the inception of the relationship, the entity assesses whether LIBOR is a separately identifiable risk component for all loans designated within the hedging relationship. As the entity updates the risk position with the origination of new loans and the maturity or repayment of existing loans, the hedging relationship is adjusted by de-designating the 'old' hedging relationship and redesignating a 'new' hedging relationship for the updated amount of the hedged items. Applying the exception in paragraph 6.8.8 of IFRS 9 requires the entity to assess whether LIBOR is a separately identifiable risk component only for the new loans added to the hedging relationship. The entity would not reassess the separately identifiable requirement for the loans that have been redesignated.

Mandatory application

BC6.580 The IASB decided to require entities to apply the exceptions in Section 6.8 of IFRS 9 to all hedging relationships to which the exceptions are applicable. In other words, the IASB decided that an entity is required to apply the exceptions to all hedging relationships that are directly affected by the uncertainties arising from the reform and continue to apply the exceptions until required to cease their application as specified in paragraphs 6.8.9–6.8.12 of IFRS 9.

BC6.581 The IASB considered but rejected alternatives that would have allowed entities to apply the exceptions voluntarily. In the IASB's view, voluntary application of these exceptions could give rise to selective discontinuation of hedge accounting and selective reclassification of the amounts recorded in other comprehensive income related to previously discontinued hedging relationships. The IASB does not expect that requiring entities to apply the exceptions would entail significant cost for preparers and other affected parties because the exceptions require entities to assume that the interest rate benchmark, on which the hedged risk and the hedged cash flows, and cash flows of the hedging instrument are based, is not altered as a result of the reform.

BC6.582 In addition, the IASB observed that in some circumstances, the exceptions in Section 6.8 of IFRS 9 may not be applicable. For example, for a particular interest rate benchmark not subject to the reform or replacement with an alternative benchmark rate, there is no uncertainty affecting the timing or the amount of the interest rate benchmark-based cash flows arising from a hedged item or a hedging instrument. The exceptions set out in Section 6.8 of IFRS 9 would not be applicable to such a hedging relationship.

BC6.583 Furthermore, for a particular hedging relationship the exceptions may be applicable to some but not all aspects of the hedging relationship. For example, if an entity designates a hedged item that is based on LIBOR against a hedging instrument that is already referenced to an alternative benchmark rate (assuming the entity can demonstrate that hedging relationship meets the qualifying criteria for hedge accounting in IFRS 9), the exceptions in paragraphs 6.8.4 and 6.8.6 of IFRS 9 would apply for the hedged item because there is uncertainty related to its future cash flows. However, there is no uncertainty regarding how the reform would impact the cash flows of the hedging instrument and, therefore, the exception in paragraph 6.8.6 of IFRS 9 is not applicable for the hedging instrument. Similarly, the exception applicable to non-contractually specified components would not be relevant for hedging relationships that do not involve the designation of non-contractually specified risk components.

End of application

BC6.584 As described in paragraph BC6.550, the IASB decided to amend IFRS 9 to address specific aspects of hedge accounting affected by uncertainties in relation to the hedged items and hedging instruments about when the interest rate benchmarks will change to alternative benchmark rates, when any spread adjustment between the interest rate benchmark and the alternative benchmark rate will be determined (collectively, timing) and what the cash flows based on the alternative benchmark rate will be, including their frequency of reset, and any spread adjustment between the interest rate benchmark and the alternative benchmark rate (collectively, amount). Therefore, the IASB intended the exceptions set out in Section 6.8 of IFRS 9 to be available only while these uncertainties are present.

BC6.585 The IASB considered whether to provide an explicit end date for the exceptions but decided not to do so. The reform is following different timelines in different markets and jurisdictions and contracts are being modified at different times and, therefore, at this stage, it is not possible to define a period of applicability for the exceptions.

BC6.586 The IASB decided that an entity ceases applying the exceptions at the earlier of (a) when the uncertainty regarding the timing and the amount of interest rate benchmark-based cash flows is no longer present as it relates to a hedged item and/or hedging instrument (depending on the particular exception) and (b) the discontinuation of the hedging relationship.[*] The exceptions require entities to apply specific hedge accounting requirements assuming the interest rate benchmark on which the hedged risk, hedged cash flows or the cash flows of the hedging instrument are based is not altered as a result of the reform. The end of applicability of the exceptions means that entities would from that date apply all hedge accounting requirements in IFRS 9 without applying these exceptions.

BC6.587 In the IASB's view, for uncertainty regarding the timing and the amount of cash flows arising from a change in an interest rate benchmark to be eliminated, the underlying contracts are generally required to be amended to specify the timing and the amount of cash flows based on the alternative benchmark rate (and any spread adjustment between the interest rate benchmark and the alternative benchmark rate). The IASB noted that, in some cases, a contract may be amended to include reference to the alternative benchmark rate without actually altering the interest rate benchmark-based cash flows in the contract. Such an amendment may not eliminate the uncertainty regarding the timing and the amount of interest rate benchmark-based cash flows in the contract. The IASB considered the following scenarios to assess the robustness of the end of application requirements. However, these scenarios are not exhaustive and other scenarios may exist in which the uncertainties arising from the reform regarding the timing and the amount of cash flows would no longer be present.

BC6.588 Scenario A—a contract is amended to include a clause that specifies (a) the date the interest rate benchmark will be replaced by an alternative benchmark rate and (b) the alternative benchmark rate on which the cash flows will be based and the relevant spread adjustment between the interest rate benchmark and the alternative benchmark rate. In this case, the uncertainty regarding the timing and the amount of cash flows for this contract is eliminated when the contract is amended to include this clause.

BC6.589 Scenario B—a contract is amended to include a clause that states modifications of contractual cash flows will occur due to the reform but that specifies neither the date that the interest rate benchmark will be replaced nor the alternative benchmark rate on which the amended cash flows will be based. In this case, the uncertainty regarding the timing and the amount of cash flows for this contract has not been eliminated by amending the contract to include this clause.

[*] For the purpose of applying the exception in paragraph 6.8.5 of IFRS 9 to a discontinued hedging relationship, the amendments require an entity to cease applying the exception at the earlier of (a) as described above and (b) when the entire amount accumulated in the cash flow hedge reserve with respect to the hedging relationship has been reclassified to profit or loss. See paragraph 6.8.10 of IFRS 9.

BC6.590 Scenario C—a contract is amended to include a clause which states that conditions specifying the amount and timing of interest rate benchmark-based cash flows will be determined by a central authority at some point in the future. But the clause does not specify those conditions. In this case, the uncertainty regarding the timing and the amount of the interest rate benchmark-based cash flows for this contract has not been eliminated by including this clause in the contract. Uncertainty regarding both the timing and the amount of cash flows for this contract will be present until the central authority specifies when the replacement of the benchmark will become effective, and what the alternative benchmark rate and any related spread adjustment will be.

BC6.591 Scenario D—a contract is amended to include a clause in anticipation of the reform that specifies the date the interest rate benchmark will be replaced and any spread adjustment between the interest rate benchmark and the alternative benchmark rate will be determined. However, the amendment does not specify the alternative benchmark rate, or the spread adjustment between the interest rate benchmark and the alternative benchmark rate, on which the cash flows will be based. In this scenario, by amending the contract to include this clause, uncertainty regarding the timing has been eliminated but uncertainty about the amount remains.

BC6.592 Scenario E—a contract is amended to include a clause in anticipation of the reform that specifies the alternative benchmark rate on which the cash flows will be based and the spread adjustment between the interest rate benchmark and the alternative benchmark rate, but does not specify the date from which the amendment to the contract will become effective. In this scenario, by amending the contract to include this clause, uncertainty about the amount has been eliminated but uncertainty with respect to timing remains.

BC6.593 Scenario F—in preparation for the reform, a central authority in its capacity as the administrator of an interest rate benchmark undertakes a multi-step process to replace an interest rate benchmark with an alternative benchmark rate. The objective of the reform is to cease the publication of the current interest rate benchmark and replace it with an alternative benchmark rate. As part of the reform, the administrator introduces an interim benchmark rate and determines a fixed spread adjustment based on the difference between the interim benchmark rate and the current interest rate benchmark. Uncertainty about the timing or the amount of the alternative benchmark rate-based cash flows will not be eliminated during the interim period because the interim benchmark rate (including the fixed spread adjustment determined by the administrator) represent an interim measure in progressing towards the reform but it does not represent the alternative benchmark rate (or any related spread adjustment agreed between parties to the contract).

BC6.594 For reasons similar to those described in paragraph BC6.583, the IASB noted that there could be situations in which the uncertainty for particular elements of a single hedging relationship could end at different times. For example, assume an entity is required to apply the relevant exceptions to both the hedged item and the hedging instrument. If the hedging instrument in that hedging relationship is subsequently amended through market protocols covering all derivatives in that market, and will be based on an alternative benchmark rate such that the uncertainty about the timing and the amount of interest rate benchmark-based cash flows of the hedging instrument is eliminated, the relevant exceptions would continue to apply to the hedged item but would no longer apply to the hedging instrument.[*]

[*] In this scenario, the entity would first consider the accounting consequences of amending the contractual terms of the hedging instrument. The IASB will consider the accounting consequences of the actual amendment of financial instruments as a result of interest rate benchmark reform in the next phase of this project (ie the replacement phase).

BC6.595 The IASB observed that continuing to apply the exception after the uncertainty was resolved would not faithfully represent the actual characteristics of the elements of the hedging relationship in which the uncertainty arising from the reform is eliminated. The IASB considered whether it should extend the relief provided such that the exceptions would apply at the hedging relationship level for as long as any element of that hedging relationship was affected by the uncertainties arising from the reform. The IASB agreed that doing so would be beyond the objective of addressing only those issues directly affected by the uncertainty arising from the reform. This is also because the exceptions in paragraphs 6.8.4–6.8.12 of IFRS 9 and the respective requirements in IFRS 9 apply to the same elements of the hedging relationship. Therefore, applying each exception at the hedging relationship level would be inconsistent with how the underlying requirements are applied.

BC6.596 The IASB decided that the end of application requirement would also apply to hedges of a forecast transaction. The IASB noted that IFRS 9 requires an entity to identify and document a forecast transaction with sufficient specificity so that, when the transaction occurs, the entity is able to determine whether the transaction is the hedged transaction. For example, if an entity designates a future issuance of a LIBOR-based debt instrument as the hedged item, although there may be no contract at the time of designation, the hedge documentation would refer specifically to LIBOR. Consequently, the IASB concluded that entities should be able to identify when the uncertainty regarding the timing and the amount of the resulting cash flows of a forecast transaction is no longer present.

BC6.597 In addition, the IASB decided not to require end of application with respect to the exception for the separately identifiable requirements set out in paragraphs 6.8.7 and 6.8.8 of IFRS 9. Applying these exceptions, entities would continue applying hedge accounting when an interest rate benchmark meets the separately identifiable requirement at the inception of the hedging relationship (assuming all other hedge accounting requirements continue to be met). If the IASB included an end date for these exceptions, an entity may be required to immediately discontinue hedge accounting because, at some point, as the reform progresses, the component based on the interest rate benchmark may no longer be separately identifiable (for example, as the market for the alternative benchmark rate is established). Such immediate discontinuation of hedge accounting would be inconsistent with the objective of the exception. The IASB noted that linking the end of application for these exceptions to contract amendments would not achieve the IASB's intention either because, by definition, non-contractually specified risk components are not explicitly stated in a contract and, therefore, these contracts may not be amended for the reform. This is particularly relevant for fair value hedges of a fixed-rate debt instrument. Therefore, the IASB decided that an entity should cease applying the exceptions to a hedging relationship only when the hedging relationship is discontinued applying IFRS 9.

BC6.598 Some respondents to the 2019 Exposure Draft noted that the IASB had not addressed when an entity ceases applying the proposed exceptions to a group of items designated as the hedged item or a combination of financial instruments designated as the hedging instrument. Specifically, when assessing whether the uncertainty arising from the reform is no longer present, these respondents asked whether that assessment should be performed on an individual basis (that is, for each individual item within the group or financial instrument within the combination) or on a group basis (that is, for all items in the group or all financial instruments in the combination until there is no uncertainty surrounding any of the items or financial instruments).

BC6.599 Consequently, the IASB decided to add paragraph 6.8.12 of IFRS 9 to clarify that, when designating a group of items as the hedged item or a combination of financial instruments as the hedging instrument, entities assess when the uncertainty arising from the reform with respect to the hedged risk and/or the timing and amount of the interest rate benchmark-based cash flows of that item or financial instrument is no longer present on an individual basis—that is, for each individual item in the group or financial instrument in the combination.

Effective date and transition

BC6.600 The IASB decided that entities shall apply the amendments for annual periods beginning on or after 1 January 2020, with earlier application permitted.

BC6.601 The IASB decided that the amendments apply retrospectively. The IASB highlighted that retrospective application of the amendments would not allow reinstating hedge accounting that has already been discontinued. Nor would it allow designation in hindsight. If an entity had not designated a hedging relationship, the exceptions, even though applied retrospectively, would not allow the entity to apply hedge accounting in prior periods to items that were not designated for hedge accounting. Doing so would be inconsistent with the requirement that hedge accounting applies prospectively. Retrospective application of the exceptions would enable entities to continue hedge accounting for a hedging relationship that the entity had previously designated and that qualifies for hedge accounting applying IFRS 9.

BC6.602 Many respondents to the 2019 Exposure Draft commented on the clarity of the proposed retrospective application and suggested that further explanation be provided in the Standard. Consequently, the IASB amended the transition paragraph to specify that retrospective application applies only to those hedging relationships that existed at the beginning of the reporting period in which an entity first applies those requirements or were designated thereafter, and to the amount accumulated in the cash flow hedge reserve that existed at the beginning of the reporting period in which an entity first applies those requirements. The IASB used this wording to permit an entity to apply the amendments from the beginning of the reporting period in which an entity first applies these amendments even if the reporting period is not an annual period.

BC6.603 The IASB noted that these amendments would also apply to entities adopting IFRS Standards for the first time as required by IFRS 1 *First-time Adoption of International Financial Reporting Standards*. Accordingly, the IASB did not provide specific transition provisions for those entities.

Effective date and transition (Chapter 7)

Effective date

Requirements issued in IFRS 9 (2009)

BC7.1 The IASB recognises that many countries require time for translation and for introducing the mandatory requirements into law. In addition, entities require time to implement new standards. The IASB usually sets an effective date of between six and eighteen months after issuing a Standard. However, the IASB has adopted a phased approach to publishing IFRS 9, so this is not possible.

BC7.2 In the response to the 2009 Classification and Measurement Exposure Draft, respondents urged that:

(a) it would be helpful to preparers if the IASB were to permit all phases of the project to replace IAS 39 to be adopted at the same time.

(b) it would be helpful to entities that issue insurance contracts if the effective date of IFRS 9 were aligned with the forthcoming Standard on accounting for insurance contracts. Most of an insurer's assets are financial assets and most of its liabilities are insurance liabilities or financial liabilities. Thus, if an insurer applies IFRS 9 before it applies any new Standard on insurance contracts, it might face two rounds of major changes in a short period. This would be disruptive for both users and preparers.

comprehensive income the 'own credit' gains or losses on financial liabilities designated under the fair value option without early applying the other requirements of IFRS 9. However, at the time, the IASB noted that its decision to incorporate the possibility to apply early only the own credit requirements into the final version of IFRS 9 instead of IFRS 9 (2010) and later versions, was based on the expectation that there would not be a significant delay in the completion of IFRS 9. In other words, the IASB believed that the own credit requirements would be available for early application at roughly the same time under both approaches. However, the IASB noted that by exposing the proposals as part of the 2012 Limited Amendments Exposure Draft, it would be possible to change this approach if necessary.

BC7.38 Nearly all respondents to the 2012 Limited Amendments Exposure Draft supported the proposal that an entity would be permitted to early apply only the own credit requirements in IFRS 9 without applying any other requirements of IFRS 9 at the same time. However, most of these respondents also asked the IASB to make these requirements available for early application before the IFRS 9 project is completed and the final Standard is issued. Many of these respondents suggested that this could be accomplished by incorporating the own credit requirements into IAS 39, whereas others suggested incorporating the requirements into IFRS 9 (2010) and later versions.

BC7.39 During the redeliberations the IASB confirmed the proposal in the 2012 Limited Amendments Exposure Draft that the own credit requirements should be made available for early application without early applying the other requirements of IFRS 9. However, in order to respond to the feedback that the own credit requirements should be made available as soon as possible, the IASB decided to incorporate those requirements into IFRS 9 (2010) and later versions. The IASB also confirmed its previous decision not to incorporate the own credit requirements into IAS 39 because that Standard is being replaced by IFRS 9.

BC7.40 Although the topic was not within the scope of the 2012 Limited Amendments Exposure Draft, some respondents asked the IASB to reconsider the requirements in IFRS 9 that prohibit an entity from reclassifying (recycling) own credit gains or losses to profit or loss when the financial liability is derecognised. The IASB noted that it is currently discussing the objective of other comprehensive income, including whether amounts should be recycled to profit or loss (and if so, when), in its project on the Conceptual Framework and therefore the IASB noted that it would be inappropriate to reconsider those requirements in IFRS 9 before it completes that work.[*]

Transition related to the hedge accounting requirements

BC7.41 IAS 8 states that retrospective application results in the most useful information to users of the financial statements. IAS 8 also states that retrospective application is the preferred approach to transition, unless such retrospective application is impracticable. In such a scenario the entity adjusts the comparative information from the earliest date practicable. In conformity with these requirements, the classification and measurement chapters of IFRS 9 require retrospective application (with some relief in particular circumstances).

BC7.42 The proposals in the 2010 Hedge Accounting Exposure Draft were a significant change from the requirements in IAS 39. However, in accordance with the proposals, a hedge accounting relationship could be designated only prospectively. Consequently, retrospective application was not applicable. This reflects that retrospective application gives rise to similar concerns about using hindsight as retrospective designation of hedging relationships, which is prohibited.

BC7.43 In developing the transition requirements proposed in the 2010 Hedge Accounting Exposure Draft, the IASB considered two alternative approaches:

(a) prospective application only for new hedging relationships; or

(b) prospective application for all hedging relationships.

[*] In 2018 the IASB issued a revised *Conceptual Framework for Financial Reporting.*

DO6 Investors have often told both the IASB and the FASB that fair value of financial instruments recognised in profit or loss provides the most useful information for their purposes. There is a worldwide demand for an improved and common solution to the accounting for financial instruments. Investors are disappointed that the Board will not take this opportunity to make, with other standard-setters, truly substantive changes rather than these minimal changes that perpetuate all the legitimate concerns that have been expressed about the mixed attribute model.

DO7 IFRS 9 does to some extent reduce complexity but that reduction is minimal. Certain measurement classifications are eliminated but others have been added. Mr Leisenring does not think that, on balance, this is an improvement over IAS 39.

DO8 Fundamental to IFRS 9 is the distinction between financial instruments measured at amortised cost and those at fair value. Mr Leisenring is concerned that neither of the two conditions necessary for that determination is operational. Paragraph BC4.86 criticises IAS 39 because the embedded derivative requirement of that Standard is based on a list of examples. However, the basic classification model of IFRS 9 is based on lists of examples in paragraphs B4.1.4, B4.1.13 and B4.1.14. The examples are helpful but are far from exhaustive of the issues that will be problematic in applying the two criteria for classification at amortised cost.

DO9 Mr Leisenring also thinks that the two criteria are inconsistently applied. When the objective of the entity's business model is to hold the assets to collect the contracted cash flows of an instrument there is no requirement that the entity must actually do so. The cash flow characteristics of the instrument are also ignored when the guidance is applied to investments in contractually linked instruments (tranches). In those circumstances the contractual cash flows of the instrument are ignored and one is required to look through to the composition of assets and liabilities of the issuing entity. This 'look through' requirement is also potentially complex and in Mr Leisenring's opinion is likely to be not very operational. Mr Leisenring also objects to eliminating the requirement to bifurcate derivatives embedded in cash instruments. This objection is primarily because of concern that the two criteria to qualify for amortised cost will not be operational. The pressure on those two conditions will be enormous because there will be an incentive to embed derivatives in a cash instrument in anticipation that the instrument might qualify for amortised cost. Derivatives should be at fair value whether embedded or standing alone and a bifurcation requirement would achieve that accounting. If Mr Leisenring were confident that the criteria for amortised cost could be applied as intended he would not be as concerned because instruments with embedded derivatives would be at fair value in their entirety.

DO10 Mr Leisenring is concerned that, in the current crisis, instruments that have provided some of the most significant losses when measured at fair value would be eligible for amortised cost. That conclusion is not responsive to the present environment. The approach also allows actively traded debt instruments, including treasury securities, to be at amortised cost. These results are unacceptable and reduce the usefulness of reported information for investors.

DO11 The Board is required by its *Framework*[57] to be neutral in its decision-making and to strive to produce neutral information to maximise the usefulness of financial information. IFRS 9 fails in that regard because it produces information based on free choice, management intention and management behaviour. Reporting that will result from this approach will not produce neutral information and diminishes the usefulness of financial reporting.

DO12 The Board is insistent in paragraph BC4.20 that accounting based on a business model is not free choice but never explains why selection of a business model is not a management choice. The existence of a trading account, a fair value option and the objective of a business model are all free choices.

DO13 The classification of selected equity instruments at fair value with the result of the remeasurement reported outside profit or loss is also a free choice. The Board concludes that reporting fair value

[57] The reference to the *Framework* is to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the ~~IASB~~ Board in 2001 and in effect when the Standard was developed. ~~In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.~~

HKFRS 10 BC
Revised ~~September 2018~~August 2020

Basis for Conclusions on
Hong Kong Financial Reporting Standard 10

Consolidated Financial Statements

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Accounting requirements

Consolidation procedures

BC154 The application requirements in IFRS 10 explain how potential voting rights should be accounted for in the consolidated financial statements. Paragraphs B89–B91 replace the guidance previously included in the implementation guidance accompanying IAS 27, but are not intended to change consolidation procedures.

Non-controlling interests (2003 revision and 2008 amendments)

BCZ155 The 2008 amendments to IAS 27 changed the term 'minority interest' to 'non-minority interest'. The change in terminology reflects the fact that the owner of a minority interest in an entity might control that entity and, conversely, that the owners of a majority interest in an entity might not control the entity. 'Non-controlling interest' is a more accurate description than 'minority interest' of the interest of those owners who do not have a controlling interest in an entity.

BCZ156 Non-controlling interest was defined in IAS 27 as the equity in a subsidiary not attributable, directly or indirectly, to a parent (this definition is now in IFRS 10). Paragraph 26 of IAS 27 (as revised in 2000) required minority (non-controlling) interests to be presented in the consolidated balance sheet (statement of financial position) separately from liabilities and the equity of the shareholders of the parent.

BCZ157 As part of its revision of IAS 27 in 2003, the Board amended this requirement to require minority (non-controlling) interests to be presented in the consolidated statement of financial position within equity, separately from the equity of the shareholders of the parent. The Board concluded that a minority (non-controlling) interest is not a liability because it did not meet the definition of a liability in the *Framework for the Preparation and Presentation of Financial Statements* ~~(replaced in 2010 by the *Conceptual Framework for Financial Reporting*)~~.[*]

BCZ158 Paragraph 49(b) of the *Framework* ~~(now paragraph 4.4(b) of the *Conceptual Framework*)~~ stated that a liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. Paragraph 60 of the *Framework* ~~(now paragraph 4.15 of the *Conceptual Framework*)~~ explained that an essential characteristic of a liability is that the entity has a present obligation and that an obligation is a duty or responsibility to act or perform in a particular way. The Board noted that the existence of a minority (non-controlling) interest in the net assets of a subsidiary does not give rise to a present obligation, the settlement of which is expected to result in an outflow of economic benefits from the group.

BCZ159 Instead, the Board noted that minority (non-controlling) interests represent the residual interest in the net assets of those subsidiaries held by some of the shareholders of the subsidiaries within the group, and therefore met the *Framework*'s definition of equity. Paragraph 49(c) of the *Framework* ~~(now paragraph 4.4(c) of the *Conceptual Framework*)~~ stated that equity is the residual interest in the assets of the entity after deducting all its liabilities.

[*] References to the *Framework* in this Basis for Conclusions are to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the Board in 2001 and in effect when the Standard was revised and amended.

Dissenting opinions

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

Cross-references have been updated.

DO1 Mr Yamada dissents from this Standard because he believes that the change in classification of minority interests in the consolidated balance sheet, that is to say, the requirement that it be shown as equity, should not be made as part of the Improvements project. He agrees that minority interests do not meet the definition of a liability under the *Framework for the Preparation and Presentation of Financial Statements*,* as stated in paragraph BCZ158 of the Basis for Conclusions, and that the current requirement, for minority interests to be presented separately from liabilities and the parent shareholders' equity, is not desirable. However, he does not believe that this requirement should be altered at this stage. He believes that before making the change in classification, which will have a wide variety of impacts on current consolidation practices, various issues related to this change need to be considered comprehensively by the Board. These include consideration of the objectives of consolidated financial statements and the accounting procedures that should flow from those objectives. Even though the Board concluded as noted in paragraph BC27, he believes that the decision related to the classification of minority interests should not be made until such a comprehensive consideration of recognition and measurement is completed.†

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

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

* The reference is to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, ~~was~~ adopted by the ~~IASB~~Board in 2001 and in effect when the Standard was revised. ~~In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.~~

† Paragraph BC27 of the Basis for Conclusions on IAS 27 (as revised in 2003) was deleted as part of the amendments to IAS 27 in 2008. The paragraph stated:

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

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

DO7 In addition, Messrs Danjou and Gélard observe that IFRS 3 *Business Combinations* (as revised in 2008) provides an option to measure non-controlling interests in a business combination as their proportionate share of the acquiree's net identifiable assets rather than at their fair value. However, paragraph BC207 of the Basis for Conclusions on IFRS 3 (as revised in 2008) states that accounting for the non-controlling interests at fair value is conceptually superior to this alternative measurement. This view implies that the subsidiary's portion of goodwill attributable to the non-controlling interests at the date when control was obtained is an asset at that date and there is no conceptual reason for it no longer to be an asset at the time of any subsequent acquisitions of non-controlling interests.

DO8 Mr Garnett disagrees with the treatment of changes in controlling interests in subsidiaries after control is established (paragraphs BCZ168–BCZ179 of the Basis for Conclusions). He believes that it is important that the consequences of such changes for the owners of the parent entity are reported clearly in the financial statements.

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

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

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* The reference is to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, ~~was~~ adopted by the ~~IASB~~Board in 2001 and in effect when the Standard was amended. ~~In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.~~

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Basis for Conclusions on
Hong Kong Financial Reporting Standard 12

Disclosure of Interests in Other Entities

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extent and financial effects of an entity's interests in joint arrangements and associates, and the nature of the risks associated with those interests.

Nature, extent and financial effects of interests in joint arrangements and associates

BC44 In response to requests from users of financial statements, the Board proposed in ED 9 that an entity should disclose a list and description of investments in significant joint ventures and associates. Respondents to ED 9 generally welcomed the proposal. The Board decided to carry the proposals forward into IFRS 12 with some modifications as described in paragraphs BC45 and BC46.

BC45 The Board decided to require the information for joint arrangements and associates that are material to the reporting entity rather than for significant joint arrangements and associates. The *Conceptual Framework for Financial Reporting* (*Conceptual Framework*)* defines materiality whereas the term 'significant' is undefined and can be interpreted differently. Consequently, the Board decided to replace 'significant' with 'material', which is also used in IFRS 3. The Board noted that materiality should be assessed in relation to an entity's consolidated financial statements or other primary financial statements in which joint ventures and associates are accounted for using the equity method.

BC46 In addition, the Board noted that ED 9 unintentionally changed the application of the requirement in IAS 31 to provide a description of interests in all joint arrangements to interests in joint ventures only. As such, the Board modified the requirement so that it would continue to be required for all joint arrangements that are material to an entity.

Summarised financial information

BC47 IAS 28 and IAS 31 required disclosure of aggregated summarised financial information relating to joint ventures and associates. In response to requests from users of financial statements, ED 9 proposed to expand the requirements so that summarised financial information would be provided for each joint venture that is material to an entity.

BC48 Respondents to ED 9 generally agreed that summarised financial information should be provided. Some had concerns about confidentiality when providing summarised financial information on an individual basis for some joint ventures that were established to implement a single project. Others, including users of financial statements, were concerned that the elimination of proportionate consolidation would result in a loss of information. They therefore requested more detailed disclosures so that the effect of joint ventures on the activities of an entity could be better understood. They stated that there was a need for a detailed breakdown of current assets and current and non-current liabilities (in particular, cash and financial liabilities excluding trade payables and provisions), which would help users understand the net debt position of joint ventures. These users also highlighted the need for a more detailed breakdown of amounts presented in the statement of comprehensive income (such as depreciation and amortisation) that would help when valuing an entity's investment in a joint venture.

* References to the *Conceptual Framework* in this Basis for Conclusions are to the *Conceptual Framework for Financial Reporting*, issued in 2010 and in effect when the Standard was developed.

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Effective for annual periods beginning
on or after 1 January 2016

Hong Kong Financial Reporting Standard 14

Regulatory Deferral Accounts

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Changes in accounting policies

13 **An entity shall not change its accounting policies in order to start to recognise regulatory deferral account balances. An entity may only change its accounting policies for the recognition, measurement, impairment and derecognition of regulatory deferral account balances if the change makes the financial statements more relevant to the economic decision-making needs of users and no less reliable[1] , or more reliable and no less relevant to those needs. An entity shall judge relevance and reliability using the criteria in paragraph 10 of HKAS 8.**

14 This Standard does not exempt entities from applying paragraphs 10 or 14–15 of HKAS 8 to changes in accounting policy. To justify changing its accounting policies for regulatory deferral account balances, an entity shall demonstrate that the change brings its financial statements closer to meeting the criteria in paragraph 10 of HKAS 8. However, the change does not need to achieve full compliance with those criteria for the recognition, measurement, impairment and derecognition of regulatory deferral account balances.

15 Paragraphs 13–14 apply both to changes made on initial application of this Standard and to changes made in subsequent reporting periods.

Interaction with other Standards

16 **Any specific exception, exemption or additional requirements related to the interaction of this Standard with other Standards are contained within this Standard (see paragraphs B7–B28). In the absence of any such exception, exemption or additional requirements, other Standards shall apply to regulatory deferral account balances in the same way as they apply to assets, liabilities, income and expenses that are recognised in accordance with other Standards.**

17 In some situations, another Standard might need to be applied to a regulatory deferral account balance that has been measured in accordance with an entity's accounting policies that are established in accordance with paragraphs 11–12 in order to reflect that balance appropriately in the financial statements. For example, the entity might have rate-regulated activities in a foreign country for which the transactions and regulatory deferral account balances are denominated in a currency that is not the functional currency of the reporting entity. The regulatory deferral account balances and the movements in those balances are translated by applying HKAS 21 *The Effects of Changes in Foreign Exchange Rates*.

Presentation

Changes in presentation

18 This Standard introduces presentation requirements, outlined in paragraphs 20–26, for regulatory deferral account balances that are recognised in accordance with paragraphs 11–12. When this Standard is applied, the regulatory deferral account balances are recognised in the statement of financial position in addition to the assets and liabilities that are recognised in accordance with other Standards. These presentation requirements separate the impact of recognising regulatory deferral account balances from the financial reporting requirements of other Standards.

[1] In ~~October~~ 2010, the HKICPA replaced the *Framework for the Preparation and Presentation of Financial Statements* (*Framework*) with the *Conceptual Framework for Financial Reporting* (*Conceptual Framework*). The term "faithful representation", which was used in the *Conceptual Framework* issued in 2010 and is also used in the revised version of the *Conceptual Framework* issued in 2018, encompasses the main characteristics that the ~~previous~~ *Framework* called "reliability". The requirement in paragraph 13 of this Standard is based on the requirements of HKAS 8, which retains the term "reliable".

HKFRS 14 BC

~~Issued February 2014~~Revised August 2020

Basis for Conclusions on
Hong Kong Financial Reporting Standard 14

Regulatory Deferral Accounts

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Basis for Conclusions on IFRS 14 *Regulatory Deferral Accounts*

This Basis for Conclusions accompanies, but is not part of, IFRS 14.

Introduction

BC1 This Basis for Conclusions summarises the considerations of the International Accounting Standards Board (IASB) in reaching the conclusions in IFRS 14 *Regulatory Deferral Accounts*. Individual IASB members gave greater weight to some factors than to others.

BC2 The IASB and the IFRS Interpretations Committee (the 'Interpretations Committee') received several requests for guidance on whether rate-regulated entities can or should recognise, in their IFRS financial statements, a regulatory deferral or variance account debit or credit balance as a result of price or rate regulation by regulatory bodies or governments. Some national accounting standard-setting bodies permit or require such balances to be recognised as assets and liabilities under some circumstances, depending on the type of rate regulation in force. In such cases, these regulatory deferral account balances are often referred to as 'regulatory assets' and 'regulatory liabilities'. However, as explained in this Basis for Conclusions (see paragraphs BC11–BC12 and BC21), the term 'regulatory deferral account balances' has been chosen as a neutral descriptor for these items for the purpose of this Standard.

BC3 US generally accepted accounting principles (US GAAP) have recognised the economic effect of certain types of rate regulation since at least 1962. In 1982, the US national standard-setter, the Financial Accounting Standards Board (FASB) issued SFAS 71 *Accounting for the Effects of Certain Types of Regulation*.[1] SFAS 71 formalised many of those principles. In the absence of specific national guidance, practice in many other jurisdictions followed SFAS 71. In the financial statements of rate-regulated entities that apply such guidance, regulatory deferral account balances are often incorporated into the carrying amount of items such as property, plant and equipment and intangible assets, or are recognised as separate items in the financial statements.

BC4 In June 2005, the Interpretations Committee received a request about SFAS 71. The request asked whether an entity could apply SFAS 71 in accordance with the hierarchy in paragraphs 10–12 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* when selecting an accounting policy in the absence of specific guidance in IFRS.

BC5 The Interpretations Committee previously discussed the possible recognition of regulatory deferral account debit balances as part of its project on service concessions. As a result of its consideration at that time, the Interpretations Committee concluded that "entities applying IFRS should recognise only assets that qualified for recognition in accordance with the IASB's *Framework for the Preparation and Presentation of Financial Statements*[2] … and relevant accounting standards, such as IAS 11 *Construction Contracts*, IAS 18 *Revenue*, IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*." In other words, the Interpretations Committee thought that an entity should recognise 'regulatory assets' only to the extent that they meet the criteria to be recognised as assets in accordance with existing IFRS.

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1 The guidance in SFAS 71, together with subsequent amendments and related guidance, has now been incorporated into Topic 980 *Regulated Operations* in the FASB *Accounting Standards Codification*®.

2 The reference is to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the IASB in 2001 and in effect when the Interpretations Committee discussed this matter.~~In September 2010, the IASB replaced the *Framework for the Preparation and Presentation of Financial Statements* with the *Conceptual Framework for Financial Reporting*. The definitions of assets and liabilities and the criteria for recognising them in the statement of financial position were unchanged.~~

BC6 The Interpretations Committee concluded that the recognition criteria in SFAS 71 were not fully consistent with the recognition criteria in IFRS. Applying the guidance in SFAS 71 would result in the recognition of regulatory deferral account balances under certain circumstances that would not meet the recognition criteria of relevant Standards. Consequently, the requirements of SFAS 71 were not indicative of the requirements of IFRS. The Interpretations Committee decided not to add a project on regulatory assets to its agenda.

BC7 In January 2008, the Interpretations Committee received a second request to consider whether rate-regulated entities could or should recognise a regulatory liability (or a regulatory asset) as a result of rate regulation by regulatory bodies or governments. The Interpretations Committee again decided not to add the issue to its agenda for several reasons. Importantly, it concluded that divergence did not seem to be significant in practice for entities that were applying IFRS. The established practice of almost all entities is to eliminate regulatory deferral account balances when IFRS is adopted and not to recognise such balances in IFRS financial statements. However, the Interpretations Committee also noted that rate regulation is widespread and significantly affects the economic environment of many entities.

BC8 The IASB noted the ongoing requests for guidance on this issue. It also considered the comments that had been received on the Interpretations Committee's tentative agenda decisions. Those comments pointed out that although divergence in IFRS practice did not exist, several jurisdictions whose local accounting principles permitted or required the recognition of regulatory deferral account balances would be adopting IFRS in the near future. This would increase pressure for definitive guidance on the recognition of regulatory deferral account balances as assets or liabilities.

BC9 Consequently, in December 2008, the IASB added a project on rate-regulated activities to its agenda and subsequently, in July 2009, published an Exposure Draft Rate-regulated Activities (the '2009 ED'). The responses to the 2009 ED raised complex and fundamental issues at a conceptual level. In September 2010, the IASB decided that the complex technical issues could not be resolved quickly, and suspended the project until it had considered whether to include rate-regulated activities in its future agenda. The 2011 Agenda Consultation asked stakeholders to provide their views as to which projects the IASB should give priority.[3] The responses to this consultation, received through comment letters and other outreach activities, persuaded the IASB to prioritise addressing the unresolved issues related to rate-regulated activities.

BC10 As a result of its agenda-setting process, in September 2012 the IASB decided to add to its agenda a comprehensive project on rate-regulated activities to investigate these complex issues. In addition, the *Conceptual Framework for Financial Reporting* (the *'Conceptual Framework'*)[4] is currently being reviewed and updated. The outcome of the Rate-regulated Activities project will be influenced by the outcome of the *Conceptual Framework* project. The initial objective is to develop a Discussion Paper for each of these projects, which the IASB hopes will provide a basis for developing guidance in the long term.[4] It also decided, in December 2012, to develop an interim Standard on the accounting for regulatory deferral accounts that would apply until the completion of the comprehensive project. This Standard is the result of that decision.

Reasons for issuing this Standard

BC11 Many rate-regulated entities think that recognising regulatory deferral account balances as assets and liabilities would provide more relevant information and would provide a more faithful representation of their rate-regulated activities than the established practice in IFRS

[3] In July 2011, the IASB published a formal Request for Views document to provide a channel for formal public input on the broad aspects of our agenda-setting process.

[4] References to the *Conceptual Framework* in this Basis for Conclusions are to the *Conceptual Framework for Financial Reporting*, issued in 2010 and in effect when the Standard was developed.

[4] ~~The IASB published, in July 2013, the Discussion Paper *A Review of the Conceptual Framework for Financial Reporting*. The deadline for comments was 14 January 2014.~~

Gomes and Zhang are concerned that developing an interim solution in this situation might create uncertainty as to what the IASB's approach might be when major projects are being researched in the future.

Recognition is contrary to the *Conceptual Framework for Financial Reporting*

DO6 Messrs Gomes and Zhang also disagree with permitting regulatory deferral account balances to be recognised in the statement of financial position because they do not think that all such balances meet the definitions of assets and liabilities in the IASB's *Conceptual Framework*.[5] This is one of the issues that the comprehensive Rate-regulated Activities project is looking to resolve. Consequently, the IASB has stated that IFRS 14 does not anticipate the outcome of the comprehensive project, and uses the neutral term 'regulatory deferral account balances' instead of 'regulatory assets' and 'regulatory liabilities' (see paragraph BC21). However, Messrs Gomes and Zhang believe that permitting them to be included in the statement of financial position is equivalent to recognising them as assets and liabilities, which, in their view, is contrary to the current accounting principles in the *Conceptual Framework* and the application of existing Standards.

DO7 In addition, Messrs Gomes and Zhang are concerned that allowing regulatory deferral account balances to be recognised in the financial statements is contrary to the IASB's objectives of requiring high-quality, transparent and comparable information in financial statements by requiring similar transactions and events to be accounted for and reported in a similar way. The IASB acknowledges that rate regulators have different objectives for regulatory reporting than the IASB has for financial reporting. In the view of Messrs Gomes and Zhang, allowing regulatory deferral account balances to be recognised will effectively allow the objectives of the rate regulator(s) to take precedence over the objectives of general purpose financial reporting, as expressed in the *Conceptual Framework*. In particular, they believe that allowing regulatory deferral account balances to be recognised effectively allows the objectives of the rate regulator(s) for setting rates and smoothing out the volatility, which results from real economic events, to be reflected in the financial statements. Messrs Gomes and Zhang think that this is inconsistent with paragraph OB17 of the *Conceptual Framework*, which notes the importance of depicting the effects of transactions and other events and circumstances on a reporting entity's economic resources and claims in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period.

[5] References to the *Conceptual Framework* in this Dissent are to the *Conceptual Framework for Financial Reporting*, issued in 2010 and in effect when the Standard was developed.

HKFRS 15 BC
Revised ~~July 2019~~August 2020

Basis for Conclusions on
Hong Kong Financial Reporting Standard 15

Revenue from Contracts with Customers

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(c) for IFRS, changes in the value of biological assets, investment properties and the inventory of commodity broker-traders; and

(d) for US GAAP, changes in regulatory assets and liabilities arising from alternative revenue programmes for rate-regulated entities in the scope of Topic 980 on regulated operations. (The FASB decided that the revenue arising from those assets or liabilities should be presented separately from revenue arising from contracts with customers. Therefore, the FASB made amendments to Subtopic 980-605 *Regulated Operations—Revenue Recognition*.)

BC29 The boards decided not to amend the existing definitions of revenue in each of their conceptual frameworks. The boards decided that they will consider the definition of revenue when they revise their respective conceptual frameworks. However, the IASB decided to carry forward into IFRS 15 the description of revenue from the IASB's *Conceptual Framework for Financial Reporting*[*] rather than the definition of revenue from a previous revenue Standard. The IASB noted that the definition in a previous revenue Standard referred to 'gross inflow of economic benefits' and it had concerns that some might have misread that reference as implying that an entity should recognise as revenue a prepayment from a customer for goods or services. As described in paragraphs BC17–BC24, the principle is that revenue is recognised in accordance with IFRS 15 as a result of an entity satisfying a performance obligation in a contract with a customer. In addition, the FASB decided to carry forward a definition of revenue that is based on the definition in FASB Concepts Statement No. 6 *Elements of Financial Statements*.

BC30 The converged definitions of a contract and a customer establish the scope of IFRS 15.

Definition of a contract (Appendix A)

BC31 The boards' definition of contract is based on common legal definitions of a contract in the United States and is similar to the definition of a contract used in IAS 32 *Financial Instruments: Presentation*. The IASB decided not to adopt a single definition of a contract for both IAS 32 and IFRS 15, because the IAS 32 definition implies that contracts can include agreements that are not enforceable by law. Including such agreements would have been inconsistent with the boards' decision that a contract with a customer must be enforceable by law for an entity to recognise the rights and obligations arising from that contract. The IASB also noted that amending the IAS 32 definition would have posed the risk of unintended consequences in accounting for financial instruments.

BC32 The definition of a contract emphasises that a contract exists when an agreement between two or more parties creates enforceable rights and obligations between those parties. The boards noted that the agreement does not need to be in writing to be a contract. Whether the agreed-upon terms are written, oral or evidenced otherwise (for example, by electronic assent), a contract exists if the agreement creates rights and obligations that are enforceable against the parties. Determining whether a contractual right or obligation is enforceable is a question to be considered within the context of the relevant legal framework (or equivalent framework) that exists to ensure that the parties' rights and obligations are upheld. The boards observed that the factors that determine enforceability may differ between jurisdictions. Although there must be enforceable rights and obligations between parties for a contract to exist, the boards decided that the performance obligations within the contract could include promises that result in the customer having a valid expectation that the entity will transfer goods or services to the customer even though those promises are not enforceable (see paragraph BC87).

BC33 The boards decided to complement the definition of a contract by specifying criteria that must be met before an entity can apply the revenue recognition model to that contract (see paragraph 9 of IFRS 15). Those criteria are derived mainly from previous revenue recognition requirements and other existing standards. The boards decided that when some or all of those criteria are not met, it is questionable whether the contract establishes enforceable rights and obligations. The boards' rationale for including those criteria is discussed in paragraphs BC35–BC46.

BC34 The boards also decided that those criteria would be assessed at contract inception and would not be reassessed unless there is an indication that there has been a significant change in facts and circumstances (see paragraph 13 of IFRS 15). The boards decided that it was important to reassess the criteria in those cases, because that change might clearly indicate that the remaining

[*] References to the *Conceptual Framework* in this Basis for Conclusions are to the *Conceptual Framework for Financial Reporting*, issued in 2010 and in effect when the Standard was developed.

HKFRS 16
Revised ~~June~~ August 2020

Hong Kong Financial Reporting Standard 16

Leases

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8 The election for short-term leases shall be made by class of underlying asset to which the right of use relates. A class of underlying asset is a grouping of underlying assets of a similar nature and use in an entity's operations. The election for leases for which the underlying asset is of low value can be made on a lease-by-lease basis.

Identifying a lease (paragraphs B9–B33)

9 At inception of a contract, an entity shall assess whether the contract is, or contains, a lease. A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration. Paragraphs B9–B31 set out guidance on the assessment of whether a contract is, or contains, a lease.

10 A period of time may be described in terms of the amount of use of an identified asset (for example, the number of production units that an item of equipment will be used to produce).

11 An entity shall reassess whether a contract is, or contains, a lease only if the terms and conditions of the contract are changed.

Separating components of a contract

12 For a contract that is, or contains, a lease, an entity shall account for each lease component within the contract as a lease separately from non-lease components of the contract, unless the entity applies the practical expedient in paragraph 15. Paragraphs B32–B33 set out guidance on separating components of a contract.

Lessee

13 For a contract that contains a lease component and one or more additional lease or non-lease components, a lessee shall allocate the consideration in the contract to each lease component on the basis of the relative stand-alone price of the lease component and the aggregate stand-alone price of the non-lease components.

14 The relative stand-alone price of lease and non-lease components shall be determined on the basis of the price the lessor, or a similar supplier, would charge an entity for that component, or a similar component, separately. If an observable stand-alone price is not readily available, the lessee shall estimate the stand-alone price, maximising the use of observable information.

15 As a practical expedient, a lessee may elect, by class of underlying asset, not to separate non-lease components from lease components, and instead account for each lease component and any associated non-lease components as a single lease component. A lessee shall not apply this practical expedient to embedded derivatives that meet the criteria in paragraph 4.3.3 of HKFRS 9 *Financial Instruments*.

16 Unless the practical expedient in paragraph 15 is applied, a lessee shall account for non-lease components applying other applicable Standards.

Lessor

17 For a contract that contains a lease component and one or more additional lease or non-lease components, a lessor shall allocate the consideration in the contract applying paragraphs 73–90 of HKFRS 15.

Lease term (paragraphs B34–B41)

18 An entity shall determine the lease term as the non-cancellable period of a lease, together with both:

(a) periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option; and

HKFRS 16 BC

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Basis for Conclusions on
Hong Kong Financial Reporting Standard 16

Leases

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(d) simplify the requirements for separating lease and non-lease components of a contract;

(e) change the lessee disclosure requirements to enable lessees to more effectively focus disclosures on the most significant features of their lease portfolios; and

(f) simplify the lessee transition requirements.

The approach to lease accounting

BC19 All contracts create rights and obligations for the parties to the contract. Lessee accounting in IFRS 16 considers the rights and obligations created by a lease from the perspective of the lessee. As discussed further in paragraphs BC105–BC126, a lease is defined as a 'contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration'. The lessee accounting model in IFRS 16 reflects the economics of a lease because, at the commencement date, a lessee obtains the right to use an underlying asset for a period of time, and the lessor has delivered that right by making the asset available for use by the lessee.

BC20 A lessee has the right to use an underlying asset during the lease term and an obligation to make payments to the lessor for providing the right to use that asset. The lessee also has an obligation to return the underlying asset in a specified condition to the lessor at the end of the lease term. The lessor has a right to receive payments from the lessee for providing the right to use the underlying asset. The lessor also retains rights associated with ownership of the underlying asset.

BC21 Having identified the rights and obligations that arise from a lease, the IASB considered which of those rights and obligations create assets and liabilities for the lessee and lessor.

Rights and obligations arising from a lease that create assets and liabilities for the lessee

Right to use an underlying asset

BC22 The IASB's *Conceptual Framework for Financial Reporting* (*Conceptual Framework*)[1] defines an asset as 'a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity'. The IASB concluded that a lessee's right to use an underlying asset meets the definition of an asset for the following reasons:

(a) the lessee controls the right to use the underlying asset throughout the lease term. Once the asset is made available for use by the lessee, the lessor is unable to retrieve or otherwise use the underlying asset for its own purposes during the lease term, despite being the legal owner of the underlying asset.

(b) the lessee has the ability to determine how to use the underlying asset and, thus, how it generates future economic benefits from that right of use. This ability demonstrates the lessee's control of the right of use. For example, suppose a lessee leases a truck for four years, for up to a maximum of 160,000 miles over the lease term. Embedded in the right to use the truck is a particular volume of economic benefits or service potential that is used up over the period that the truck is driven by the lessee. After the truck is made available for use by the lessee, the lessee can decide how it wishes to use up or consume the economic benefits embedded in its right of use within the parameters defined in the contract. The lessee could decide to drive the truck constantly during the first three years of the lease, consuming all of the economic benefits in those first three years. Alternatively, it could use the truck only during particular months in each year or decide to use it evenly over the four-year lease term.

(c) the right to control and use the asset exists even when a lessee's right to use an asset includes some restrictions on its use. Although restrictions may affect the value and scope of a lessee's right to use an asset (and thus the payments made for the right of use), they do not affect the existence of the right-of-use asset. It is not unusual for restrictions to be placed on the use of owned assets as well as leased assets. For example, assets acquired from a competitor may be subject to restrictions on where they

[1] References to the *Conceptual Framework* in this Basis for Conclusions are to the *Conceptual Framework for Financial Reporting*, issued in 2010 and in effect when the Standard was developed.

HKFRS 17

~~Issued January 2018~~Revised August 2020

Effective for annual periods
beginning on or after 1 January 2021

Hong Kong Financial Reporting Standard 17

Insurance Contracts

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(ii) the change in the risk adjustment for non-financial risk that does not relate to future service or past service; and

(iii) *experience adjustments* (see paragraphs ~~B96(a),~~ B97(c) and B113(a)).

(c) changes that relate to past service, ie changes in fulfilment cash flows relating to incurred claims (see paragraphs B97(b) and B113(a)).

105 To complete the reconciliations in paragraphs 100–101, an entity shall also disclose separately each of the following amounts not related to insurance services provided in the period, if applicable:

(a) cash flows in the period, including:

(i) premiums received for insurance contracts issued (or paid for reinsurance contracts held);

(ii) insurance acquisition cash flows; and

(iii) incurred claims paid and other insurance service expenses paid for insurance contracts issued (or recovered under reinsurance contracts held), excluding insurance acquisition cash flows.

(b) the effect of changes in the risk of non-performance by the issuer of reinsurance contracts held;

(c) insurance finance income or expenses; and

(d) any additional line items that may be necessary to understand the change in the net carrying amount of the insurance contracts.

106 For insurance contracts issued other than those to which the premium allocation approach described in paragraphs 53–59 has been applied, an entity shall disclose an analysis of the insurance revenue recognised in the period comprising:

(a) the amounts relating to the changes in the liability for remaining coverage as specified in paragraph B124, separately disclosing:

(i) the insurance service expenses incurred during the period as specified in paragraph B124(a);

(ii) the change in the risk adjustment for non-financial risk, as specified in paragraph B124(b); and

(iii) the amount of the contractual service margin recognised in profit or loss because of the transfer of services in the period, as specified in paragraph B124(c).

(b) the allocation of the portion of the premiums that relate to the recovery of insurance acquisition cash flows.

107 For insurance contracts other than those to which the premium allocation approach described in paragraphs 53–59 or 69–70 has been applied, an entity shall disclose the effect on the statement of

B109 Reinsurance contracts issued and reinsurance contracts held cannot be insurance contracts with direct participation features for the purposes of HKFRS 17.

B110 For insurance contracts with direct participation features, the contractual service margin is adjusted to reflect the variable nature of the fee. Hence, changes in the amounts set out in paragraph B104 are treated as set out in paragraphs B111–B114.

B111 Changes in the obligation to pay the policyholder an amount equal to the fair value of the underlying items (paragraph B104(a)) do not relate to future service and do not adjust the contractual service margin.

B112 Changes in the entity's share of the fair value of the underlying items (paragraph B104(b)(i)) relate to future service and adjust the contractual service margin, applying paragraph 45(b).

B113 Changes in the fulfilment cash flows that do not vary based on the returns on underlying items (paragraph B104(b)(ii)) comprise:

(a) changes in ~~estimates of~~ the fulfilment cash flows other than those specified in (b). An entity shall apply paragraphs B96–B97, consistent with insurance contracts without direct participation features, to determine to what extent they relate to future service and, applying paragraph 45(c), adjust the contractual service margin. All the adjustments are measured using current discount rates.

(b) the change in the effect of the time value of money and financial risks not arising from the underlying items; for example, the effect of financial guarantees. These relate to future service and, applying paragraph 45(c), adjust the contractual service margin, except to the extent that paragraph B115 applies.

B114 An entity is not required to identify the adjustments to the contractual service margin required by paragraphs B112 and B113 separately. Instead, a combined amount may be determined for some or all of the adjustments.

Risk mitigation

B115 To the extent that an entity meets the conditions in paragraph B116, it may choose not to recognise a change in the contractual service margin to reflect some or all of the changes in the effect of financial risk on the entity's share of the underlying items (see paragraph B112) or the fulfilment cash flows set out in paragraph B113(b).

B116 To apply paragraph B115, an entity must have a previously documented risk-management objective and strategy for using derivatives to mitigate financial risk arising from the insurance contracts and, in applying that objective and strategy:

(a) the entity uses a derivative to mitigate the financial risk arising from the insurance contracts.

(b) an economic offset exists between the insurance contracts and the derivative, ie the values of the insurance contracts and the derivative generally move in opposite directions because they respond in a similar way to the changes in the risk being mitigated. An entity shall not consider accounting measurement differences in assessing the economic offset.

(c) credit risk does not dominate the economic offset.

Determining the contractual service margin or loss component for groups of insurance contracts with direct participation features

C17 To the extent permitted by paragraph C8, for contracts with direct participation features an entity shall determine the contractual service margin or loss component of the liability for remaining coverage at the transition date as:

(a) the total fair value of the underlying items at that date; minus

(b) the fulfilment cash flows at that date; plus or minus

(c) an adjustment for:

(i) amounts charged by the entity to the policyholders (including amounts deducted from the underlying items) before that date.

(ii) amounts paid before that date that would not have varied based on the underlying items.

(iii) the change in the risk adjustment for non-financial risk caused by the release from risk before that date. The entity shall estimate this amount by reference to the release of risk for similar insurance contracts that the entity issues at the transition date.

(d) if (a)–(c) result in a contractual service margin—minus the amount of the contractual service margin that relates to services provided before that date. The total of (a)–(c) is a proxy for the total contractual service margin for all services to be provided under the group of contracts, ie before any amounts that would have been recognised in profit or loss for services provided. The entity shall estimate the amounts that would have been recognised in profit or loss for services provided by comparing the remaining coverage units at the transition date with the coverage units provided under the group of contracts before the transition date; or

(e) if (a)–(c) result in a loss component—adjust the loss component to nil and increase the liability for remaining coverage excluding the loss component by the same amount.

Insurance finance income or expenses

C18 For groups of insurance contracts that, applying paragraph C10, include contracts issued more than one year apart:

(a) an entity is permitted to determine the discount rates at the date of initial recognition of a group specified in paragraphs B72(b)–B72(e)(ii) and the discount rates at the date of the incurred claim specified in paragraph B72(e)(iii) at the transition date instead of at the date of initial recognition or incurred claim.

(b) if an entity chooses to disaggregate insurance finance income or expenses between amounts included in profit or loss and amounts included in other comprehensive income applying paragraphs 88(b) or 89(b), the entity needs to determine the cumulative amount of insurance finance income or expenses recognised in other comprehensive income at the transition date to apply paragraph 91(a) in future periods. The entity is permitted to determine that cumulative ~~difference~~ amount either by applying paragraph C19(b) or:

(i) as nil, unless (ii) applies; and

(ii) for insurance contracts with direct participation features to which paragraph B134 applies, as equal to the cumulative amount recognised in other comprehensive income on the underlying items.

C19 For groups of insurance contracts that do not include contracts issued more than one year apart:

(a) if an entity applies paragraph C13 to estimate the discount rates that applied at initial recognition (or subsequently), it shall also determine the discount rates specified in paragraphs B72(b)–B72(e) applying paragraph C13; and

(b) if an entity chooses to disaggregate insurance finance income or expenses between amounts included in profit or loss and amounts included in other comprehensive income, applying paragraphs 88(b) or 89(b), the entity needs to determine the cumulative amount of insurance finance income or expenses recognised in other comprehensive income at the transition date to apply paragraph 91(a) in future periods. The entity shall determine that cumulative ~~difference~~amount:

(i) for insurance contracts for which an entity will apply the methods of systematic allocation set out in paragraph B131—if the entity applies paragraph C13 to estimate the discount rates at initial recognition—using the discount rates that applied at the date of initial recognition, also applying paragraph C13;

(ii) for insurance contracts for which an entity will apply the methods of systematic allocation set out in paragraph B132—on the basis that the assumptions that relate to financial risk that applied at the date of initial recognition are those that apply on the transition date, ie as nil;

(iii) for insurance contracts for which an entity will apply the methods of systematic allocation set out in paragraph B133—if the entity applies paragraph C13 to estimate the discount rates at initial recognition (or subsequently)—using the discount rates that applied at the date of the incurred claim, also applying paragraph C13; and

(iv) for insurance contracts with direct participation features to which paragraph B134 applies—as equal to the cumulative amount recognised in other comprehensive income on the underlying items.

Fair value approach

C20 To apply the fair value approach, an entity shall determine the contractual service margin or loss component of the liability for remaining coverage at the transition date as the difference between the fair value of a group of insurance contracts at that date and the fulfilment cash flows measured at that date. In determining that fair value, an entity shall not apply paragraph 47 of HKFRS 13 *Fair Value Measurement* (relating to demand features).

C21 In applying the fair value approach, an entity may apply paragraph C22 to determine:

(a) how to identify groups of insurance contracts, applying paragraphs 14–24;

(b) whether an insurance contract meets the definition of an insurance contract with direct participation features, applying paragraphs B101–B109; and

(c) how to identify discretionary cash flows for insurance contracts without direct participation features, applying paragraphs B98–B100.

HKFRS 17 BC
~~Issued January 2018~~
Revised August 2020

Basis for Conclusions on
Hong Kong Financial Reporting Standard 17

Insurance Contracts

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Insurable interest (paragraphs B7–B16 of IFRS 17)

BC73 The definition of an insurance contract reflects the risk the entity accepts from the policyholders by agreeing to compensate the policyholders if they are adversely affected by an uncertain event (paragraph B12 of IFRS 17). The notion that the uncertain event must have an adverse effect on the policyholder is known as 'insurable interest'.

BC74 The Board considered whether it should eliminate the notion of insurable interest and replace it with the notion that insurance involves assembling risks into a pool in which they can be managed together. Some argued that doing so would appropriately include the following within the scope of the Standard:

(a) contracts that require payment if a specified uncertain future event occurs, causing economic exposure similar to insurance contracts, whether the other party has an insurable interest or not; and

(b) some contracts used as insurance that do not include a notion of insurable interest, for example, weather derivatives.

BC75 However, the Board decided to retain the notion of insurable interest because without the reference to 'adverse effect', the definition might have captured any prepaid contract to provide services with uncertain costs. Such a definition would have extended the meaning of the term 'insurance contract' beyond its traditional meaning, which the Board did not want to do. The notion of insurable interest is also needed to avoid including gambling in the definition of insurance. Furthermore, it is a principle-based distinction, particularly between insurance contracts and contracts used for hedging.

Quantity of insurance risk (paragraphs B17–B25 of IFRS 17)

BC76 Paragraphs B17–B25 of IFRS 17 discuss how much insurance risk must be present before a contract qualifies as an insurance contract.

BC77 In developing this material, the Board considered the criteria in US GAAP for a contract to be treated as an insurance contract, which includes the notion that there should be a 'reasonable possibility' of a 'significant loss'. The Board observed that some practitioners use the following guideline when applying US GAAP: a reasonable possibility of a significant loss is at least a 10 per cent probability of a loss of at least 10 per cent of premium.

BC78 However, quantitative guidance risks creating an arbitrary dividing line that results in different accounting treatments for similar transactions that fall marginally on different sides of the line. Quantitative guidance also creates opportunities for accounting arbitrage by encouraging transactions that fall marginally on one side of the line or the other. For these reasons, IFRS 17 does not include quantitative guidance. Instead, noting the criteria applied in US GAAP, the Board decided to add the requirement that a contract transfers insurance risk only if there is a scenario with commercial substance in which the issuer has a possibility of a loss on a present value basis.

BC79 The Board also considered whether it should define the significance of insurance risk by referring to materiality, which the *Conceptual Framework for Financial Reporting*[*] describes as follows:

> Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity.[#]

However, a single contract, or even a single book of similar contracts, would rarely generate a material loss in relation to the financial statements as a whole. Although entities manage contracts by portfolios, the contractual rights and obligations arise from individual contracts. Consequently, IFRS 17 defines the significance of insurance risk in relation to individual contracts (see paragraph B22 of IFRS 17).

[*] References to the *Conceptual Framework for Financial Reporting* (*Conceptual Framework*) in this Basis for Conclusions are to the *Conceptual Framework for Financial Reporting*, issued in 2010 and in effect when the Standard was developed.

[#] Amendments to the definition of material in the *Conceptual Framework for Financial Reporting* were issued in October 2018.

HKFRS 17 IE

~~Issued January 2018~~Revised August 2020

Illustrative Examples

Hong Kong Financial Reporting Standard 17

Insurance Contracts

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…continued

(a) Insurance revenue of CU222 is:

(i) determined by the entity applying paragraph B123 as the change in the liability for remaining coverage, excluding changes that do not relate to services provided in the period, for example changes resulting from cash inflows from premiums received, changes related to investment components and changes related to insurance finance income or expenses.

Thus, in this example insurance revenue is the difference between the opening and closing carrying amounts of the liability for remaining coverage of CU617, excluding insurance finance expenses of CU39, cash inflows of CU900 and the investment component of CU100 (CU222 = CU0 – CU617 + CU39 + CU900 – CU100).

(ii) analysed by the entity applying paragraph B124 as the sum of the changes in the liability for remaining coverage in the period that relate to services for which the entity expects to receive consideration. Those changes are:

1 insurance service expenses incurred in the period (measured at the amounts expected at the beginning of the period), excluding repayments of investment components;

2 the change in the risk adjustment for non-financial risk, excluding changes that adjust the contractual service margin because they relate to future service ie the change caused by the release from risk; and

3 the amount of contractual service margin recognised in profit or loss in the period.

Thus, in this example insurance revenue is the sum of insurance service expenses of CU100, the change in the risk adjustment for non-financial risk caused by the release from risk of CU40 and the contractual service margin recognised in profit or loss of CU82 (CU222 = CU100 + CU40 + CU82).

(b) Applying paragraph 84, the entity presents insurance service expenses of CU100 as the claims incurred in the period of CU200 minus the investment component of CU100.

(c) Applying paragraph 85, the entity presents insurance revenue and insurance service expenses in profit or loss excluding amounts related to an investment component. In this example, the investment component equals CU100.

(d) Insurance finance expenses are the same as in Example 2. The whole amount of insurance finance expenses is related to the liability for remaining coverage because the liability for incurred claims is paid immediately after the expenses are incurred (see the assumptions in Example ~~1~~2).

IE34 In Year 2, the actual claims of CU150 are lower than expected. The entity also revises its estimates relating to the fulfilment cash flows in Year 3. Consequently, the entity recognises in profit or loss the effect of the revised claims relating to Year 2, and adjusts the contractual service margin for changes in the fulfilment cash flows for Year 3. This change is only related to incurred claims and does not affect the investment component.

IE35 A possible format of the reconciliation required by paragraph 100 between the amounts recognised in the statement of financial position and the statement of profit or loss for Year 2 is as follows:

Separating the asset management component

IE50 The asset management activities, similarly to claims processing activities, are part of the activities the entity must undertake to fulfil the contract, and the entity does not transfer a good or service to the policyholder because the entity performs those activities. Thus, applying paragraph B33, the entity would not separate the asset management component from the insurance contract.

Example 5—Separating components from a stop-loss contract with claims processing services

Assumptions

IE51 An entity issues a stop-loss contract to an employer (the policyholder). The contract provides health coverage for the policyholder's employees and has the following features:

(a) insurance coverage of 100 ~~hundred~~ per cent for the aggregate claims from employees exceeding CU25 million (the 'stop-loss threshold'). The employer will self-insure claims from employees up to CU25 million.

(b) claims processing services for employees' claims during the next year, regardless of whether the claims have passed the stop-loss threshold of CU25 million. The entity is responsible for processing the health insurance claims of the employees on behalf of the employer.

IE52 The entity considers whether to separate the claims processing services. The entity notes that similar services to process claims on behalf of customers are sold on the market.

Analysis

Separating the claims processing services

IE53 The criteria for identifying distinct non-insurance services in paragraph B34 are met in this example:

(a) the claims processing services, similar to the services to process the employees' claims on behalf of the employer, are sold as a standalone service without any insurance coverage; and

(b) the claims processing services benefit the policyholder independently of the insurance coverage. Had the entity not agreed to provide those services, the policyholder would have to process its employees' medical claims itself or engage other service providers to do this.

IE54 Additionally, the criteria in paragraph B35 that establishes if the service is not distinct are not met because the cash flows associated with the claims processing services are not highly interrelated with the cash flows associated with the insurance coverage, and the entity does not provide a significant service of integrating the claims processing services with the insurance components. In addition, the entity could provide the promised claims processing services separately from the insurance coverage.

IE55 Accordingly, the entity separates the claims processing services from the insurance contract and accounts for them applying IFRS 15 *Revenue from Contracts with Customers*.

HK(IFRIC)-Int 5
Revised ~~September 2018~~August 2020

Effective for annual periods
beginning on or after 1 January 2006

HK(IFRIC) Interpretation 5

Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds

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Basis for consensus

Accounting for an interest in a fund (paragraphs 7-9)

BC7 The IFRIC concluded that the contributor should recognise a liability unless the contributor is not liable to pay decommissioning costs even if the fund fails to pay. This is because the contributor remains liable for the decommissioning costs. Additionally, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* provides that:

(a) when an entity remains liable for expenditure, a provision should be recognised even where reimbursement is available; and

(b) if the reimbursement is virtually certain to be received when the obligation is settled, then it should be treated as a separate asset.

BC8 In concluding that the contributor should recognise separately its liability to pay decommissioning costs and its interest in the fund, the IFRIC also noted the following:

(a) There is no legally enforceable right to set off the rights under the decommissioning fund against the decommissioning liabilities. Also, given that the main objective is reimbursement, it is likely that settlement will not be net or simultaneous. Accordingly, treating these rights and liabilities as analogous to financial assets and financial liabilities would not result in offset because the offset criteria in IAS 32 *Financial Instruments: Disclosure and Presentation*[5] are not met.

(b) Treating the decommissioning obligation as analogous to a financial liability would not result in derecognition through extinguishment. If the fund does not assume the obligation for decommissioning, the criteria in IAS 39[6] for derecognition of financial liabilities through extinguishment are not met. At best, the fund acts like an in-substance defeasance that does not qualify for derecognition of the liability.

(c) It would not be appropriate to treat decommissioning funds as analogous to pension funds, which are presented net of the related liability. This is because, in allowing a net presentation for pension plans in IAS 19 *Employee Benefits,* the International Accounting Standards Board's predecessor organisation, IASC, stated that it believed the situation is 'unique to employee benefit plans and [it did] not intend to permit this net presentation for other liabilities if the conditions in IAS 32 and IAS 39[7] are not met' (IAS 19, Basis for Conclusions paragraph 68I)[8].

BC9 As to the accounting for the contributor's interest in the fund, the IFRIC noted that some interests in funds would be within the scope of IAS 27, IAS 28, IAS 31[9] or SIC-12. As noted in paragraph BC2, the IFRIC concluded that, in such cases, the normal requirements of those Standards would apply and there is no need for interpretative guidance.

BC10 Otherwise, the IFRIC concluded that the contributor has an asset for its right to receive amounts from the fund.

The right to receive reimbursement from a fund and amendment to the scope of IAS 39[10]

BC11 The IFRIC noted that under existing IFRSs, there are two forms of rights to reimbursement that would be accounted for differently:

(a) A contractual right to receive reimbursement in the form of cash. This meets the definition of a financial asset and is within the scope of IAS 39. Such a financial asset would be classified as an available-for-sale financial asset[11] (unless accounted for using the fair value option) because it does not meet the definitions of a financial asset held for trading, a held-to-maturity investment or a loan or receivable.

[5] In August 2005, IAS 32 has amended as IAS 32 *Financial Instruments*: *Presentation.*
[6] IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.
[7] IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.
[8] Paragraph BC68I was renumbered as paragraph BC186 when IAS 19 was amended in 2011.
[9] IFRS 11 *Joint Arrangements*, issued in May 2011, replaced IAS 31.
[10] IFRS 9 *Financial Instruments* replaced IAS 39. IFRS 9 applies to all items that were previously within the scope of IAS 39.
[11] IFRS 9 *Financial Instruments* eliminated the categories of available-for-sale and held-to-maturity financial assets.

(b) A right to reimbursement other than a contractual right to receive cash. This does not meet the definition of a financial asset and is within the scope of IAS 37.

BC12 The IFRIC concluded that both these forms of reimbursement have economically identical effects. Therefore accounting for both forms in the same way would provide relevant and reliable information to a user of the financial statements. However, the IFRIC noted that this did not appear possible under existing IFRSs because some such rights are within the scope of IAS 39, and others are not. Therefore, it asked the Board to amend the scope of IAS 39 to exclude rights to reimbursement for expenditure required to settle:

(a) a provision that has been recognised in accordance with IAS 37; and

(b) obligations that had been originally recognised as provisions in accordance with IAS 37, but are no longer provisions because their timing or amount is no longer uncertain. An example of such a liability is one that was originally recognised as a provision because of uncertainty about the timing of the cash outflow, but subsequently becomes another type of liability because the timing is now certain.

BC13 This amendment was approved by the Board and is set out in the Appendix of IFRIC 5[12]. As a result, all such rights to reimbursement are within the scope of IAS 37.

BC14 The IFRIC noted that paragraph 53 of IAS 37 specifies the accounting for rights to receive reimbursement. It requires this right to reimbursement to be separately recognised when it is virtually certain that reimbursement will be received if the contributor settles the obligation. The IFRIC also noted that this paragraph prohibits the recognition of an asset in excess of the recognised liability. For example, rights to receive reimbursement to meet decommissioning liabilities that have yet to be recognised as a provision are not recognised. Accordingly, the IFRIC concluded that when the right to reimbursement is virtually certain to be received if the contributor settles its decommissioning obligation, it should be measured at the lower of the amount of the decommissioning obligation recognised and the reimbursement right.

BC15 The IFRIC discussed whether the reimbursement right should be measured at:

(a) the contributor's share of the fair value of the net assets of the fund attributable to contributors, taking into account any inability to access any surplus of the assets of the fund over eligible decommissioning costs (with any obligation to make good potential defaults of other contributors being treated separately as a contingent liability); or

(b) the fair value of the reimbursement right (which would normally be lower than (a) because of the risks involved, such as the possibility that the contributor may be required to make good defaults of other contributors).

BC16 The IFRIC noted that the right to reimbursement relates to a decommissioning obligation for which a provision would be recognised and measured in accordance with IAS 37. Paragraph 36 of IAS 37 requires such provisions to be measured at 'the best estimate of the expenditure required to settle the present obligation at the end of the reporting period'. The IFRIC noted that the amount in paragraph BC15(a)—ie the contributor's share of the fair value of the net assets of the fund attributable to contributors, taking into account any inability to access any surplus of the assets of the fund over eligible decommissioning costs—is the best estimate of the amount available to the contributor to reimburse it for expenditure it had incurred to pay for decommissioning. Thus, the amount of the asset recognised would be consistent with the amount of the liability recognised.

BC17 In contrast, the IFRIC noted that the amount in paragraph BC15(b)—ie the fair value of the reimbursement right—would take into account the factors such as liquidity that the IFRIC believed to be difficult to measure reliably. Furthermore, this amount would be lower than that in paragraph BC15(a) because it reflects the possibility that the contributor may be required to make potential additional contributions in the event of default by other contributors. The IFRIC noted that its decision that the obligation to make potential additional contributions should be treated as a contingent liability in accordance with IAS 37 (see paragraphs BC22-BC25) would result in double-counting of the risk of the additional contribution being required if the measure in paragraph BC15(b) were to be used.

BC18 Consequently, the IFRIC concluded that the approach in paragraph BC15(a) would provide the most useful information to users.

[12] The amendment has been incorporated into the text of IAS 39 as published in this volume.

The asset cap

BC19 Many respondents to D4 expressed concern about the 'asset cap' that is imposed by the requirement in paragraph 9. This asset cap limits the amount recognised as a reimbursement asset to the amount of the decommissioning obligation recognised. These respondents argued that rights to benefit in excess of this amount give rise to an additional asset, separate from the reimbursement asset. Such an additional asset may arise in a number of ways, for example:

(a) the contributor has the right to benefit from a repayment of any surplus in the fund that exists once all the decommissioning has been completed or on winding up the fund.

(b) the contributor has the right to benefit from reduced contributions to the fund or increased benefits from the fund (eg by adding new sites to the fund for no additional contributions) in the future.

(c) the contributor expects to obtain benefit from past contributions in the future, based on the current and planned level of activity. However, because contributions are made before the decommissioning obligation is incurred, IAS 37 prevents recognition of an asset in excess of the obligation.

BC20 The IFRIC concluded that a right to benefit from a repayment of any surplus in the fund that exists once all the decommissioning has been completed or on winding up the fund may be an equity instrument within the scope of IAS 39,[13] in which case IAS 39 would apply. However, the IFRIC agreed that an asset should not be recognised for other rights to receive reimbursement from the fund. Although the IFRIC had sympathy with the concerns expressed by constituents that there may be circumstances in which it would seem appropriate to recognise an asset in excess of the reimbursement right, it concluded that it would be inconsistent with paragraph 53 of IAS 37 (which requires that 'the amount recognised for the reimbursement should not exceed the amount of the provision') to recognise this asset. The IFRIC also noted that the circumstances in which this additional asset exists are likely to be limited, and apply only when a contributor has restricted access to a surplus of fund assets that does not give it control, joint control or significant influence over a fund. The IFRIC expects that most such assets would not meet the recognition criteria in the *Framework*[14] because they are highly uncertain and cannot be measured reliably.

BC21 The IFRIC also considered arguments that there should not be a difference between the treatment of a surplus when a fund is accounted for as a subsidiary, joint venture or associate, and when it is not. However, the IFRIC noted that, under IFRSs, restrictions on assets in subsidiaries, joint ventures or associates do not affect recognition of those assets. Hence it concluded that the difference in treatment between funds accounted for as subsidiaries, joint ventures or associates and those accounted for as a reimbursement right is inherent in IFRSs. The IFRIC also concluded that this is appropriate because, in the former case, the contributor exercises a degree of control not present in the latter case.

Obligations to make additional contributions (paragraph 10)

BC22 In some cases, a contributor has an obligation to make potential additional contributions, for example, in the event of the bankruptcy of another contributor.

BC23 The IFRIC noted that by 'joining' the fund, a contributor may assume the position of guarantor of the contributions of the other contributors, and hence become jointly and severally liable for the obligations of other contributors. Such an obligation is a present obligation of the contributor, but the outflow of resources associated with it may not be probable. The IFRIC noted a parallel with the example in paragraph 29 of IAS 37, which states that 'where an entity is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties is treated as a contingent liability.' Accordingly, the IFRIC concluded that a liability would be recognised by the contributor only if it is probable that it will make additional contributions. The IFRIC noted that such a contingent liability may arise both when the contributor's interest in the fund is accounted for as a reimbursement right and when it is accounted for in accordance with IAS 27, IAS 28, IAS 31[15] or SIC-12.

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

[14] The reference to the *Framework* is to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the ~~IASB~~Board in 2001 and in effect when the Interpretation was developed. ~~In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.~~

[15] IFRS 11 *Joint Arrangements*, issued in May 2011, replaced IAS 31.

BC24 The IFRIC considered the argument that an obligation to make good potential shortfalls of other contributors is a financial instrument (ie a financial guarantee) as defined in IAS 32 and hence should be accounted for in accordance with IAS 39.[16] The grounds for this point of view are that the contributor has an obligation to deliver cash to the fund, and the fund has a right to receive cash from the contributor if a shortfall in contributions arises. However, the IFRIC noted that:

(a) a contractual obligation to make good shortfalls of other contributors is a financial guarantee. Financial guarantee contracts that provide for payments to be made if the debtor fails to make payment when due are excluded from the scope of IAS 39.

(b) when the obligation is not contractual, but rather arises as a result of regulation, it is not a financial liability as defined in IAS 32 nor is it within the scope of IAS 39.

BC25 Therefore, the IFRIC concluded that an obligation to make additional contributions in the event of specified circumstances should be treated as a contingent liability in accordance with IAS 37.

Disclosure (paragraphs 11-13)

BC26 The IFRIC noted that the contributor may not be able to access the assets of the fund (including cash or cash equivalents) for many years (eg until it undertakes the decommissioning), if ever. Therefore, the IFRIC concluded that the nature of the contributor's interest and the restriction on access should be disclosed. The IFRIC also concluded that this disclosure is equally relevant when a contributor's interest in a fund is accounted for by consolidation, proportional consolidation[17] or using the equity method because the contributor's ability to access the underlying assets may be similarly restricted.

Effective date and transition (paragraphs 14 and 15)

BC27 D4 proposed that the Interpretation should be effective for annual periods beginning on a date set at three months after the Interpretation was finalised. The IFRIC considered the view of some respondents that the Interpretation should apply from 1 January 2005 (an earlier date) on the grounds that this is the date from which many entities will adopt IFRSs, and hence adopting the Interpretation at that time would promote comparability between periods. However, the IFRIC noted its general practice is to allow at least three months between finalising an Interpretation and its application, to enable entities to obtain the Interpretation and implement any necessary systems changes. In addition, the IFRIC considered the Board's concern that the amendment to IAS 39[18] issued as part of the Interpretation would change the 'stable platform' of Standards that are in force for entities that will apply IFRSs for the first time in 2005. Therefore, the IFRIC decided to require that the Interpretation should be applied for annual periods beginning on or after 1 January 2006, with earlier application encouraged.

BC28 The IFRIC observed that the implementation of the Interpretation is not expected to be problematic. Therefore, the IFRIC concluded that IAS 8 should apply. Respondents to D4 did not disagree with this conclusion.

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

17 IFRS 11 *Joint Arrangements*, issued in May 2011, replaced IAS 31. IFRS 11 does not permit an entity to use 'proportionate consolidation' for accounting for interests in joint ventures.

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

HK(IFRIC)-Int 12
Revised ~~July 2019~~August 2020

Effective for annual periods
beginning on or after 1 January 2008

HK(IFRIC) Interpretation 12

Service Concession Arrangements

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Hong Kong (IFRIC) Interpretation 12
Service Concession Arrangements

References

- *Framework for the Preparation and Presentation of Financial Statements*[1]
- HKFRS 1 *First-time Adoption of Hong Kong Financial Reporting Standards*
- HKFRS 7 *Financial Instruments: Disclosures*
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- HKFRS 15 *Revenue from Contracts with Customers*
- HKFRS 16 *Leases*
- HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*
- HKAS 16 *Property, Plant and Equipment*
- HKAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*
- HKAS 23 *Borrowing Costs*
- HKAS 32 *Financial Instruments: Presentation*
- HKAS 36 *Impairment of Assets*
- HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*
- HKAS 38 *Intangible Assets*
- HK(SIC)-Int 29 *Service Concession Arrangements: Disclosures*[2]

Background

1 In many countries, infrastructure for public services–such as roads, bridges, tunnels, prisons, hospitals, airports, water distribution facilities, energy supply and telecommunication networks–has traditionally been constructed, operated and maintained by the public sector and financed through public budget appropriation.

2 In some countries, governments have introduced contractual service arrangements to attract private sector participation in the development, financing, operation and maintenance of such infrastructure. The infrastructure may already exist, or may be constructed during the period of the service arrangement. An arrangement within the scope of this Interpretation typically involves a private sector entity (an operator) constructing the infrastructure used to provide the public service or upgrading it (for example, by increasing its capacity) and operating and maintaining that infrastructure for a specified period of time. The operator is paid for its services over the period of the arrangement. The arrangement is governed by a contract that sets out performance standards, mechanisms for adjusting prices, and arrangements for arbitrating disputes. Such an arrangement is often described as a 'build-operate-transfer', a 'rehabilitate-operate-transfer' or a 'public-to-private' service concession arrangement.

[1] ~~*Framework for the Preparation and Presentation of Financial Statements* was replaced by the *Conceptual Framework for Financial Reporting* in October 2010.~~ The reference is to the *Framework for the Preparation and Presentation of Financial Statements* and in effect when the Interpretation was developed.

[2] The title of HK(SIC)-Int 29, formerly *Disclosure – Service Concession Arrangements*, was amended by HK(IFRIC)-Int 12.

Example 3: The grantor gives the operator a financial asset and an intangible asset

Arrangement terms

IE23 The terms of a service arrangement require an operator to construct a road–completing construction within two years–and to operate the road and maintain it to a specified standard for eight years (ie years 3-10). The terms of the arrangement also require the operator to resurface the road when the original surface has deteriorated below a specified condition. The operator estimates that it will have to undertake the resurfacing at the end of year 8. At the end of year 10, the arrangement will end. Assume that the operator identifies a single performance obligation for construction services. The operator estimates that the costs it will incur to fulfil its obligations will be:

Table 3.1 ***Contract costs***

	Year	CU*
Construction services	1	500
	2	500
Operating the road (per year)	3-10	10
Road resurfacing	8	100

* in this example, monetary amounts are denominated in 'currency units (CU)'.

IE24 The operator estimates the consideration in respect of construction services to be CU1,050 by reference to the stand-alone selling price of those services (which it estimates at forecast costs plus 5 per cent).

IE25 The terms of the arrangement allow the operator to collect tolls from drivers using the road. In addition, the grantor guarantees the operator a minimum amount of CU700 and interest at a specified rate of 6.18% to reflect the timing of cash receipts. The operator forecasts that vehicle numbers will remain constant over the duration of the contract and that it will receive tolls of CU200 in each of years 3-10.

IE26 For the purpose of this illustration, it is assumed that all cash flows take place at the end of the year.

Dividing the arrangement

IE27 The contractual right to receive cash from the grantor for the services and the right to charge users for the public services should be regarded as two separate assets under IFRSs. Therefore in this arrangement it is necessary to divide the operator's contract asset during the construction phase into two components–a financial asset component based on the guaranteed amount and an intangible asset for the remainder. When the construction services are completed, the two components of the contract asset would be classified and measured as a financial asset and an intangible asset accordingly.

Grantor accounting

BC15 The Interpretation does not specify the accounting by grantors, because the IFRIC's objective and priority were to establish guidance for operators. Some commentators asked the IFRIC to establish guidance for the accounting by grantors. The IFRIC discussed these comments but reaffirmed its view. It noted that in many cases the grantor is a government body, and that IFRSs are not designed to apply to not-for-profit activities in the private sector, public sector or government, though entities with such activities may find them appropriate (see *Preface to IFRSs* paragraph 9).[#]

Existing assets of the operator

BC16 The Interpretation does not specify the treatment of existing assets of the operator because the IFRIC decided that it was unnecessary to address the derecognition requirements of existing standards.

BC17 Some respondents asked the IFRIC to provide guidance on the accounting for existing assets of the operator, stating that the scope exclusion would create uncertainty about the treatment of these assets.

BC18 In its redeliberations the IFRIC noted that one objective of the Interpretation is to address whether the operator should recognise as its property, plant and equipment the infrastructure it constructs or to which it is given access. The accounting issue to be addressed for existing assets of the operator is one of derecognition, which is already addressed in IFRSs (IAS 16 *Property, Plant and Equipment*). In the light of the comments received from respondents, the IFRIC decided to clarify that certain public-to-private service arrangements may convey to the grantor a right to use existing assets of the operator, in which case the operator would apply the derecognition requirements of IFRSs to determine whether it should derecognise its existing assets.

The significant residual interest criterion

BC19 Paragraph 5(b) of D12 proposed that for a service arrangement to be within its scope the residual interest in the infrastructure handed over to the grantor at the end of the arrangement must be significant. Respondents argued, and the IFRIC agreed, that the significant residual interest criterion would limit the usefulness of the guidance because a service arrangement for the entire physical life of the infrastructure would be excluded from the scope of the guidance. That result was not the IFRIC's intention. In its redeliberation of the proposals, the IFRIC decided that it would not retain the proposal that the residual interest in the infrastructure handed over to the grantor at the end of the arrangement must be significant. As a consequence, 'whole of life' infrastructure (ie where the infrastructure is used in a public-to-private service arrangement for the entirety of its useful life) is within the scope of the Interpretation.

Treatment of the operator's rights over the infrastructure (paragraph 11)

BC20 The IFRIC considered the nature of the rights conveyed to the operator in a service concession arrangement. It first examined whether the infrastructure used to provide public services could be classified as property, plant and equipment of the operator under IAS 16. It started from the principle that infrastructure used to provide public services should be recognised as property, plant and equipment of the party that controls its use. This principle determines which party should recognise the property, plant and equipment as its own. The reference to control stems from the *Framework*[*]:

(a) an asset is defined by the *Framework* as 'a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.'

(b) the *Framework* notes that many assets are associated with legal rights, including the right of ownership. It goes on to clarify that the right of ownership is not essential.

[#] *Preface to International Financial Reporting Standards* renamed *Preface to IFRS Standards*, December 2018.

[*] References to the *Framework* in this Basis for Conclusions are to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the ~~IASB~~ Board in 2001 and in effect when the Interpretation was developed. ~~In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.~~

BC66 The IFRIC considered when the operator should first recognise the intangible asset. The IFRIC concluded that the intangible asset (the licence) received in exchange for construction services should be recognised in accordance with general principles applicable to contracts for the exchange of assets or services.

BC67 The IFRIC noted that it is current practice not to recognise executory contracts to the extent that they are unperformed by both parties (unless the contract is onerous). IAS 37 describes executory contracts as 'contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent'. Paragraph 91 of the *Framework*[*] states:

> In practice, obligations under contracts that are equally proportionately unperformed (for example, liabilities for inventory ordered but not yet received) are generally not recognised as liabilities in the financial statements.

BC68 Therefore, the IFRIC concluded that contracts within the scope of the Interpretation should not be recognised to the extent that they are executory. The IFRIC noted that service concession arrangements within the scope of the Interpretation are generally executory when the contracts are signed. The IFRIC also concluded that during the construction phase of the arrangement the operator's asset (representing its accumulating right to be paid for providing construction services) should be classified as an intangible asset to the extent that it represents a right to receive a right (licence) to charge users of the public service (an intangible asset).

Items provided to the operator by the grantor (paragraph 27)

BC69 For service arrangements within the scope of the Interpretation, pre-existing infrastructure items made available to the operator by the grantor for the purpose of the service arrangement are not recognised as property, plant and equipment of the operator.

BC70 However, different considerations apply to other assets provided to the operator by the grantor if the operator can keep or deal with the assets as it wishes. Such assets become assets of the operator and so should be accounted for in accordance with general recognition and measurement principles, as should the obligations undertaken in exchange for them.

BC71 The IFRIC considered whether such assets would represent government grants, as defined in paragraph 3 of IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*:

> 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.

The IFRIC concluded that if such assets were part of the overall consideration payable by the grantor on an arms' length basis for the operator's services, they would not constitute 'assistance'. Therefore, they would not meet the definition of government grants in IAS 20 and that standard would not apply.

Transition (paragraphs 29 and 30)

BC72 IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* states that an entity shall account for a change in accounting policy resulting from initial application of an Interpretation in accordance with any specific transitional provisions in that Interpretation. In the absence of any specific transitional provisions, the general requirements of IAS 8 apply. The general requirement in IAS 8 is that the changes should be accounted for retrospectively, except to the extent that retrospective application would be impracticable.

~~[*] now paragraph 4.46 of the *Conceptual Framework*~~

HK(IFRIC)-Int 14
Revised ~~November 2016~~August 2020

Effective for annual periods beginning on or after 1 January 2008

HK (IFRIC) Interpretation 14

HKAS 19—The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction

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BC6 These effects raised general questions about the availability of economic benefits in the form of a refund or a reduction in future contributions.

Availability of the economic benefit

BC7 One view of "available" would limit the economic benefit to the amount that is realisable immediately at the end of the reporting period.

BC8 The IFRIC disagreed with this view. The *Framework** defines an asset as a resource "from which future economic benefits are expected to flow to the entity." Therefore, it is not necessary for the economic benefit to be realisable immediately. Indeed, a reduction in future contributions cannot be realisable immediately.

BC9 The IFRIC concluded that a refund or reduction in future contributions is available if it could be realisable at some point during the life of the plan or when the plan liability is settled. Respondents to D19 were largely supportive of this conclusion.

BC10 In the responses to D19, some argued that an entity may expect to use the surplus to give improved benefits. Others noted that future actuarial losses might reduce or eliminate the surplus. In either case there would be no refund or reduction in future contributions. The IFRIC noted that the existence of an asset at the end of the reporting period depends on whether the entity has the right to obtain a refund or reduction in future contributions. The existence of the asset at that date is not affected by possible future changes to the amount of the surplus. If future events occur that change the amount of the surplus, their effects are recognised when they occur. Accordingly, if the entity decides to improve benefits, or future losses in the plan reduce the surplus, the consequences are recognised when the decision is made or the losses occur. The IFRIC noted that such events of future periods do not affect the existence or measurement of the asset at the end of the reporting period.

The asset available as a refund of a surplus

BC11 The IFRIC noted that a refund of a surplus could potentially be obtained in three ways:

(a) during the life of the plan, without assuming that the plan liabilities have to be settled in order to get the refund (eg in some jurisdictions, the entity may have a right to a refund during the life of the plan, irrespective of whether the plan liabilities are settled); or

(b) assuming the gradual settlement of the plan liabilities over time until all members have left the plan; or

(c) assuming the full settlement of the plan liabilities in a single event (ie as a plan wind-up).

BC12 The IFRIC concluded that all three ways should be considered in determining whether an economic benefit was available to the entity. Some respondents to D19 raised the question of when an entity controls an asset that arises from the availability of a refund, in particular if a refund would be available only if a third party (for example the plan trustees) gave its approval. The IFRIC concluded that an entity controlled the asset only if the entity has an unconditional right to the refund. If that right depends on actions by a third party, the entity does not have an unconditional right.

BC13 If the plan liability is settled by an immediate wind-up, the costs associated with the wind-up may be significant. One reason for this may be that the cost of annuities available on the market is expected to be significantly higher than that implied by the IAS 19 basis. Other costs include the legal and other professional fees expected to be incurred during the winding-up process. Accordingly, a plan with an apparent surplus may not be able to recover any of that surplus on wind-up.

* The reference to the *Framework* is to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the ~~IASB~~ Board in 2001 and in effect when the Interpretation was developed. ~~In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.~~

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HK(IFRIC) Interpretation 17

Distributions of Non-cash Assets to Owners

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Should any exception be made to the principle of measuring a dividend payable at the fair value of the assets to be distributed?

BC28 Some are concerned that the fair value of the assets to be distributed might not be reliably measurable in all cases. They believe that exceptions should be made in the following circumstances:

(a) An entity distributes an ownership interest of another entity that is not traded in an active market and the fair value of the ownership interest cannot be measured reliably. The IFRIC noted that IAS 39[∀] does not permit investments in equity instruments that do not have a quoted market price in an active market[*] and whose fair value cannot be measured reliably to be measured at fair value.

(b) An entity distributes an intangible asset that is not traded in an active market and therefore would not be permitted to be carried at a revalued amount in accordance with IAS 38 *Intangible Assets*.

BC29 The IFRIC noted that in accordance with IAS 39 paragraphs AG80 and AG81,[α] the fair value of equity instruments that do not have a quoted price in an active market[†] is reliably measurable if:

(a) the variability in the range of reasonable fair value estimates is not significant for that instrument, or

(b) the probabilities of the various estimates within the range can be reasonably assessed and used in estimating fair value.

BC30 The IFRIC noted that, when the management of an entity recommends a distribution of a non-cash asset to its owners, one or both of the conditions for determining a reliable measure of the fair value of equity instruments that do not have a quoted price in an active market is likely to be satisfied. Management would be expected to know the fair value of the asset because management has to ensure that all owners of the entity are informed of the value of the distribution. For this reason, it would be difficult to argue that the fair value of the assets to be distributed cannot be determined reliably.

BC31 In addition, the IFRIC recognised that in some cases the fair value of an asset must be estimated. As mentioned in paragraph 86 of the *Framework for the Preparation and Presentation of Financial Statements*[#], the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

[∀] IFRS 9 *Financial Instruments* requires all investments in equity instruments to be measured at fair value.

[*] IFRS 13 *Fair Value Measurement*, issued in May 2011, defines fair value and contains the requirements for measuring fair value. IFRS 13 defines a Level 1 input as a quoted price in an active market for an identical asset or liability. Level 2 inputs include quoted prices for identical assets or liabilities in markets that are not active. As a result IFRS 9 refers to such equity instruments as 'an equity instrument that does not have a quoted price in an active market for an identical instrument (ie a Level 1 input)'.

[α] IFRS 9 *Financial Instruments* deleted paragraphs AG80 and AG81 of IAS 39. IFRS 13 *Fair Value Measurement*, issued in May 2011, defines fair value and contains requirements for measuring fair value. IFRS 13 defines a Level 1 input as a quoted price in an active market for an identical asset or liability. Level 2 inputs include quoted prices for identical assets or liabilities in markets that are not active. As a result IFRS 9 refers to such equity instruments as 'an equity instrument that does not have a quoted price in an active market for an identical instrument (ie a Level 1 input)'.

[†] IFRS 13 *Fair Value Measurement*, issued in May 2011, defines fair value and contains the requirements for measuring fair value. IFRS 13 defines a Level 1 input as a quoted price in an active market for an identical asset or liability. Level 2 inputs include quoted prices for identical assets or liabilities in markets that are not active. As a result IFRS 9 refers to such equity instruments as 'an equity instrument that does not have a quoted price in an active market for an identical instrument (ie a Level 1 input)'.

[#] ~~now paragraph 4.1 of the *Conceptual Framework*.~~ References to the *Framework* in this Basis for Conclusions are to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the ~~IASB~~Board in 2001 and in effect when the Interpretation was developed. ~~In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.~~

BC48 The IFRIC concluded that the requirement in IAS 1 prevents any of these items from being applied by analogy to the credit balance. In addition, the IFRIC noted that, with the exception of the items described in paragraph BC47(a)–(c), the applicable IFRSs require the items of income and expenses listed in paragraph BC47 to be reclassified to profit or loss when the related assets or liabilities are derecognised. Those items of income and expenses are recognised as items of other comprehensive income when incurred, deferred in equity until the related assets are disposed of (or the related liabilities are settled), and reclassified to profit or loss at that time.

BC49 The IFRIC noted that, when the dividend payable is settled, the asset distributed is also derecognised. Therefore, given the existing requirements in IFRSs, even if the credit balance were recognised as an item of other comprehensive income, it would have to be reclassified to profit or loss immediately. As a result, the credit balance would appear three times in the statement of comprehensive income—once recognised as an item of other comprehensive income, once reclassified out of other comprehensive income to profit or loss and once recognised as an item of profit or loss as a result of the reclassification. The IFRIC concluded that such a presentation does not faithfully reflect what has occurred. In addition, users of financial statements were likely to be confused by such a presentation.

BC50 Moreover, when an entity distributes its assets to its owners, it loses the future economic benefit associated with the assets distributed and derecognises those assets. Such a consequence is, in general, similar to that of a disposal of an asset. IFRSs (eg IAS 16, IAS 38, IAS 39[#] and IFRS 5) require an entity to recognise in profit or loss any gain or loss arising from the derecognition of an asset. IFRSs also require such a gain or loss to be recognised when the asset is derecognised. As mentioned in paragraph BC42, the *Framework* requires an entity to consider the effect of a transaction from the perspective of an entity for which the financial statements are prepared. For these reasons, the IFRIC concluded that the credit balance and gains or losses on derecognition of an asset should be accounted for in the same way.

BC51 Furthermore, paragraph 92 of the *Framework*[*] states: 'Income is recognised in the income statement when an increase in future economic benefits related to an increase in an asset or *a decrease of a liability* has arisen that can be measured reliably' (emphasis added). At the time of the settlement of a dividend payable, there is clearly a decrease in a liability. Therefore, the credit balance should be recognised in profit or loss in accordance with paragraph 92 of the *Framework*. Some might argue that the entity does not receive any additional economic benefits when it distributes the assets to its owners. As mentioned in paragraph BC41, the credit balance does not represent any additional economic benefits to the entity. Instead, it represents the unrecognised economic benefits that the entity obtained while it held the assets.

BC52 The IFRIC also noted that paragraph 55 of the *Framework*[†] states: 'The future economic benefits embodied in an asset may flow to the entity in a number of ways. For example, an asset may be: (a) used singly or in combination with other assets in the production of goods or services to be sold by the entity; (b) exchanged for other assets; (c) used to settle a liability; or (d) *distributed to the owners of the entity* [emphasis added].'

BC53 In the light of these requirements, in D23 the IFRIC concluded that the credit balance should be recognised in profit or loss. This treatment would give rise to the same accounting results regardless of whether an entity distributes non-cash assets to its owners, or sells the non-cash assets first and distributes the cash received to its owners. Most commentators on D23 supported the IFRIC's conclusion and its basis.

BC54 Some IFRIC members believed that it would be more appropriate to treat the distribution as a single transaction with owners and therefore recognise the credit balance directly in equity. This alternative view was included in D23 and comments were specifically invited. However, this view was not supported by commentators. To be recognised directly in equity, the credit balance must be considered an owner change in equity in accordance with IAS 1. The IFRIC decided that the credit balance does not arise from the distribution transaction. Rather, it represents the increase in value of the assets. The increase in the value of the asset does not meet the definition of an owner change in equity in accordance with IAS 1. Rather, it meets the definition of income and should be recognised in profit and loss.

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

~~[*] now paragraph 4.47 of the *Conceptual Framework*~~

~~[†] now paragraph 4.10 of the *Conceptual Framework*~~

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beginning on or after 1 July 2010

HK(IFRIC) Interpretation 19

Extinguishing Financial Liabilities with Equity Instruments

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Hong Kong (IFRIC) Interpretation 19
Extinguishing Financial Liabilities with Equity Instruments

References

- *Framework for the Preparation and Presentation of Financial Statements*[*]
- HKFRS 2 *Share-based Payment*
- HKFRS 3 (Revised) *Business Combinations*
- HKFRS 9 *Financial Instruments*
- HKFRS 13 *Fair Value Measurement*
- HKAS 1 *Presentation of Financial Statements*
- HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*
- HKAS 32 *Financial Instruments: Presentation*

Background

1 A debtor and creditor might renegotiate the terms of a financial liability with the result that the debtor extinguishes the liability fully or partially by issuing equity instruments to the creditor. These transactions are sometimes referred to as 'debt for equity swaps'. The International Financial Reporting Interpretations Committee has received requests for guidance on the accounting for such transactions.

Scope

2 This Interpretation addresses the accounting by an entity when the terms of a financial liability are renegotiated and result in the entity issuing equity instruments to a creditor of the entity to extinguish all or part of the financial liability. It does not address the accounting by the creditor.

3 An entity shall not apply this Interpretation to transactions in situations where:

(a) the creditor is also a direct or indirect shareholder and is acting in its capacity as a direct or indirect existing shareholder.

(b) the creditor and the entity are controlled by the same party or parties before and after the transaction and the substance of the transaction includes an equity distribution by, or contribution to, the entity.

(c) extinguishing the financial liability by issuing equity shares is in accordance with the original terms of the financial liability.

[*] ~~In October 2010 the HKICPA replaced the *Framework* with the *Conceptral Framework for Financial Reporting*.~~The reference is to the *Framework for the Preparation and Presentation of Financial Statements* and in effect when the Interpretation was developed.

(b) *cost of equity transactions and own equity instruments ('treasury shares') acquired and reissued or cancelled* (IAS 32). No gain or loss is recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments. These are transactions with an entity's owners in their capacity as owners.

(c) *equity instruments issued in share-based payment transactions* (IFRS 2). For equity-settled share-based payment transactions, the entity measures the goods or services received, and the corresponding increase in equity, directly, at the fair value of the goods or services received, unless that fair value cannot be estimated reliably. If the entity cannot estimate reliably the fair value of the goods or services received (eg transactions with employees), the entity measures their value, and the corresponding increase in equity, indirectly, by reference to the fair value of the equity instruments granted.

(d) *consideration transferred in business combinations* (IFRS 3). The total consideration transferred in a business combination is measured at fair value. It includes the acquisition-date fair values of any equity interests issued by the acquirer.

BC16 The IFRIC noted that the general principle of IFRSs is that equity is a residual and should be measured initially by reference to changes in assets and liabilities (the *Framework*[*] and IFRS 2). IFRS 2 is clear that when goods or services are received in return for the issue of equity instruments, the increase in equity is measured directly at the fair value of the goods or services received.

BC17 The IFRIC decided that the same principles should apply when equity instruments are issued to extinguish financial liabilities. However, the IFRIC was concerned that entities might encounter practical difficulties in measuring the fair value of both the equity instruments issued and the financial liability, particularly when the entity is in financial difficulty. Therefore, the IFRIC decided in D25 that equity instruments issued to extinguish a financial liability should be measured initially at the fair value of the equity instruments issued or the fair value of the liability extinguished, whichever is more reliably determinable.

BC18 However, in response to comments received on D25, the IFRIC reconsidered whether the entity should initially measure equity instruments issued to a creditor to extinguish all or part of a financial liability at the fair value of the equity instruments issued or the fair value of the liability extinguished. The IFRIC noted that many respondents proposed that a preferred measurement basis should be determined to avoid an 'accounting choice' developing in practice, acknowledging that both measurement approaches would need to be used to identify which was more reliably determinable.

BC19 Therefore the IFRIC decided to modify the proposal in D25 and identify a preferred measurement basis. In identifying this preferred measurement basis, the IFRIC noted that many respondents considered that the principles in IFRS 2 and the *Framework* referred to in paragraph BC16 support a measurement based on the fair value of the liability extinguished.

BC20 However, some respondents argued that the fair value of the equity issued should be the proposed measurement basis. They pointed out that this approach would be consistent with the consensus that the issue of an entity's equity instruments is consideration paid in accordance with paragraph 41 of IAS 39.[#] They also argued that the fair value of the equity issued best reflects the total amount of consideration paid in the transaction, which may include a premium that the creditor requires to renegotiate the terms of the financial liability.

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[*] References to the *Framework* in this Basis for Conclusions are to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the ~~IASB~~ Board in 2001 and in effect when the Interpretation was developed. ~~In September 2010 the IASB replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.~~

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

the creditor accepts cash to extinguish the liability, the entity should recognise a gain or loss in profit or loss.

BC26 Similarly, the IFRIC noted that, in accordance with IAS 32, when an entity amends the terms of a convertible instrument to induce early conversion, the entity recognises in profit or loss the fair value of any additional consideration paid to the holder. Thus, the IFRIC concluded that when an entity settles an instrument by issuing its own equity instruments and that settlement is not in accordance with the original terms of the financial liability, the entity should recognise a gain or loss in profit or loss.

BC27 As a result of its conclusions, the IFRIC decided that the entity should recognise a gain or loss in profit or loss. This gain or loss is equal to the difference between the carrying amount of the financial liability and the fair value of the equity instruments issued, or fair value of the liability extinguished if the fair value of the equity instruments issued cannot be reliably measured.

Partial extinguishment

BC28 The IFRIC also observed that the restructuring of a financial liability can involve both the partial settlement of the liability by the issue of equity instruments to the creditor and the modification of the terms of the liability that remains outstanding. Therefore, the IFRIC decided that the Interpretation should also apply to partial extinguishments. In the case of a partial extinguishment, the discussion in paragraphs BC25–BC27 applies to the part of the liability extinguished.

BC29 Many respondents requested clarification of the guidance on partial extinguishment included in D25. During its redeliberations, the IFRIC acknowledged that the issue of an entity's equity shares may reflect consideration paid for both the extinguishment of part of a financial liability and the modification of the terms of the part of the liability that remains outstanding.

BC30 The IFRIC decided that to reflect this, an entity should allocate the consideration paid between the part of the liability extinguished and the part of the liability that remains outstanding. The entity would consider this allocation in determining the profit or loss to be recognised on the part of the liability extinguished and in its assessment of whether the terms of the remaining liability have been substantially modified.

BC31 The IFRIC concluded that providing additional guidance on determining whether the terms of the part of the financial liability that remains outstanding has been substantially modified in accordance with paragraph 40 of IAS 39[#] was outside the scope of the Interpretation.

Presentation

BC32 The IFRIC decided that an entity should disclose the gain or loss on the extinguishment of the financial liability by the issue of equity instruments as a separate line item in profit or loss or in the notes. This requirement is consistent with the *Framework* and the requirements in other IFRSs, for example:

(a) When gains are recognised in the income statement, they are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions. (paragraph 76 of the *Framework*)[*]

(b) An entity shall present additional line items, headings and subtotals in the statement of comprehensive income and the separate income statement (if presented), when

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

[*] ~~now paragraph 4.31 of the *Conceptual Framework*~~

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HK (IFRIC) Interpretation 20

Stripping Costs in the Production Phase of a Surface Mine

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Hong Kong (IFRIC) Interpretation 20
Stripping Costs in the Production Phase of a Surface Mine

References

- *Conceptual Framework for Financial Reporting*[*]
- HKAS 1 *Presentation of Financial Statements*
- HKAS 2 *Inventories*
- HKAS 16 *Property, Plant and Equipment*
- HKAS 38 *Intangible Assets*

Background

1 In surface mining operations, entities may find it necessary to remove mine waste materials ('overburden') to gain access to mineral ore deposits. This waste removal activity is known as 'stripping'.

2 During the development phase of the mine (before production begins), stripping costs are usually capitalised as part of the depreciable cost of building, developing and constructing the mine. Those capitalised costs are depreciated or amortised on a systematic basis, usually by using the units of production method, once production begins.

3 A mining entity may continue to remove overburden and to incur stripping costs during the production phase of the mine.

4 The material removed when stripping in the production phase will not necessarily be 100 per cent waste; often it will be a combination of ore and waste. The ratio of ore to waste can range from uneconomic low grade to profitable high grade. Removal of material with a low ratio of ore to waste may produce some usable material, which can be used to produce inventory. This removal might also provide access to deeper levels of material that have a higher ratio of ore to waste. There can therefore be two benefits accruing to the entity from the stripping activity: usable ore that can be used to produce inventory and improved access to further quantities of material that will be mined in future periods.

5 This Interpretation considers when and how to account separately for these two benefits arising from the stripping activity, as well as how to measure these benefits both initially and subsequently.

Scope

6 This Interpretation applies to waste removal costs that are incurred in surface mining activity during the production phase of the mine ('production stripping costs').

[*] The reference is to the *Conceptual Framework for Financial Reporting*, issued in 2010 and in effect when the Interpretation was developed.

Consensus

Recognition of production stripping costs as an asset

BC6 The Committee decided that an entity may create two benefits by undertaking stripping activity (and incurring stripping costs). These benefits are the extraction of the ore in the current period and improved access to the ore body for a future period. The result of this is that the activity creates an inventory asset and a non-current asset.

BC7 The asset recognition criteria included in paragraph 9 of this Interpretation are those referred to in paragraph 4.44 of the *Conceptual Framework for Financial Reporting*.* An additional criterion is, however, also included in this Interpretation for recognising the stripping activity asset—that the entity can specifically identify the 'component' of the ore body for which access is being improved. All three criteria must be met for the costs to qualify for recognition as an asset. If the criteria are not met, a stripping activity asset will not be recognised.

BC8 'Component' refers to the specific volume of the ore body that is made more accessible by the stripping activity. The identified component of the ore body would typically be a subset of the total ore body of the mine. A mine may have several components, which are identified during the mine planning stage. As well as providing a basis for measuring the costs reliably at recognition stage, identification of components of the ore body is necessary for the subsequent depreciation or amortisation of the stripping activity asset, which will take place as that identified component of the ore body is mined.

BC9 Identifying components of the ore body requires judgement. The Committee understands that an entity's mine plan will provide the information required to allow these judgements to be made with reasonable consistency.

BC10 This Interpretation also states that the stripping cost asset should be recognised as 'part' of an existing asset. 'Part' refers to the addition to, or enhancement of, the existing asset that relates to the stripping activity asset. The Committee took the view that the stripping activity asset was more akin to being a part of an existing asset, rather than being an asset in its own right. The stripping activity asset might add to or improve a variety of existing assets, for example the mine property (land), the mineral deposit itself, an intangible right to extract the ore or an asset that originated in the mine development phase.

BC11 The Committee decided that it is not necessary for the Interpretation to define whether the benefit created by the stripping activity is tangible or intangible in nature—this will be determined from the nature of the related underlying existing asset.

Initial measurement of the stripping activity asset

BC12 IAS 16 paragraph 16(b) states that the cost of an item of property, plant and equipment includes 'any costs directly attributable to bringing the asset to the location and condition necessary...'. Examples of the types of costs that the Committee would expect to be included as directly attributable overhead costs (paragraph 12 of the Interpretation) would include an allocation of salary costs of the mine supervisor overseeing that component of the mine, and an allocation of rental costs of any equipment that was hired specifically to perform the stripping activity.

* The reference is to the *Conceptual Framework for Financial Reporting*, issued in 2010 and in effect when the Interpretation was developed.

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HK(IFRIC) Interpretation 22

Foreign Currency Transactions and Advance Consideration

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Hong Kong (IFRIC) Interpretation 22
Foreign Currency Transactions and Advance Consideration

References

- *Conceptual Framework for Financial Reporting*[1]
- HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*
- HKAS 21 *The Effects of Changes in Foreign Exchange Rates*

Background

1 Paragraph 21 of HKAS 21 *The Effects of Changes in Foreign Exchange Rates* requires an entity to record a foreign currency transaction, on initial recognition in its functional currency, by applying to the foreign currency amount the spot exchange rate between the functional currency and the foreign currency (the exchange rate) at the date of the transaction. Paragraph 22 of HKAS 21 states that the date of the transaction is the date on which the transaction first qualifies for recognition in accordance with HKFRS Standards (Standards).

2 When an entity pays or receives consideration in advance in a foreign currency, it generally recognises a non-monetary asset or non-monetary liability[2] before the recognition of the related asset, expense or income. The related asset, expense or income (or part of it) is the amount recognised applying relevant Standards, which results in the derecognition of the non-monetary asset or non-monetary liability arising from the advance consideration.

3 The International Financial Reporting Standards Interpretations Committee (the Interpretations Committee) initially received a question asking how to determine 'the date of the transaction' applying paragraphs 21–22 of IAS 21 when recognising revenue. The question specifically addressed circumstances in which an entity recognises a non-monetary liability arising from the receipt of advance consideration before it recognises the related revenue. In discussing the issue, the Interpretations Committee noted that the receipt or payment of advance consideration in a foreign currency is not restricted to revenue transactions. Accordingly, the Interpretations Committee decided to clarify the date of the transaction for the purpose of determining the exchange rate to use on initial recognition of the related asset, expense or income when an entity has received or paid advance consideration in a foreign currency.

[1] The reference is to the *Conceptual Framework for Financial Reporting*, issued in 2010 and in effect when the Interpretation was developed.

[2] For example, paragraph 106 of HKFRS 15 *Revenue from Contracts with Customers* requires that if a customer pays consideration, or an entity has a right to an amount of consideration that is unconditional (ie a receivable), before the entity transfers a good or service to the customer, the entity shall present the contract as a contract liability when the payment is made or the payment is due (whichever is earlier).

Monetary and non-monetary items

BC13 The payment or receipt of advance consideration generally gives rise to the recognition of a non-monetary asset or non-monetary liability. However, an advance payment or receipt could give rise to a monetary asset or liability instead of a non-monetary asset or liability.

BC14 When the asset or liability is a monetary item, paragraphs 28–29 of IAS 21 require an entity to recognise an exchange difference in profit or loss for any change in the exchange rate between the transaction date and the date of settlement of that asset or liability. Consequently, the question about which exchange rate to use on initial recognition of the related asset, expense or income arises only when the advance consideration gives rise to the recognition of a non-monetary asset or non-monetary liability. Accordingly, the Interpretations Committee decided that this Interpretation applies only in circumstances in which an entity recognises a non-monetary asset or non-monetary liability arising from advance consideration.

BC15 Some respondents to the draft Interpretation requested guidance in determining whether the payment or receipt of advance consideration gives rise to a monetary or non-monetary asset or liability. These respondents said that, for some transactions, this assessment can be difficult.

BC16 In considering the request, the Interpretations Committee noted that the Interpretation is not adding a new requirement to determine whether an item is monetary or non-monetary—this requirement already exists in IAS 21. The Interpretation simply clarifies which exchange rate to use for particular transactions. The Interpretations Committee decided that it was outside the scope of this Interpretation to provide application guidance on the definition of monetary and non-monetary items.

BC17 Nonetheless, the Interpretations Committee acknowledged that an entity may need to apply judgement in determining whether an item is monetary or non-monetary. It also noted references in Standards and *The Conceptual Framework for Financial Reporting* (the *Conceptual Framework*)[1] that may be helpful in determining whether an item is monetary or non-monetary. These references include:

(a) paragraph 16 of IAS 21;

(b) paragraph AG11 of IAS 32 *Financial Instruments: Presentation*; and

(c) paragraph 4.17 of *The Conceptual Framework*.

Consensus

The date of the transaction

BC18 Paragraph 22 of IAS 21 defines the date of the transaction for the purpose of determining the exchange rate to use on initial recognition of a foreign currency transaction as 'the date on which the transaction first qualifies for recognition in accordance with IFRSs'.

BC19 The Interpretations Committee observed that there could be two ways of identifying 'the transaction' for the purpose of determining the exchange rate to use on initial recognition:

(a) the 'one-transaction' approach—the receipt or payment of consideration and the transfer of the goods or services are all considered to be part of the same transaction. Thus, the date of the transaction is determined by the date on which the first element of the transaction qualifies for recognition applying the relevant Standards.

1 References to the *Conceptual Framework for Financial Reporting* in this Basis for Conclusions are to the *Conceptual Framework for Financial Reporting*, issued in 2010 and in effect when the Interpretation was developed.

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Hong Kong (SIC) Interpretation 29

Service Concession Arrangements: Disclosures

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8 Paragraph 15 of the *Framework*[1] states that the economic decisions taken by users of financial statements require an evaluation of the ability of the entity to generate cash and cash equivalents and of the timing and certainty of their generation. Paragraph 21 of the *Framework* states that financial statements also contain notes and supplementary schedules and other information. For example, they may contain additional information that is relevant to the needs of users about the items in the statement of financial position and statement of comprehensive income. They may also include disclosures about the risks and uncertainties affecting the entity and any resources and obligations not recognised in the statement of financial position.

9 A service concession arrangement often has provisions or significant features that warrant disclosure of information necessary to assist in assessing the amount, timing and certainty of future cash flows, and the nature and extent of the various rights and obligations involved. The rights and obligations associated with the services to be provided usually involve a high level of public involvement (eg to provide electricity to a city). Other obligations could include significant acts such as building an infrastructure asset (eg power plant) and delivering that asset to the grantor at the end of the concession period.

10 IAS 1.112(c) requires an entity's notes to provide additional information that is not presented elsewhere in the financial statements, but is relevant to an understanding of any of them. The definition of notes in IAS 1.7 indicates that notes provide narrative descriptions or disaggregations of items disclosed in the statement of financial position, statement of comprehensive income, separate income statement (if presented), statement of changes in equity and statement of cash flows, as well as information about items that do not qualify for recognition in those statements.

Date of issue

December 2004

Effective date

This Interpretation becomes effective for annual accounting periods beginning on or after 1 January 2005; earlier application is encouraged. Changes in accounting policies shall be accounted for in accordance with HKAS 8.

An entity shall apply the amendment in paragraphs 6(e) and 6A for annual periods beginning on or after 1 January 2008. If an entity applies HK(IFRIC)-Int 12 for an earlier period, the amendment shall be applied for that earlier period.

HKFRS 16, issued in May 2016, amended paragraph 5. An entity shall apply that amendment when it applies HKFRS 16.

This Interpretation supersedes Interpretation 16 *Disclosure - Service Concession Arrangements* (issued in July 2002).

[1] Reference to the *Framework* in this Basis for Conclusions are to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the IASB in 2001 and in effect when the Interpretation was developed.

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Hong Kong (SIC) Interpretation 32

Intangible Assets — Web Site Costs

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4 When accounting for internal expenditure on the development and operation of an entity's own web site for internal or external access, the issues are:

(a) whether the web site is an internally generated intangible asset that is subject to the requirements of HKAS 38; and

(b) the appropriate accounting treatment of such expenditure.

5 This Interpretation does not apply to expenditure on purchasing, developing, and operating hardware (eg web servers, staging servers, production servers and Internet connections) of a web site. Such expenditure is accounted for under HKAS 16. Additionally, when an entity incurs expenditure on an Internet service provider hosting the entity's web site, the expenditure is recognised as an expense under HKAS 1.88 and the ~~*Framework*[1]~~ *Conceptual Framework for Financial Reporting* when the services are received.

6 HKAS 38 does not apply to intangible assets held by an entity for sale in the ordinary course of business (see HKAS 2 and HKFRS 15) or leases of intangible assets accounted for in accordance with HKFRS 16. Accordingly, this Interpretation does not apply to expenditure on the development or operation of a web site (or web site software) for sale to another entity or that is accounted for in accordance with HKFRS 16.

Conclusions

7 An entity's own web site that arises from development and is for internal or external access is an internally generated intangible asset that is subject to the requirements of HKAS 38.

8 A web site arising from development shall be recognised as an intangible asset if, and only if, in addition to complying with the general requirements described in HKAS 38.21 for recognition and initial measurement, an entity can satisfy the requirements in HKAS 38.57. In particular, an entity may be able to satisfy the requirement to demonstrate how its web site will generate probable future economic benefits in accordance with HKAS 38.57(d) when, for example, the web site is capable of generating revenues, including direct revenues from enabling orders to be placed. An entity is not able to demonstrate how a web site developed solely or primarily for promoting and advertising its own products and services will generate probable future economic benefits, and consequently all expenditure on developing such a web site shall be recognised as an expense when incurred.

9 Any internal expenditure on the development and operation of an entity’s own web site shall be accounted for in accordance with HKAS 38. The nature of each activity for which expenditure is incurred (eg training employees and maintaining the web site) and the web site’s stage of development or post-development shall be evaluated to determine the appropriate accounting treatment (additional guidance is provided in the Appendix to this Interpretation). For example:

(a) the Planning stage is similar in nature to the research phase in HKAS 38.54-.56. Expenditure incurred in this stage shall be recognised as an expense when it is incurred.

~~[1] References to the *Framework* are to *Framework for the Preparation and Presentation of Financial Statements*, issued by the HKICPA in 1997. In October 2010 the HKICPA replaced the *Framework* with the *Conceptual Framework for Financial Reporting*.~~

17 Once development of a web site is complete, an entity begins the activities described in the Operating stage. Subsequent expenditure to enhance or maintain an entity's own web site is recognised as an expense when incurred unless it meets the recognition criteria in IAS 38.18. IAS 38.20 explains that most subsequent expenditures are likely to maintain the future economic benefits embodied in an existing intangible asset rather than meet the definition of an intangible asset and the recognition criteria set out in IAS 38. In addition, it is often difficult to attribute subsequent expenditure directly to a particular intangible asset rather than to the business as a whole. Therefore, only rarely will subsequent expenditure — expenditure incurred after the initial recognition of a purchased intangible asset or after completion of an internally generated intangible asset — be recognised in the carrying amount of an asset*.

18 An intangible asset is measured after initial recognition by applying the requirements of IAS 38.72-.87. The revaluation model in IAS 38.75 is applied only when the fair value of an intangible asset can be determined by reference to an active market.† However, as an active market is unlikely to exist for web sites, the cost model applies. Additionally, as indicated in IAS 38.92, many intangible assets are susceptible to technological obsolescence, and given the history of rapid changes in technology, the useful life of web sites will be short.

Amended reference to the *Conceptual Framework*

19 Following the issue of the revised *Conceptual Framework for Financial Reporting* in 2018 (2018 *Conceptual Framework*), the Board issued *Amendments to References to the Conceptual Framework in IFRS Standards*. In SIC-32, that document replaced a reference in paragraph 5 to the *Framework for the Preparation and Presentation of Financial Statements* adopted by the Board in 2001 (*Framework*) with a reference to the 2018 *Conceptual Framework*. The Board does not expect that replacement to have a significant effect on the application of the Interpretation. Paragraph 5 describes the accounting for expenditure excluded from the scope of the Interpretation. That paragraph also states that this type of expenditure—expenditure on an Internet service provider hosting the entity's web site—is recognised as an expense, so the amendment will not affect the accounting treatment.

Date of Issue

December 2004

Effective Date

This Interpretation becomes effective for annual accounting periods beginning on or after 1 January 2005; earlier application is encouraged. Changes in accounting policies shall be accounted for in accordance with HKAS 8.

HKAS 1 (as revised in 2007) amended the terminology used throughout HKFRSs. In addition it amended paragraph 5. An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. If an entity applies HKAS 1 (revised 2007) for an earlier period, the amendments shall be applied for that earlier period.

* The new text was added by IFRS 3 *Business Combinations* in 2004.

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

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HKFRS 15 *Revenue from Contracts with Customers*, issued in July 2014, amended the 'References' section and paragraph 6. An entity shall apply that amendment when it applies HKFRS 15.

HKFRS 16, issued in May 2016, amended paragraph 6. An entity shall apply that amendment when it applies HKFRS 16.

Amendments to References to the Conceptual Framework in HKFRS Standards, issued in 2018, amended paragraph 5. An entity shall apply that amendment for annual periods beginning on or after 1 January 2020. Earlier application is permitted if at the same time an entity also applies all other amendments made by *Amendments to References to the Conceptual Framework in HKFRS Standards*. An entity shall apply the amendment to HK(SIC)-Int 32 retrospectively in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. However, if an entity determines that retrospective application would be impracticable or would involve undue cost or effort, it shall apply the amendment to HK(SIC)-Int 32 by reference to paragraphs 23–28, 50–53 and 54F of HKAS 8.

This Interpretation supersedes Interpretation 19 *Intangible Asset – Website Costs* (issued in October 2002).

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