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Introduction

Grant Thornton International Ltd (Grant Thornton International or GTI), through its International Financial Reporting Standards (IFRS) team, is pleased to make available this full text edition of IFRS Hot Topics (Hot Topics). Hot Topics are relevant to professional personnel in those member firms where clients' financial statements are, or will be required to be, issued under IFRS. Hot Topics set out Grant Thornton International's analysis of how IFRS should be applied in particular situations where IFRS does not provide specific guidance. The analyses are based on the collective expertise of our GTI IFRS team and experts from member firms participating in the Grant Thornton IFRS Interpretations Group and the Financial Instruments Working Group. Grant Thornton International is a membership organisation that does not practice accounting and Hot Topics are therefore intended as guidance without binding effect upon preparers and engagement teams. Nevertheless, to encourage careful deliberation and consistent application of IFRS, engagement teams are advised to consult the GTI IFRS team before accepting an accounting policy that conflicts with the recommended approach. As always, determining the appropriate accounting treatment of transactions in accordance with IFRS depends on the specific facts and circumstances.

How to use this document
This document combines all Hot Topics published as of 30 November 2012, which have not been subsequently withdrawn, for convenience. An outline of all issues covered is provided by the table of contents, from where you can 'jump' into each Hot Topic by clicking on the relevant page number. This PDF-file also allows a full text search to locate a word, a series of words or a fraction of a word within the file. Depending on the program used to view this PDF-file, the search function is usually triggered by pressing <Ctrl> and <F> simultaneously. Also, an index of Hot Topics by Standard, Interpretation or Conceptual Framework is included after the contents page.

Updating of Hot Topics
Since the previous update in January 2010, the Hot Topics have been updated to reflect new standards and changes to IFRS published up to 30 November 2012 (excluding IFRS 9 Financial Instruments - see text box below), where applicable. Such updates consist mostly of changes to specific references to IFRS paragraphs, and changes in definitions or terminologies. The relevant version of each IFRS used in updating the Hot Topic is indicated at the beginning of each Hot Topic. The IFRSs used are the latest published versions as at 30 November 2012, except where stated otherwise.

Standard updates
Most Hot Topics have been revised only for changes in terminology or references (due to the issuance of new IFRS guidance or amendments) without a change to the conclusion reached or guidance given. Text boxes have also been added to indicate current International Accounting Standards Board (IASB or Board) or International Financial Reporting Interpretations Committee (IFRIC) projects that could lead to future changes.

Amended Hot Topics
Some updates resulted in more substantial changes (where the guidance or discussion in the Hot Topic has been amended since last publication). These Hot Topics are identified in Appendix A with a brief description of the changes.

Withdrawn Hot Topics
In situations where new standards or amendments to IFRS have addressed the issues discussed in a Hot Topic or the issue is included in a more comprehensive Grant Thornton International guidance publication, the Hot Topics have been withdrawn. These Hot Topics are identified in Appendix B with the reasons for withdrawal.
The effective dates of new standards and amendments considered in updating the Hot Topics vary. Engagement teams should always consider the effective dates of the new standards and amendments and consider whether earlier adoption is permitted.

**IFRS 9 project update**

This Hot Topics update does not address the requirements of IFRS 9 *Financial Instruments* (IFRS 9), the project to replace IAS 39 *Financial Instruments: Recognition and Measurement* (IAS 39). At this time, IFRS 9 only addresses the classification and measurement of financial assets and liabilities along with derecognition. Most of the requirements for financial liabilities and derecognition were carried forward unchanged from IAS 39 (with the exception of some changes to the fair value option for financial liabilities to address the issue of own credit risk).

In December 2011, the Board amended IFRS 9 to require application for annual periods beginning on or after 1 January 2015 (early application is permitted) and to not require the restatement of comparative-period financial statements upon initial application. On 28 November 2012, the Board issued an exposure draft proposing limited modifications to IFRS 9’s financial asset classification model to address application issues. Work continues to progress on Phases 2 and 3 of the IFRS 9 project which address impairment and hedge accounting, respectively.

Every effort has been made to refer to new standards issued up to 30 November 2012; however, preparers and engagement teams are encouraged to carefully study subsequent amendments to standards and interpretations as well as other relevant guidance to ensure that the Hot Topic remains relevant (specifically for Hot Topics dealing with financial instruments as these Hot Topics still contain guidance based on the provisions of IAS 39). The provisions of IFRS 9 should be considered for issues related to financial assets and liabilities, where appropriate.

This update also includes references to certain exposure drafts or discussion papers issued by the IASB. These are provided for informational purposes only and are not sources of authoritative guidance until issued as actual IFRSs.

*Where to find this document and distribution*

This document will be made available via GTInet (www.GTInet.org> Services & markets> Assurance> IFRS>Internal IFRS Publications). Please distribute this document within your firm as necessary. This document is intended for the internal use of Grant Thornton personnel only and should not be distributed to third parties.

For further information you may contact GTT’s IFRS team at ifrs@gtinet.org

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<td>Acquisition date fair value and subsequent selling price</td>
<td>HT 2008-14</td>
</tr>
<tr>
<td>IFRS 3</td>
<td>Consolidated financial statements when an entity ceases to be a parent entityCost of an investment in a subsidiary in separate financial statements</td>
<td>HT 2009-01</td>
</tr>
<tr>
<td>IFRS 3</td>
<td>Acquisitions and disposals of assets held in a corporate shell</td>
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<td>IFRS 3</td>
<td>Non-controlling interests and other comprehensive income</td>
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<td>IFRS 4</td>
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<td>IFRS</td>
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</tr>
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<td>5</td>
<td>Acquisition date fair value and subsequent selling price</td>
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</tr>
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<td>10</td>
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<td>2006-21</td>
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<td>10</td>
<td>Derivatives and non-controlling interest participation rates</td>
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<td>10</td>
<td>Consolidated financial statements when an entity ceases to be a parent entity</td>
<td>2008-09</td>
</tr>
<tr>
<td>10</td>
<td>Acquisitions and disposals of assets held in a corporate shell</td>
<td>2009-02</td>
</tr>
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<td>Accounting for the contribution of assets or businesses to a joint arrangement by a party to the joint arrangement on formation</td>
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<td>2006-03</td>
</tr>
<tr>
<td>13</td>
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<td>2006-19</td>
</tr>
</tbody>
</table>
IFRS Hot Topics 2005
HT 2005-01  Share-based payments of an associate

Relevant IFRS
IAS 28 Investments in Associates and Joint Ventures
IFRS 2 Share-based Payment

Issue
How and when should the investor record a change in its ownership interest when an associate (investee) issues new shares under a share-based payment scheme?

Guidance
An issue of new shares by an associate, for example on exercise of options granted in a share-based payment arrangement, will (usually) increase the associate's net assets but reduce the investor's percentage ownership interest. This will increase or decrease the investor's share of net assets (unless the proceeds per share exactly equals the net assets per share of the associate).

IAS 28 is clear that if the change results in the investment ceasing to be an associate and becoming a financial asset, then the investor recognises in profit or loss any difference between the fair value of any retained investment plus any sale proceeds from the part disposal and the carrying value of the investment at the date the equity method was discontinued (IAS 28.22(b)). Also, the investor reclassifies its share of any gains or losses the investee's previously recognised through other comprehensive income to profit or loss (IAS 28.22(c)). Further, IAS 28.24 states that when an investment in an associate becomes an investment in a joint venture (or vice versa), the investor continues to apply the equity method and does not remeasure the retained interest.

IFRS does not directly address how to reflect this change in ownership interest when significant influence is retained in the financial statements of the investor. Our preferred view is that this increase or decrease should be recorded in profit and loss in the investor's financial statements with a corresponding adjustment to the carrying value of the associate.

However, this is a matter of interpretation and so other treatments may be possible. The investor should make an accounting policy choice to report the increase or decrease either in equity or profit/loss, since IFRS is not explicit on this issue. This accounting policy should be applied consistently.

Project update
In November 2012, the IASB issued an exposure draft Equity Method: Share of Other Net Asset Changes whereby it proposes that an investor should recognize, in the investor’s equity, its share of the changes in the net assets of the investee that are not recognised in profit or loss or other comprehensive income of the investee, and that are not distributions received (eg other net asset changes). The comment period ends 22 March 2013. If approved as presently written, this proposed amendment would change the guidance in this Hot Topic. This Hot Topic has not been updated to reflect the proposed amendments.
Discussion

IFRS 2 specifies the financial reporting by an entity when it undertakes a share-based payment transaction. The required reporting depends on the type of share-based payment arrangement but the main principle of IFRS 2 is that goods or services received in a share-based payment arrangement are recognised when the goods or services are received. For transactions with an entity's employees to be settled in the entity's own equity instruments (employee share scheme), IFRS 2 requires an expense to be recognised, calculated in most circumstances as the fair value of the award at the date of grant. The expense is recognised in the income statement over the vesting period of the award (if any) and the share option credited to equity.

Where awards are granted in the form of options, employees will typically exercise some or all of their options after vesting. On exercise the employee pays the exercise price and receives shares. The exercise proceeds are credited to equity (with a debit to cash).

IAS 28 requires that an investment in an associate is accounted for under the equity method except in limited circumstances (IAS 28.16 and 17). Under the equity method, the "investment is initially recognised at cost and adjusted thereafter for the post-acquisition change in the investor's share of the investee's net assets…" (IAS 28.3). The investor will therefore include its share of the associate's profit or loss including its share of the associate’s IFRS 2 expense. IAS 28.10 states that:

"Under the equity method, on initial recognition the investment in an associate or a joint venture is recognised at cost, and the carrying amount is increased or decreased to recognise the investor's share of the profit or loss of the investee after the date of acquisition. The investor's share of the profit or loss of the investee is recognised in the investor's profit or loss. Distributions received from an investee reduce the carrying amount of the investment. Adjustments to the carrying amount may also be necessary for changes in the investor's proportionate interest in the investee arising from changes in the investee's other comprehensive income. Such changes include those arising from the revaluation of property, plant and equipment and from foreign exchange translation differences. The investor's share of those changes is recognised in the investor's other comprehensive income (see IAS 1 'Presentation of Financial Statements')."

IAS 28.10 explicitly deals with changes in the carrying amount of the investment due to the investee’s profits or losses, dividend distributions and changes in other comprehensive income but does not provide explicit guidance on accounting for other transactions (eg share issuance by the investee) that affects the investor's proportionate share of the investee.

However, IAS 28.22 and 23 discuss how an investor accounts for its investment when it discontinues the use of the equity method. In that situation, the investor recognises in profit or loss any difference between the fair value of any retained investment plus any sale proceeds and the carrying value of the investment at the date when the investment ceases to be an associate or a joint venture.

Although this is not the situation covered by this Hot Topic, IAS 28.25 includes provisions that suggest that a similar treatment is intended for part disposals (or deemed disposals) when the proportionate interest is decreased but significant interest is retained. IAS 28.25 states: "…If an entity's ownership interest in an associate or a joint venture is reduced, but the entity continues to apply the equity method, the entity shall reclassify to profit or loss the proportion of the gain or loss that had previously been recognised in other comprehensive income relating to that reduction in ownership interest if that gain or loss would be required to be reclassified to profit or loss on the disposal of the related assets or liabilities".

This can be interpreted such that all dilution gains and losses resulting from changes in the investee’s equity should be recorded in profit or loss rather than equity or other comprehensive income. This is our preferred view but other views may also be acceptable. Management judgement is needed to develop an acceptable accounting policy for this type of transaction in accordance with the general principles of IAS 28 and IAS 8.

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IAS 28.12 requires that the investor's share of profit or loss and changes in equity of the associate are based on present ownership interests and are not affected by the possible exercise or conversion of potential voting rights except when an entity has, in substance, an existing ownership as a result of a transaction that currently gives it access to the returns associated with an ownership interest (IAS 28.13). Hence the issue of shares by the associate is generally accounted for when it takes place, not when options over the shares are issued.

Example
An investor acquires 250 shares in a company with a total issued share capital of 1,000 shares on 1/1/X0. The investor determines that the investee in an associate in accordance with IAS 28. Cost is CU800, and the fair value of the investee's net assets is CU2,000. Hence on acquisition the investor records the investment at CU800, comprising:

<table>
<thead>
<tr>
<th>CU</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Goodwill</td>
<td>300</td>
</tr>
<tr>
<td>Share of net assets (CU2,000*25%)</td>
<td>500</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>800</strong></td>
</tr>
</tbody>
</table>

For the year-ended 31/12/X0 the associate generates net profits of CU1,000, increasing its net assets to CU3,000. The investor's carrying amount is increased to CU1,050 [800 + 1,000*25%] at 31/12/X0.

At 1/1/X1, the associate issues 250 share options to its employees, which can be converted into 250 shares. The exercise price of each option is CU2. The grant-date fair value of each option issued is CU1 and the vesting period is 2 years. The total grant-date fair value of the options issued is CU250 (250 x CU1). All 250 options are expected to vest.

The associate recognises share-based remuneration expense of CU125 in profit or loss and an offsetting credit to equity for the year-ended 31/12/X1. The investor recognises its share of the share-based remuneration expense in profit or loss as part of income from equity method investments but records the offsetting credit as a reduction of its investment. Assuming no other profit or loss items for the year-ended 31/12/X1, and ignoring any tax effects (with the effect that the associate's net assets are unchanged from 1/12/X1), the entries are as follows at 31/12/X1:

<table>
<thead>
<tr>
<th></th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Associate’s Entry</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share-based payment remuneration</td>
<td>CU125</td>
<td></td>
</tr>
<tr>
<td>Shareholders’ equity</td>
<td></td>
<td>CU125</td>
</tr>
<tr>
<td><strong>Investor’s Entry</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share of profit or loss of associate (25%*125)</td>
<td>CU31.25</td>
<td></td>
</tr>
<tr>
<td>Investment in associate</td>
<td></td>
<td>CU31.25</td>
</tr>
</tbody>
</table>

At the end of the vesting period, 12/31/X2, all options vest. In 20X2, the associate generates net profits of CU875 (comprising CU1,000 less the share-based payment charge of CU125). It records the following entry:

<table>
<thead>
<tr>
<th></th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Associate’s Entry</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Share-based payment remuneration</td>
<td>CU125</td>
<td></td>
</tr>
<tr>
<td>Other net profits</td>
<td></td>
<td>CU1,000</td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td>CU500</td>
</tr>
<tr>
<td>Other net assets</td>
<td></td>
<td>CU1,000</td>
</tr>
<tr>
<td>Shareholders’ equity</td>
<td></td>
<td>CU625</td>
</tr>
</tbody>
</table>
The exercise of the share options results in the dilution of the investor’s interest in the associate.

**Dilution calculation**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investor’s share of associate’s net assets before exercise (25% X CU4,000)</td>
<td>1,000</td>
</tr>
<tr>
<td>Change in investor’s ownership interest (25% - (250 / (1,000 + 250))</td>
<td>5%</td>
</tr>
<tr>
<td>Investor’s share of associate’s net assets after exercise (20% X (CU4,000 + CU500))</td>
<td>900</td>
</tr>
<tr>
<td>Cumulative adjustment required*</td>
<td>100</td>
</tr>
<tr>
<td>Less adjustment previously recognised for share-based payment expense (2 years X CU31.25)</td>
<td>62.50</td>
</tr>
<tr>
<td>Loss on dilution</td>
<td>37.50</td>
</tr>
</tbody>
</table>

**Cumulative adjustment calculation**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net assets lost = CU4,000 X 5%</td>
<td>200</td>
</tr>
<tr>
<td>Share of proceeds on exercise of options (CU500 X 20%)</td>
<td>100</td>
</tr>
<tr>
<td>Cumulative adjustment required*</td>
<td>100</td>
</tr>
</tbody>
</table>

The investor's accounting entry to record the dilution loss is:

<table>
<thead>
<tr>
<th>Investor’s Entry</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share of profit or loss of associate</td>
<td>CU37.5</td>
<td></td>
</tr>
<tr>
<td>Investment in associate</td>
<td></td>
<td>CU37.5</td>
</tr>
</tbody>
</table>

In future periods the investor will recognise 20% of the associate's profit or loss and gains or losses recognised through other comprehensive income.
Deferred tax on first-time adoption of IFRS

Issues
a) Does the IAS 12 initial recognition exemption apply on first-time adoption and how does the IFRS 1 election to use fair value as deemed cost for some assets affect this?
b) IFRS 1.D2 provides an exemption from recognising the expense relating to equity-settled share-based payments granted prior to 7 November 2002. What is the deferred tax treatment for such grants?
c) If an entity has acquired intangible assets with a zero tax base in a pre-transition date business combination, is a deferred tax provision required? Is the corresponding adjustment made to goodwill or to retained earnings?

Note: In October 2012, the IFRS team issued an update to its *Road to IFRS - A practical guide to IFRS 1 and first-time adoption*. The Guide includes a summary of the discussion contained in this Hot Topic. This Guide is available in the IFRS section of the GTInet website under 'external publications'.

Guidance
(a) Does the IAS 12 initial recognition exemption apply on first-time adoption and how does the IFRS 1 election to use fair value as deemed cost for some assets affect this?

Note that the initial recognition exemption does not apply to assets acquired in a business combination. The guidance in this section (a) does not apply to assets acquired in such a combination.

The IAS 12 initial recognition exemption relates to temporary differences on initial recognition of an asset or liability where initial recognition does not affect accounting or taxable profit (IAS 12.15 and 12.24). It may apply, for example, on purchase of an asset with a zero tax base (i.e., for which no tax allowances are available). IAS 12 also makes it clear that subsequent depreciation of an 'exempted asset' is also considered to result from initial recognition (IAS 12.22(c)).

In our view, this initial recognition exemption does apply on first-time adoption of IFRS, including to assets/liabilities acquired before the date of transition to IFRS. In applying IAS 12 to the opening IFRS statement of financial position, it is therefore necessary to consider the effects of the exemption as if the entity had always applied IFRS. The amount of deferred tax recognised in the opening IFRS statement of financial position is adjusted accordingly.
Applying IAS 12 to the opening IFRS statement of financial position will therefore require:

- identification of those assets and liabilities to which the initial recognition exemption applies
- determination of any temporary differences in relation to those assets and liabilities not covered by the initial recognition exemption, such as revaluations. For this purpose a difference between actual cost (less depreciation) and deemed cost is considered to be a revaluation
- recognition of deferred tax on the temporary differences not covered by the exemption. Any adjustment to the amount of deferred tax recorded under previous GAAP is taken to opening retained earnings.

(b) IFRS 1.D2 provides an exemption from recognising an expense relating to equity-settled share-based payments granted prior to 7 November 2002. What is the deferred tax treatment for those grants?

IFRS 1.D2 provides an exemption from recognising an expense relating to equity-settled share-based payment arrangements granted prior to 7 November 2002. However, IFRS 1 does not include any similar exemption from recognising deferred tax on such an arrangement.

Share based payments attract tax deductions in some jurisdictions. Where a deduction will be available in future periods in respect of a pre-7 November 2002 grant, a deductible temporary difference exists. A deferred tax asset should be recognised in respect of this difference, subject to its recovery being probable (IAS 12.24). The credit in respect of the deferred tax asset recognised should be made to equity in the opening IFRS statement of financial position. This also applies to subsequent movements in the deferred tax relating to these share-based payments.

(c) If an entity has acquired intangible assets with a zero tax base in a pre-transition date business combination, is a deferred tax provision required? Is the corresponding adjustment made to goodwill or to retained earnings?

A deferred tax provision will be required in the opening IFRS statement of financial position if the intangible asset is recognised in the opening IFRS statement of financial position. The initial recognition exemption in IAS 12 does not apply to assets acquired in a business combination, so a deferred tax provision will be required on the full taxable temporary difference.

Adjustments to deferred tax amounts recognised under previous GAAP may therefore be required. If the entity applies IFRS 3 Business Combinations retrospectively, the corresponding entry is made to goodwill and, where applicable, non-controlling interests. This approach follows from application of IFRS 3, under which goodwill is measured as the excess of the consideration transferred, measured using acquisition-date fair values (if applicable, including amount of any non-controlling interest and acquisition-date fair value of previously held equity interest of acquiree) over the net acquisition-date amounts of identifiable assets acquired and liabilities assumed (IFRS 3.32).

If the entity decides not to apply IFRS 3 retrospectively, it applies the requirements in Appendix C of IFRS 1 in accounting for the combination. Where this leads to separate recognition in the opening IFRS statement of financial position of intangible assets acquired in the combination, a deferred tax provision will be required on the full taxable temporary difference. If those assets were also recognised separately under previous GAAP, any consequent adjustment to deferred tax balances will lead to an adjustment to retained earnings. By contrast, if the assets were previously subsumed within recognised goodwill, adjustments to deferred tax will lead to adjustments to goodwill and (if applicable) non-controlling interests (IFRS 1.C.4(g)(i)).

Discussion

(a) Does the IAS 12 initial recognition exemption apply on first-time adoption and how does the IFRS 1 election to use fair value as deemed cost (eg for property, plant & equipment) affect this?
The initial recognition exemption in IAS 12.15 (and IAS 12.24) requires that no deferred tax is recognised on any temporary difference between the carrying value and the tax base of an asset or liability on initial recognition, subject to recognition not affecting accounting or taxable profit (loss). Nor is deferred tax recognised on changes to that initial difference, e.g. when the asset is depreciated (IAS 12.22(c)). However, unlike subsequent depreciation, IAS 12 does not extend the initial recognition exemption to a temporary difference arising from a subsequent revaluation of an 'exempted asset' (IAS 12 Illustrative examples A11).

If an entity purchases an asset for which future tax allowances will be available in respect of the full cost, the IAS 12 exemption will not apply. That is because there is no temporary difference to exempt. If the asset's cost is non-deductible, or only partly deductible, the exemption does apply. As a result of this, deferred tax will not be provided over the life of an exempted asset that is carried at cost less depreciation.

Some standards, including IAS 16 and IAS 38, permit entities to adopt a policy of revaluation for certain assets. If such a policy is adopted, deferred tax will be recognised in respect of temporary differences resulting from revaluation.

A first-time adopter should apply the initial recognition exemption for assets acquired prior to its date of transition to IFRS. Retrospective application of IFRS involves the entity applying IFRS on transition as though it had always applied IFRS.

On transition to IFRS, where relevant standards permit, an entity may adopt a policy of depreciated cost or fair value (revaluation) for different types of asset. Similar to an existing IFRS preparer, an entity would not recognise deferred tax on 'exempted assets' carried at depreciated cost, but would where a policy of revaluation has been adopted.

Further, IFRS 1 gives entities a choice to include certain assets at a revalued amount in the opening IFRS statement of financial position and treat this as the deemed cost (IFRS 1.30 and paragraphs D5 to D8). Where the deemed cost exemption has been taken up, we consider that the adjustment to deemed cost should be treated like a revaluation for the purposes of IAS 12. The adjustment for the purposes of applying IAS 12 should be calculated as:

- (deemed cost carrying amount in opening IFRS statement of financial position) less
- (depreciated historical cost determined in accordance with IFRS)

In rare circumstances where it is impractical to apply this approach, we recommend that deferred tax is provided on the entire temporary difference.

(b) IFRS 1.D2 provides an exemption from recognising the expense relating to equity-settled share-based payments granted prior to 7 November 2002. What should happen to the deferred tax on such grants of share options?

IFRS 2 specifies the financial reporting by an entity when it undertakes a share-based payment transaction. The required reporting depends on the type of share-based payment arrangement but the main principle of IFRS 2 is that goods or services received in a share-based payment arrangement are recognised when the goods or services are received. For transactions with an entity’s employees to be settled in the entity’s own equity instruments (employee share scheme) IFRS 2 requires an expense to be recognised, calculated in most circumstances as the fair value of the award at the date of grant.

In some jurisdictions, an entity may receive a tax deduction on share-based payment arrangements. The timing and amount of the deduction commonly differs from the amount recorded as an expense under IFRS 2. For example, in some jurisdictions the entity receives a deduction when the employee exercises the option, based on the intrinsic value at the time (i.e. the difference between the share price and the exercise price).
In accordance with IAS 12.68B, deferred tax should be recognised on grants of share options where the difference between the tax base of the employee services to date (being the amount the taxation authorities will permit as a deduction in future periods) and the carrying amount of nil is a deductible temporary difference that results in a deferred tax asset.

Under IAS 12.68C some of the deferred tax charge or credit on share-based payments should be taken direct to equity and some recognised in the income statement; the split between these is dependent on the IFRS 2 charge relating to the share-based payment. However IFRS 1.D2 provides an exemption from recognising the IFRS 2 expense relating to equity-settled share-based payments granted prior to 7 November 2002. The question therefore arises as to what should happen to the deferred tax on such grants of share options.

As no expense is recognised in the income statement in relation to these grants then the entire deferred tax relating to these grants should be taken direct to equity. This includes both the deferred tax on such grants recognised on transition to IFRS and subsequent movements in the deferred tax relating to these share-based payments.

(c) If an entity has acquired intangible assets with a zero tax base in a pre-transition date business combination is a deferred tax provision required? Is the corresponding adjustment made to goodwill or to retained earnings?

Accounting for business combinations is covered by IFRS 3. IFRS 3 requires a separately identifiable intangible asset to be recognised apart from goodwill, if it meets either the separability criterion or the contractual-legal criterion (IFRS 3.B31).

Deferred tax is recognised in respect of temporary differences arising in the combination and such amounts affect goodwill (IAS 12.66). Hence, a deferred tax liability recognised in business combination accounting will increase (positive) goodwill.

A first-time adopter of IFRS has a choice in accounting for pre-transition date combinations between:

- retrospectively applying IFRS 3 or
- following the alternative approach in Appendix C of IFRS 1 (Appendix C).
Many entities will take the Appendix C approach, as full retrospective application of IFRS 3 to past combinations can be onerous. The Appendix C approach will lead to separate recognition of any intangibles that would be recognised under IFRS 3 except where:

- the asset was subsumed into goodwill under previous GAAP and
- the asset would not be recognised separately in the statement of financial position of the acquiree in accordance with IAS 38 (IFRS 1.C4(f)).

In other words, intangibles previously subsumed into goodwill remain there unless IAS 38 would require their recognition by the acquiree. This will have the effect that many acquiree-generated assets (eg customer relationships) remain in goodwill, but that certain acquiree-purchased assets (eg a purchased software license) will be separated from goodwill.

Where assets are separated from goodwill, IFRS 1.C4(g)(i) requires that goodwill is adjusted and that (if applicable) deferred tax and non-controlling interests are also adjusted. Hence if a deferred tax liability is recorded in these circumstances the 'debit' is in effect to goodwill.

However, if the asset was previously recognised under previous GAAP the approach is different. Deferred tax will need to be provided/adjusted if previous GAAP did not conform to IAS 12. However, IFRS 1.Appendix C does not permit an adjustment to goodwill in these circumstances (IFRS 1.C4(h)). In these circumstances the 'debit' is to retained earnings.

Note: The IASB has debated whether or not to issue a Technical Correction (TC) to the applicable standards to address the difference in treatment of deferred tax dependent on whether or not the entity separately recognised the intangible, or subsumed it into goodwill, under its previous GAAP. The Board has decided against issuing a TC. The Standards are considered to be clear, and preparers should therefore consider the consequences of their accounting policy choices for pre-transition combinations.

Examples

Initial recognition exemption
The application of the preferred approach in specific situations is considered below. Assume in each case that the asset was purchased before the date of transition to IFRS and that initial recognition under IFRS of the asset would not have affected accounting or taxable profit or loss.

Example 1
An entity has an IFRS date of transition of 1 January 20X4. It acquired an asset on 1 January 20X3 for which no tax deductions are available. The entity has not taken up IFRS 1 deemed cost exemption and elects for a policy of historical cost in relation to the asset.

The initial recognition exemption applies. At acquisition there was a taxable temporary difference but, in accordance with IAS 12.15 a deferred tax liability would not have been recognised. Subsequent changes in the carrying value as a result of depreciation charges are also considered to result from initial recognition. No deferred tax liability is recognised in the opening IFRS statement of financial position.

Example 2
Facts as in Example 1 but the asset's cost was fully deductible for tax purposes.

In this case there was no taxable temporary difference on initial recognition so IAS 12.15 does not apply. A deferred tax liability is recognised in the opening IFRS statement of financial position, based on the carrying amount in that opening statement of financial position and the tax base of the asset at that date.
Example 3
Facts as in Example 1 but the entity adopts a policy of revaluation for the asset.

In this case deferred tax is provided in the opening IFRS statement of financial position on the revaluation element. A temporary difference arising from revaluation is not covered by the initial recognition exemption.

Example 4
Facts as in Example 1 but the entity elects to treat fair value or a revalued amount as deemed cost.

In this case the adjustment from depreciated historical cost to deemed cost should be treated like a revaluation for the purposes of applying IAS 12. Deferred tax is provided in the opening IFRS statement of financial position on the adjustment to deemed cost.

Intangible assets with a zero tax base in a pre-transition date business combination
Assume in the following examples that an entity has a date of transition to IFRS of 1 January 20X4. On 31 December 20X2, the entity entered into a business combination in which an intangible asset with a zero tax base was acquired. The entity elects not to apply IFRS 3 retrospectively to the combination.

Example 5
Intangible asset recognised separately under previous GAAP and qualifies for separate recognition under IFRS.

The asset will also be recognised in the IFRS opening statement of financial position. If the tax base is less than the carrying amount deferred tax should be provided on the taxable temporary difference. Any adjustment to deferred tax liabilities should be debited or credited against opening retained earnings. IFRS 1 does not permit an adjustment to goodwill in these circumstances.

Example 6
Intangible asset recognised separately under previous GAAP but does not qualify for separate recognition under IFRS.

The asset is not recognised in the opening IFRS statement of financial position but is reclassified into goodwill (IFRS 1.C4(c)(i)). In this case there is no asset for IFRS purposes and therefore no deferred tax is recorded.

Example 7
Intangible subsumed within goodwill under previous GAAP but would qualify for separate recognition in accordance with IFRS 3.

The treatment depends on whether or not the asset would have been recognised in the statement of financial position of the acquiree under IAS 38. If it would qualify, IFRS 1.C4(f) requires that it is recognised separately in the opening IFRS statement of financial position. Deferred tax is recorded on any temporary difference. Any consequent adjustment to deferred tax results in an adjustment to goodwill and, if applicable, non-controlling interests (IFRS 1.C4(g)(ii)).

By contrast, if the asset would not qualify for recognition under IAS 38 in the acquiree’s statement of financial position (which would be the case for many internally generated intangibles) it remains part of goodwill. No deferred tax is recognised in respect of this item. The entity applies the requirements of IAS 12 as they apply to goodwill.
HT 2005-03 Revenue and gains

Relevant IFRS
The Conceptual Framework for Financial Reporting
IAS 1 Presentation of Financial Statements
IAS 18 Revenue

Project update
The IASB and FASB (the Boards) have been working together on a joint project to clarify the principles for recognising revenue and to develop a converged revenue standard. A revised exposure draft was published in November 2011. Consistent with the prior proposal, the guidance in the revised exposure draft would replace the current multiple sources of guidance on revenue with a single model; however, the earlier proposals had been amended to reduce disruption to established practices (eg the revised exposure draft includes additional “practical expedients” intended to simplify application in several areas). A final standard is now predicted in the first half of 2013. The areas that may be most affected include multiple-element arrangements, revenue subject to variable payments and contracts with significant financing and contract costs. The proposed revenue recognition guidance is not considered in this Hot Topic; the Hot Topic continues to reflect the guidance in IAS 18 Revenue.

Issue
Is it permissible to report gains as a component of revenue?

Guidance
An IFRS income statement is required to include a line item 'revenue' (IAS 1.82(a)). This will generally be the top line of the income statement. IFRS also distinguishes revenue from gains. Gains should be presented separately from revenue in the income statement, and should not therefore be described as revenue or included in any subtotal labeled revenue.

Guidance note
In June 2011, the IASB issued Presentation of Items of Other Comprehensive Income (Amendments to IAS 1). Part of the amendments include providing an option to financial statement preparers to present a single statement that includes profit or loss and other comprehensive income or two separate statements (one of profit or loss immediately preceded by a statement presenting comprehensive income, which begins with profit or loss). This Hot Topic makes reference to the 'income statement' but the guidance also applies when an entity presents a single statement of profit or loss and other comprehensive income.

Revenue is defined as the gross inflow of economic benefits … arising in the course of ordinary activities (IAS 18.7). Revenue will therefore comprise different types of income for different entities (since ordinary activities differ between entities). Depending on the circumstances, revenue might arise from:

- sales of goods or services (in the course of ordinary activity)
- construction contracts revenue determined in accordance with IAS 11
- interest, royalties or rent.

Gains are other forms of income that are not revenue. Gains include:

- increases in fair value of assets reported at fair value (eg investment property at fair value, biological assets, many financial instruments)
- decreases in fair value of liabilities reported at fair value
- reversals of impairment losses
- profits on disposal of property, plant and equipment, investment property and other non-current assets
- initial recognition of biological assets in accordance with IAS 41.
An entity may generate income in its ordinary activities from several sources. It is then important to distinguish between the different types of income, because of the different economic characteristics of different types of income (such as predictability, frequency and potential for losses). This is achieved through reporting the different types of income as different line items in the income statement. Judgment will be required in assessing what should be included as revenue, and also how other forms of income should be presented.

Some entities earn all of their income from ordinary activities in the form of gains. In such cases, the entity’s gains may be reported on the ‘top line’ of the income statement but are usually described under a different heading rather than as revenue.

An entity may amend the descriptions used for line items in the income statement when doing so is necessary to better explain financial performance to readers (IAS 1.86). Accordingly, an entity is not obliged to use the term 'revenue' in its income statement, even if it earns revenue. It may use alternative descriptors as long as it includes a line item that presents the amount it considers to comprise revenue.

**Discussion**

IFRS requires the presentation of a revenue (or equivalent) line item in the income statement (IAS 1.82(a)) but does not set out detailed requirements as to what should be included in that line. It is therefore necessary to develop an appropriate accounting policy, taking account of the definition of revenue, the general guidance in the IASB’s Conceptual Framework for Financial Reporting (the Framework), the general principles of income statement presentation and the facts and circumstances of the entity. The accounting policy should be applied consistently from one period to the next.

IAS 18 defines revenue as:

"the gross inflow of economic benefits … arising in the course of the ordinary activities of an entity when those inflows result in increases in equity rather than increases relating to contributions from equity participants" (IAS 18.7)

Since revenue is defined in terms of gross inflows, it follows that gains/income that are presented net (such as gains on disposal of property, plant and equipment) should not be presented as revenue.

IAS 18 includes within its scope gross inflows arising from sale of goods, rendering of services, use by others of entity assets yielding rentals, interest, royalties and dividends. This list gives an indication of what should be presented as revenue but is not definitive (since IAS 18 deals primarily with measurement rather than presentation). For example, 'rentals' are within the scope of IAS 18. However, earning rentals is an ordinary course activity for some entities but not for others. Hence, it is appropriate for a property company to present 'rentals' within revenue. A manufacturing company that sells products and also earns sundry rental from leasing surplus property may decide to present rentals as a component of revenue, but alternative presentations are acceptable and are likely to be more transparent.

The presentation of revenue should take account of the general principle in IAS 1 to present the income statement in a way that assists in understanding performance. IAS 1.86 provides generic indicators of whether additional line items should be provided for different types of activity, transaction or event. These include the potential for gain or loss, predictability and frequency.
The Framework also includes some discussion of **income**, **revenue** and **gains** at paragraphs 4.25 to 4.32. These paragraphs explain that:

- income encompasses both revenue and gains (4.29)
- revenue arises in the ordinary course of activities (4.29)
- revenue is referred to by other names including 'sales, fees, interest, dividends, royalties and rent' (4.29)
- gains are other items that meet the definition of income and may or may not arise in ordinary activities (4.30)
- examples of gains are those arising on disposal of non-current assets and those resulting from increases in the carrying amount of long-term assets (4.31)
- where gains are included in the income statement they are usually displayed separately (4.31).

**Project update**

As part of its Memorandum of Understanding Agreement, the IASB and FASB (the Boards) undertook a project, Conceptual Framework, to create a sound foundation for future accounting standards that are principles-based, internally consistent and internationally converged. In September 2010 the IASB and the FASB announced the completion of the first phase (Phase A) of their joint project by publishing Objectives and Qualitative Characteristics. The new framework builds on existing IASB and FASB frameworks. The project has since been paused until the IASB concludes its ongoing deliberations about its future work plan. At this stage, the elements phase of the project is not complete and the definitions of key terms (such as asset, liability, equity, income, expense and gain) therefore remain unchanged; however, the referencing throughout this Hot Topic has been updated to reflect the new publication.

The guidance is clear that increases in the fair value of assets such as investment property are gains rather than revenue, and should be reported separately from revenue. The issue is perhaps confused by IAS 18.6, which lists types of revenue not dealt with in that standard including:

- changes in the fair value of financial assets and liabilities or their disposal
- changes in value of other current assets
- initial recognition and changes in fair value of biological assets.

In our view, the purpose of IAS 18.6 is to exclude these types of gain from the measurement requirements of IAS 18, not to suggest that they should be reported as a component of revenue.

IFRS is explicit that gains on disposal of property, plant and equipment must not be classified as revenue (IAS 16.68). This is explained at IAS 16.BC35 by reference to the need of users to distinguish such gains from sales in the course of ordinary activities.

One area where diversity in practice exists is the presentation of gains or losses on the disposal of investment securities (eg trading securities). For entities whose main business is other than that of an investment company, gains or losses on disposal of investment securities are usually shown as part of other income or expense. However for investment companies, sales of investment securities form part of their day to day activities. In practice, some investment companies include these gains or losses within revenue while others show it as part of other income or expense.

Based on the discussions above, it is our preferred view that gains or losses on disposal of investment securities should be shown as part of other income or expense rather than included within the revenue line.

However, a number of arguments can be made to support recognition of such gains or losses as revenue. In particular, the exclusion of the gains or losses on disposal of financial assets and liabilities from the scope of IAS 18 (IAS 18.6) can be interpreted as an exclusion on the grounds that securities trading transactions are covered by a more specific standard (IAS 39). Consequently, this exclusion does not imply that inflows arising from securities trading activities cannot be considered revenue. Other arguments include:
• the definition of revenue per IAS 18.7, suggests that revenue includes the gross inflow of economic benefits arising from the ordinary course of business (ie trading of investment securities). This is also consistent with paragraph 4.29 of the Framework
• paragraph 4.29 of the Framework provides examples of how revenues can be classified in the income statement based on the nature of an entity's operations. In addition, IAS 1.86 allows entities to include additional line items in the income statement and can amend descriptions to explain the elements of financial performance
• paragraph 4.30 of the Framework indicates that gains represent increases in economic benefits and as such are no different in nature from revenue.

The determination of the appropriate presentation of gains or loss arising from trading of investment securities is a matter of judgement. An investment company can make an accounting policy choice and this should be disclosed in the notes to financial statements (as required by IAS 1.122) to inform the readers of the nature of the transactions. This accounting policy choice should include an assessment of whether the gains or losses should be presented as gross amounts of proceeds presented as revenues and carrying amount of investments as part of costs or as the net of proceeds and carrying amount of investments. Should an entity present gains as revenues, such presentation should be done on a consistent basis, including presentation of losses in the same line where gains are presented.

Examples
Property developer/investor
Ordinary income-generating activities include:
• property development and sale - 100 (A)
• receipt of rentals (operating lease rentals and finance lease interest receivable) - 50 (B)
• net changes in fair value of investment property - 70 (C)
• profits on sales of investment property - 30 (D)

A and B clearly meet the definition of revenue and are included as examples of revenue items in IAS 18 and the Framework. C and D are (net) gains in the ordinary course of activities.

A and B should therefore be reported as revenue, either combined on the face of the income statement or on separate lines with a subtotal. C and D may not be presented as part of revenue nor included in a line item or sub-total described as revenue. A subtotal of A, B, C and D may be provided if suitably described (eg 'total property income'). An example of a possible presentation is set out below (ignoring comparatives):

<table>
<thead>
<tr>
<th></th>
<th>CU</th>
</tr>
</thead>
<tbody>
<tr>
<td>Development property sales</td>
<td>100</td>
</tr>
<tr>
<td>Rental income</td>
<td>50</td>
</tr>
<tr>
<td><strong>Revenue</strong></td>
<td>150</td>
</tr>
<tr>
<td>Net increase in fair value of investment properties</td>
<td>70</td>
</tr>
<tr>
<td>Gains on sales of investment properties</td>
<td>30</td>
</tr>
<tr>
<td><strong>Total property income</strong></td>
<td>250</td>
</tr>
</tbody>
</table>

Dairy farm
Ordinary income-generating activities include:
• sales of dairy products - 400 (A)
• gains on initial recognition of new livestock - 80 (B)
• changes in fair value of livestock - 70 (C)
• profit on sale of livestock - 50 (D)

A meets the definition of revenue and so can be described as such. B and C are gains and are referred to as such in IAS 41. Although D arises from sales of livestock, livestock is reported at fair value and a gain on sale is in effect a final adjustment to fair value. Hence our preferred view is to present B, C and D separately from revenue.
The illustrative examples to IAS 41 include an example of a dairy farm’s income statement that does not use the term 'revenue' at all. This is acceptable under IAS 1 because the amount representing revenue is presented with a more specific description.

Another example of an acceptable presentation is:

<table>
<thead>
<tr>
<th></th>
<th>CU</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue - sale of dairy products</td>
<td>400</td>
</tr>
<tr>
<td>New livestock</td>
<td>80</td>
</tr>
<tr>
<td>Changes in fair value of livestock</td>
<td>70</td>
</tr>
<tr>
<td>Gains on sale of livestock</td>
<td>50</td>
</tr>
<tr>
<td><strong>Livestock income, net of point of sale costs</strong></td>
<td><strong>200</strong></td>
</tr>
<tr>
<td><strong>Revenue and livestock income</strong></td>
<td><strong>600</strong></td>
</tr>
</tbody>
</table>

**Gaming operator**

Ordinary activity is entering into betting contracts with customers that are reported at fair value through profit and loss and settled net.

In this case, the entity has no sales-type revenue. The (net) income from betting contracts would therefore be the top line of the income statement. The top line is not usually labeled as revenue. A more transparent descriptor might, for example, be 'Net gaming income'.
**HT 2006-03 Inter-company loans**

**Relevant IFRS**
- IAS 24 Related Party Disclosures
- IAS 39 Financial Instrument: Recognition and Measurement
- IFRS 13 Fair Value Measurement

**Project update**
This Hot Topic reflects the requirements of IAS 39 *Financial Instruments: Recognition and Measurement* (IAS 39) and not those of IFRS 9 *Financial Instruments* (IFRS 9). IFRS 9 will eventually replace IAS 39 in its entirety. At this stage, IFRS 9 addresses the classification and measurement of financial assets and financial liabilities, along with derecognition. The requirements for financial liabilities and derecognition were carried forward unchanged (with the exception of some changes to the fair value option for financial liabilities to address the issue of own credit risk). On 28 November 2012, the Board issued an exposure draft proposing limited modifications to IFRS 9’s financial asset classification model to address application issues. IFRS 9 is effective for annual periods beginning on or after 1 January 2015 (early adoption permitted). Work continues on Phases 2 and 3 of the project, which address impairment and hedge accounting, respectively.

**Issue**
Accounting for loans between group companies in the separate financial statements of the lender and borrower.

**Guidance**
Inter-company loans meet the definition of financial instruments and are therefore within the scope of IAS 39. IAS 39.43 requires that financial instruments are initially recognised at fair value while IAS 39.43A requires an entity to apply IAS 39.AG76 if the fair value of the financial asset or financial liability at initial recognition differs from the transaction price. While the best evidence of fair value for a financial instrument at initial recognition is normally the transaction price, when an entity determines otherwise (as may be the case in accounting for loans between group companies), the entity must separately account for the difference between the transaction price and the fair value (IAS 39.AG76).

**Guidance note**
The IASB issued IFRS 13 *Fair Value Measurement* (IFRS 13) in May 2011 which is effective for annual periods beginning on or after 1 January 2013 (early application permitted). IFRS 13 defines fair value, sets out in a single framework for measuring fair value and requires disclosures about fair value measurements. IFRS 13 does not determine when an asset, a liability or an entity’s own equity instrument is measured at fair value. Rather, the measurement and disclosure requirements of IFRS 13 apply when another IFRS requires or permits the item to be measured at fair value (with limited exceptions).

IFRS 13 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (ie an exit price). The definition of fair value emphasises that fair value is a market-based measurement, not an entity-specific measurement. When measuring fair value, an entity uses the assumptions that market participants would use when pricing the asset or liability under current market conditions, including assumptions about risk.

Where inter-company loans are made on normal commercial terms (both in terms of principal and interest), no specific accounting issues arise and the fair value at inception will usually equal the loan amount. Normal commercial terms would reflect the interest rate that a lender would demand in making a typical commercial loan to a third party, including the credit risk of the borrower.

Where the loan is not on normal commercial terms, the required accounting depends on the terms, conditions and circumstances of the loan. It is therefore necessary to ascertain the terms and conditions, which may not be immediately apparent if the loan documentation is not comprehensive.
1. **Short-term and on-demand loans**  
Loans that are expected to be repaid in the near future should be recorded at the loan amount by both parties. The loan amount is likely to be a sufficiently close approximation to fair value. Inter-company current accounts or balances arising from cash pooling (or sweep) arrangements might fall into this category.

2. **Fixed term loans - from parent to subsidiary**  
Fixed term inter-company loans should be recognised initially at fair value, estimated by discounting the future loan repayments using a rate based on the rate the borrower would pay to an unrelated lender for a loan with similar conditions (amount, term, security etc.). The estimated future loan repayments will usually be the same as the contractual loan provisions, but this may not always be the case.

Where the loan is from a parent to a subsidiary, the difference between the loan amount and the fair value (discount or premium) should be recorded as:

- an investment in the parent's financial statements (as a component of the overall investment in the subsidiary)
- a component of equity in the subsidiary's financial statements (this is sometimes referred to as a capital contribution).

Subsequently, the loan should be measured at amortised cost, using the effective interest method. This involves 'unwinding' the discount such that, at repayment, the carrying value of the loan equals the amount to be repaid. The unwinding of the discount should be reported as interest income or expense.

3. **Loans between fellow subsidiaries**  
Where the loan is made between fellow subsidiaries any initial difference between loan amount and fair value should usually be recorded in profit or loss by both subsidiaries. As in the other scenarios, however, if the loan contains a demand feature it should be recorded at the full loan amount by the borrower (IFRS 13.47).

In some circumstances it will be clear that the transfer of value from one subsidiary to the other has been made under instruction from the parent company. In these cases, an acceptable alternative treatment is for any gain on initial recognition to be recorded as a credit to equity (capital contribution) and for any loss to be recorded as a distribution (debit to equity).

4. **Loans from subsidiary to parent**  
Where a loan is made by a subsidiary to its parent, any initial difference between loan amount and fair value should usually be recorded:

- as a distribution by the subsidiary and
- as income by the parent.

Distributions received from a subsidiary are recognised in profit or loss in the financial statements of the parent (IAS 27.12). When recording income, the parent entity should also consider whether the distribution is an indicator of impairment in the investment in the subsidiary (IAS 36.12(h)). See Section 7 for additional discussion regarding impairment.

If the loan contains a demand feature, it should, as in other scenarios, be recorded at the full loan amount by the parent (borrower).
Guidance note
In May 2011 the IASB issued three new standards (IFRS 10 Consolidated Financial Statements, IFRS 11 Joint Arrangements, and IFRS 12 Disclosures of Interests in Other Entities) and amended two (IAS 27 Separate Financial Statements and IAS 28 Investments in Associates and Joint Ventures) – sometimes referred to as the consolidation package. IFRS 10 redefines ‘control’ and provides extensive new guidance on applying the revised definition. The new model applies to both traditional entities and to special purpose entities (replacing IAS 27 and SIC-12 Consolidation – Special Purpose Entities). The guidance in IFRS 10 applies only to consolidated financial statements. The requirements for separate financial statements are unchanged and remain in IAS 27. The new guidance is effective for annual periods beginning on or after 1 January 2013. Cross-references to IAS 27 in this Hot Topic have been updated to reflect these changes.

5. Capital contributions

Loans with limited stated documentation
Often loan agreements between a parent and subsidiary will lack the level of detail and documentation of commercial lending agreements. Every effort should be made by the entity to clarify (and document) the terms of the agreement, including obtaining legal advice if necessary.

It is worth noting that in some parts of the world (eg South Africa), loans without stated repayment terms are deemed to be legally payable on demand under the local law. If so, the loan should be accounted for as an on-demand asset or liability (see guidance below). Even in the absence of legislation, loans without stated repayment terms are often deemed to be payable on demand due to the nature of the parent and subsidiary relationship whereby the parent can demand repayment as a result of the control it exercises over the subsidiary.

In practice, a parent may provide some form of assurance that it does not intend to demand repayment of a loan to a subsidiary within a certain timeframe despite having the contractual right to do so. This assurance may be provided verbally, via a comfort letter or as an amendment or addendum to the contract. In our view, amendments to the contract should be reflected in the amortised cost of the loan asset or liability while non-binding assurances should not (although they should be considered as part of the impairment assessment). Legal advice may need to be obtained to make that distinction.

A parent may make an advance to a subsidiary (the advance may or may not be termed a ‘loan’) whereby the contractual terms state that the amount:

- is not repayable or
- is repayable at the discretion of the subsidiary in all circumstances.

In our view, this advance shall be recorded as equity by the subsidiary (no discounting or amortisation required) and as part of the net investment in the subsidiary by the parent (sometimes referred to as a ‘capital contribution’ as discussed above).

6. Changes in inter-company loan terms
Like any other loan, the terms of the original agreement may change for a variety of reasons. A change in inter-company loan terms may give rise to a number of additional considerations including, but not limited to the following:

- determining if the change represents a substantial modification (whereby extinguishment accounting may apply) or a non-substantial modification (whereby either modification or extinguishment accounting may apply). See Hot Topic 2006-23 Debt modifications for more discussion on this area
- evaluating the substance of the change to understand if the modification represent an additional investment in the subsidiary or if the modification should be recorded in profit or loss
- consideration of impairment.
While changes in the timing and/or amount of estimated future cash flows for normal commercial loans are recognised in profit or loss (IAS 39.AG8) at the time of change, this generally will not be the case for inter-company loans. Consistent with Section 5, when a parent modifies the original agreement, thereby modifying either the timing and/or amount of future cash flows, (perhaps by extending the loan maturity date, lowering the interest rate, or modifying the terms such that the loan no longer has a maturity date), the substance of the change usually represents an additional investment in the subsidiary by the parent. The substance of the change must be carefully considered to understand the appropriate accounting.

Such changes in terms should also trigger the parent to assess whether there is objective evidence that the financial asset is impaired. See Section 7 below for more on this topic.

7. Impairment
In all cases it will be necessary for the lender to assess whether there is objective evidence that its financial asset is impaired (IAS 39.58). If all or part of the loan is, in substance, part of the parent's net investment, the total investment should be assessed.

**Guidance note**
When a parent recognises an amount receivable for an inter-company loan made to a subsidiary, it is important that the parent continues to assess the receivable for impairment. IAS 39.58 requires an entity to assess at the end of each reporting period whether there is any objective evidence that a financial asset measured at amortised cost is impaired. If any such evidence exists, the entity shall apply paragraph 63 to determine the amount of any impairment loss.

Regulators have been known to question whether impairment should have been recognised for inter-company loans. Entities should be alert to factors such as overdue loans, loss making subsidiaries and subsidiaries with net current liabilities in considering whether objective evidence of impairment exists.

**Project update**
Work continues on Phase 2 of the IFRS 9 project (amortised cost and impairment of financial assets – discussed above). The IASB is likely to move from the ‘incurred loss’ model presently used in IAS 39 to an ‘expected loss’ approach. At the time of writing, deliberations are ongoing. This Hot Topic reflects the requirements of IAS 39 and not those of IFRS 9.

8. Related party disclosures
Inter-company loans meet the definition of related party transactions in IAS 24.9 and the disclosures required by IAS 24.13 - 24 must be given in sufficient detail to enable the effect of the loans on the financial statements to be understood. Where there are significant uncertainties, such as the expected terms of a loan, the disclosures should refer to this.

**Discussion**
Loans are commonly made between entities in a group on non-arm’s length terms (ie terms that are favourable or unfavourable in comparison to the terms available with an unrelated third party lender). For example, inter-company loans are often:

- interest free or have a below-market rate of interest and/or
- made with no stated date for repayment.

Loans are within the scope of IAS 39 and complications arise if they are not on arm’s length terms. The fair value of such loans is not usually the same as the loan amount, and IAS 39.43 requires both parties to initially record the asset or liability at fair value (plus directly attributable transaction costs for items that will not be measured at fair value subsequently). IFRS 13.47 also requires that, for this purpose, the fair value of a financial liability with a demand feature is not less than the amount repayable.
IAS 39.43A requires an entity to apply IAS 39. AG76 if the fair value of the financial asset or financial liability at initial recognition differs from the transaction price. While the best evidence of fair value for a financial instrument at initial recognition is normally the transaction price, when an entity determines otherwise (as may be the case in accounting for loans between group companies), the entity must separately account for the difference between the transaction price and the fair value (IAS 39. AG76). Given that there is no active market for inter-company loans, fair value will usually need to be estimated. IAS 39. AG64 indicates that the appropriate way to do this is to determine the present value of future cash receipts using a market rate of interest for a similar instrument.

The difference between fair value and loan amount then needs to be accounted for. Where the loan is from a parent to a subsidiary, it would be inappropriate to recognise a gain or loss for the discount or premium; in substance this is an additional contribution by the parent (or a return of capital/distribution by the subsidiary). Contributions from and distributions to 'equity participants' do not meet the basic definition of income or expenses (Framework 4.25).

**Project update**
As part of its Memorandum of Understanding Agreement, the IASB and FASB (the Boards) undertook a project, Conceptual Framework, to create a sound foundation for future accounting standards that are principles-based, internally consistent and internationally converged. In September 2010 the IASB and the FASB announced the completion of the first phase (Phase A) of their joint project by publishing Objectives and Qualitative Characteristics. The new framework builds on existing IASB and FASB frameworks. The project has since been paused until the IASB concludes its ongoing deliberations about its future work plan. At this stage the elements phase of the project is not complete and the definitions of key terms (such as asset, liability, equity, income, expense and gain) therefore remain unchanged; however, this Hot Topic does reflect the updated referencing due to the new publication.

Where the loan is between group entities other than a parent and subsidiary, the discount or premium may meet the definition of income or expense depending on whether or not, in substance, the transaction is carried out at the behest of the parent.

On consolidation the inter-company loans will be eliminated, including any discount or premium to fair value. It should be noted that, if the loan is denominated in a currency that is not the functional currency of one or both of the group entities that are a party to the loan, resulting foreign exchange gains or losses will not eliminate on consolidation.

**Example**
Parent company (P) makes a three year interest-free loan of CU100 to its subsidiary (S) on 31 December 20X0. The borrowing rate available to S in the market is 8%. The entries in P's and S's separate financial statements are as follows.

**Initial recognition**
The fair value of the future cash flows is CU79 (calculated as CU100 discounted at 8% over three years). The substance of the arrangement comprises a capital contribution or equity component of CU21, and a fair value receivable/payable element of CU79. The following entries are recorded by the parent and the subsidiary on 31 December 20X0:
Unwinding of discount in years 20X1, 20X2 and 20X3
In years 1, 2 and 3 the discount is 'unwound' using the 8% interest rates, giving cumulative interest income/expense of CU21 (CU6.5, CU7.0 and CU7.5 in years 1 to 3 respectively):

Repayment
The entries to record repayment of CU100 at 31 December 20X3 are:
HT 2006-04 Additional subtotals in the income statement

Relevant IFRS
IAS 1 Presentation of Financial Statements

Issues
a) Is it permissible to disclose subtotals such as earnings before interest, tax, depreciation and amortisation (EBITDA) on the face of an IFRS income statement?
b) Is it permissible to disclose 'operating profit' on the face of an IFRS income statement? What items can be excluded from operating profit?

Guidance
(a) Is it permissible to disclose subtotals such as EBITDA on the face of an IFRS income statement?

Yes, but only if the subtotal is consistent with the requirement that an IFRS income statement should be relevant to, and of assistance in, explaining financial performance (IAS 1.85 and 86). The following paragraphs provide guidance on how to apply this basic principle.

Subtotals that are inherently misleading (or potentially so) should be avoided. Examples of inappropriate subtotals include 'maintainable earnings', 'core earnings', 'underlying earnings', 'business performance' and 'earnings before volatility'. These are potentially misleading because they suggest that any income and expenditure excluded from the subtotal is not likely to recur or is less relevant to understanding the 'true' performance of the business. Any such suggestion is highly subjective and may not be borne out by future events.

Where subtotals are used that are not defined in IFRS and are not necessarily clearly understandable care should be taken to ensure that:

- the subtotal is properly described and includes all income and expenses consistent with that description (eg EBITDA excludes interest, tax, depreciation and amortisation but should not exclude other expense items such as restructuring costs or losses on disposal of non-current assets)
- line items above the sub-total are properly described and include all income and expense appropriate to their description
- the additional sub-total is defined and that definition is applied consistently from one period to the next. The definition should be given in the notes to the financial statements in cases where it is not obvious (eg it is not a commonly used sub-total or it is commonly used but definitions vary between entities).
- IAS 1 gives entities a choice in how expenses are presented in the income statement. The options are presenting expenses (i) by function (eg cost of sales, distribution costs, administrative expenses etc); or (ii) by nature (eg changes in inventories, raw materials used, depreciation and amortisation etc). Generally, only a presentation by nature is compatible with including an EBITDA subtotal. This is because functional expense line items such as cost of sales and administration expenses usually include depreciation (and/or amortisation).
(b) Is it permissible to disclose an 'operating profit' or similar subtotal on the face of an IFRS income statement? What items can be excluded from operating profit?

It is permissible to disclose an operating profit or similar subtotal (eg 'results from operations'). However, the guidance given under (a) above applies equally here. In particular, in this case the amount disclosed as operating profit must include all income and expenses that are operating in nature.

Expenses should not be excluded from operating profit solely on the grounds that they are unusual, infrequent or insignificant. Items such as inventory write-downs, restructuring costs, gains or losses on disposal of non-current assets and litigation costs are all operating in nature and should not therefore be excluded, even if they are considered by the entity to be exceptional.

Operating profit will in most cases be presented before (ie excluding):

- finance costs (although these are 'operating' items for many financial services entities)
- share of profits or losses of equity method investments (ie associates and joint ventures)
- income taxes.

If an entity wishes to disclose a subtotal for profit that excludes certain other items, such as items considered to be exceptional, this sub-total should be properly described. Depending on the circumstances, a description such as 'operating profit before exceptional items' or 'trading profit' might be appropriate.

**Discussion**

**Guidance note**

In June 2011, the IASB issued *Presentation of Items of Other Comprehensive Income (Amendments to IAS 1)*. Part of the amendments include providing an option to financial statement preparers to present a single statement that includes profit or loss and other comprehensive income or two separate statements (one of profit or loss immediately preceded by a statement presenting comprehensive income, which begins with profit or loss). This Hot Topic makes reference to the 'income statement' but the guidance also applies when an entity presents a single statement of profit or loss and other comprehensive income.

As revised, IAS 1 requires a subtotal for profit or loss in the statement of comprehensive income. If an entity chooses to present comprehensive income by using two statements, it should begin the second statement with profit or loss - the bottom line of the first statement (the 'income statement') - and display the components of other comprehensive income immediately after.

The IFRS requirements on presentation of the income statement are set out in IAS 1.81-105. These paragraphs set out certain minimum contents for the income statement (IAS 1.82), and other general principles to be followed. However, there is no set format for the income statement and entities therefore need to exercise judgement in determining which headings and subtotals to include and the order in which they are presented.

The most important principle in presenting an income statement is that it should be relevant to, and of assistance in, explaining financial performance (IAS 1.85 and 86). The appropriateness of additional sub-totals needs to be judged against those criteria. Subtotals that have the potential to confuse or mislead users of the financial statements should be avoided.

With respect to 'operating profit', IAS 1.BC56 explains that "it would be misleading and would impair the comparability of financial statements if items of an operating nature were to be excluded from the results of operating activities, even if that had been industry practice. For example, it would be inappropriate to exclude items clearly related to operations (such as inventory write-downs and restructuring and relocation expenses)".

The financial statements, including the income statement, should be presented consistently from one period to the next unless significant changes in the entity’s operations or new IFRS requirements justify otherwise.
Examples

Example 1 - acceptable disclosure of EBITDA

<table>
<thead>
<tr>
<th></th>
<th>20X2</th>
<th>20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Changes in inventory and work-in progress</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Raw materials consumed</td>
<td>(x)</td>
<td>(x)</td>
</tr>
<tr>
<td>Employee benefits expense</td>
<td>(x)</td>
<td>(x)</td>
</tr>
<tr>
<td>Other operating income</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td><strong>Earnings before interest, tax, depreciation and amortisation</strong></td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Depreciation and amortisation expense</td>
<td>(x)</td>
<td>(x)</td>
</tr>
<tr>
<td>Finance costs</td>
<td>(x)</td>
<td>(x)</td>
</tr>
<tr>
<td>Share of profits of associates</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td><strong>Profit before tax</strong></td>
<td>x</td>
<td>x</td>
</tr>
</tbody>
</table>

Note: this is an example of an income statement presenting expenses by nature.

Example 2 - unacceptable disclosure of EBITDA

<table>
<thead>
<tr>
<th></th>
<th>20X2</th>
<th>20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Costs of sales</td>
<td>(x)</td>
<td>(x)</td>
</tr>
<tr>
<td><strong>Gross profit</strong></td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Distribution costs</td>
<td>(x)</td>
<td>(x)</td>
</tr>
<tr>
<td>Administration expenses</td>
<td>(x)</td>
<td>(x)</td>
</tr>
<tr>
<td><strong>Earnings before interest, tax depreciation and amortisation</strong></td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Depreciation and amortisation expense</td>
<td>(x)</td>
<td>(x)</td>
</tr>
<tr>
<td>Finance costs</td>
<td>(x)</td>
<td>(x)</td>
</tr>
<tr>
<td>Share of profits of associates</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td><strong>Profit before tax</strong></td>
<td>x</td>
<td>x</td>
</tr>
</tbody>
</table>

Note: this is an example of an income statement presenting expenses by function. It is unacceptable because costs of sales, distribution costs and administrative expenses are disclosed but do not include depreciation and amortisation expenses. Typically in a functional presentation, the expenses by function (costs of sales, distribution costs etc) include an allocation of depreciation and amortisation.

Example 3 - acceptable disclosure of operating profit

<table>
<thead>
<tr>
<th></th>
<th>20X2</th>
<th>20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(x)</td>
<td>(x)</td>
</tr>
<tr>
<td><strong>Gross profit</strong></td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Distribution costs</td>
<td>(x)</td>
<td>(x)</td>
</tr>
<tr>
<td>Administration expenses, excluding restructuring costs</td>
<td>(x)</td>
<td>(x)</td>
</tr>
<tr>
<td>Restructuring costs</td>
<td>(x)</td>
<td>(x)</td>
</tr>
<tr>
<td><strong>Operating profit</strong></td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Finance costs</td>
<td>(x)</td>
<td>(x)</td>
</tr>
<tr>
<td>Share of profits of associates</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td><strong>Profit before tax</strong></td>
<td>x</td>
<td>x</td>
</tr>
</tbody>
</table>

Note: this format is acceptable because operating profit includes all items of an operating nature, including restructuring costs. In the example, a line item is also described as 'administration costs, excluding restructuring costs'. This is because restructuring costs might in many cases also comprise administration costs. It could therefore be misleading to show a line item 'administration costs' if that line item in fact excludes the administrative component of restructuring costs.
### Example 4 - unacceptable disclosure of operating profit

<table>
<thead>
<tr>
<th></th>
<th>20X2</th>
<th>20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(x)</td>
<td>(x)</td>
</tr>
<tr>
<td><strong>Gross profit</strong></td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Distribution costs</td>
<td>(x)</td>
<td>(x)</td>
</tr>
<tr>
<td>Administration expenses</td>
<td>(x)</td>
<td>(x)</td>
</tr>
<tr>
<td><strong>Operating profit</strong></td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Restructuring costs</td>
<td>(x)</td>
<td>(x)</td>
</tr>
<tr>
<td>Finance costs</td>
<td>(x)</td>
<td>(x)</td>
</tr>
<tr>
<td>Share of profits of associates</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td><strong>Profit before tax</strong></td>
<td>x</td>
<td>x</td>
</tr>
</tbody>
</table>

**Note:** This format is unacceptable because operating profit excludes restructuring costs, which are operating in nature. The line item 'administration costs' would also be misleading if there is an administrative component within restructuring costs.

### Example 5 - acceptable disclosure of alternative sub-total

<table>
<thead>
<tr>
<th></th>
<th>20X2</th>
<th>20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(x)</td>
<td>(x)</td>
</tr>
<tr>
<td><strong>Gross profit</strong></td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Distribution costs</td>
<td>(x)</td>
<td>(x)</td>
</tr>
<tr>
<td>Administration expenses, excluding restructuring costs</td>
<td>(x)</td>
<td>(x)</td>
</tr>
<tr>
<td><strong>Operating profit before restructuring costs</strong></td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Restructuring costs</td>
<td>(x)</td>
<td>(x)</td>
</tr>
<tr>
<td><strong>Operating profit</strong></td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Finance costs</td>
<td>(x)</td>
<td>(x)</td>
</tr>
<tr>
<td>Share of profits of associates</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td><strong>Profit before tax</strong></td>
<td>x</td>
<td>x</td>
</tr>
</tbody>
</table>

**Note:** This format is acceptable because 'operating profit before restructuring costs' is an accurate description of the amounts shown against that subtotal.
HT 2006-05 Additional investments in associates and joint ventures

Relevant IFRS
IAS 28 Investments in Associates and Joint Ventures
IFRS 3 Business Combinations

Project update
In May 2011 the IASB issued three new standards (IFRS 10 Consolidated Financial Statements, IFRS 11 Joint Arrangements, and IFRS 12 Disclosures of Interests in Other Entities) and amended two (IAS 27 Separate Financial Statements and IAS 28 Investments in Associates and Joint Ventures) – sometimes referred to as the consolidation package. IFRS 10 redefines ‘control’ and provides extensive new guidance on applying the revised definition. The new model applies to both traditional entities and to special purpose entities (replacing IAS 27 and SIC-12 Consolidation – Special Purpose Entities). The guidance in IFRS 10 applies only to consolidated financial statements. The requirements for separate financial statements are unchanged and remain in IAS 27. The amended version of IAS 28, now renamed IAS 28 Investments in Associates and Joint Venturers, also remains substantively unchanged from the previous version. The new guidance is effective for annual periods beginning on or after 1 January 2013. Cross-references in this Hot Topic have been updated to reflect these changes.

Issue
How should the purchase of an additional investment in an associate or joint venture be accounted for, if the investment continues to be an associate or joint venture? Should any increase or decrease in the fair value of identifiable net assets relating to the previously held interest be recognised? Users of this Hot Topic should also consider Hot Topic 2006-30 which discusses the adjustments required on initial acquisition of an investment in an associate or a joint venture, and the effect of those adjustments on the investor's share of the associate's or joint venture’s profit or loss (including impairment charges).

Guidance
An investment is accounted for using the equity method from the date on which it becomes an associate or a joint venture. On acquisition, any excess of the cost of the investment over the entity’s share of the net fair value of the investee’s identifiable assets and liabilities is included in the carrying amount of the investment (as notional goodwill). Any excess of the net fair values over cost is included as income in determining the entity’s share of the investment’s profit or loss for the period (IAS 28.32). Subsequently, the investor's share of profit or loss is determined taking into account the acquisition-date fair values of the investee’s assets and liabilities, for example by adjusting the depreciation or amortization amounts reported in the investee’s own financial statements (IAS 28.32). The investor must therefore determine the acquisition-date fair values of the investee’s assets and liabilities in order to apply the equity method (ie perform a fair value exercise).

An additional investment in an associate or joint venture (that does not result in a change of status) is initially accounted for by adding the cost to the carrying amount of the investment. A new fair value exercise at the date of the subsequent investment is also required if its effect is material. This is in order to:

- determine whether the subsequent investment gives rise to an excess of the entity’s share of the net fair value of the investee’s identifiable assets and liabilities over cost. If so, that amount is recognised in profit or loss in the same way as any such excess on an initial investment in an associate or joint venture
• recognise the appropriate share of profit or loss of the associate or joint venture subsequently. In our view this amount should be determined taking into account the fair values of the assets and liabilities at the date each tranche was acquired, and the related proportionate ownership interest acquired at each date (ie on a mixed measurement basis).

In certain circumstances, however, an entity may determine that a new fair value is not necessary because its effect on the subsequent equity accounting would be immaterial. For example, if the subsequent investment is made soon after the initial acquisition, the entity might conclude that it may rely on the initial or most recent fair value exercise. The entity must use judgement in making this determination.

This guidance applies only where the investment is an associate or joint venture both before and after the additional investment. In two other common situations:

• **Investment in an associate or joint venture becomes a subsidiary:** In this case, an entity follows the 'business combination achieved in stages' principles in IFRS 3.41 - 42

• **An existing investment becomes an associate or joint venture:** In this situation, the 'cost' of the associate or joint venture should include the cost of the additional interest and the carrying value of the existing investment. That carrying value of the existing investment will reflect its measurement basis, which will depend on its classification in accordance with IAS 39. This will often be cost, since an investment in equity instruments that are not quoted in an active market and whose fair value cannot be reliably measured is required to be carried at cost (less any impairment losses) (IAS 39.46(c)). Alternatively, the investment could be carried at fair value through profit or loss, or fair value through equity (for an available for sale investment). In the case of an available for sale investment, any gains or losses recognised in equity should **not be recycled** into profit or loss (ie they should remain in equity). Any previous impairment losses should not in our view be reversed.

**Discussion**

IAS 28 requires that an entity with joint control of, or significant influence over, an investee shall account for its investment in an associate or a joint venture using the equity method except in limited circumstances (IAS 28.16-19). Under the equity method, "...on initial recognition the investment in an associate or a joint venture is recognised at cost, and the carrying amount is increased or decreased to recognize the investor’s share of the profit or loss of the investee after the date of acquisition” (IAS 28.10).

In its July 2009 meeting, the IFRIC noted that IFRSs consistently require assets not measured at fair value through profit or loss to be measured at initial recognition at cost. Generally stated, cost includes the purchase price and other costs directly attributable to the acquisition or issuance of the asset such as professional fees for legal services, transfer taxes and other transaction costs. Therefore, the cost of an investment in an associate at initial recognition determined in accordance with paragraph IAS 28.10 comprises its purchase price and any directly attributable expenditures necessary to obtain it.

IAS 28.32 requires that positive goodwill relating to an associate or a joint venture be included in its carrying value. Negative goodwill, referred to as an 'excess of the entity's share of the net fair value of the investee’s identifiable assets, liabilities and contingent liabilities', is included as income. It is therefore necessary to determine the fair values of the identifiable assets etc. This exercise should be undertaken for each material separate investment.

An additional investment in an associate or joint venture and the subsequent share of the associate’s profits or losses is determined taking into account the fair values of the assets and liabilities at the date each tranche was acquired (ie on a mixed measurement basis). IAS 28.32 requires that “appropriate adjustments to the entity's share of the associate's or joint venture's profit or loss after acquisition are made in order to account, for example, for depreciation of the depreciable assets based on their fair values at the acquisition date.” In the example below, the applicable adjustment in accordance with IAS 28.32 would reflect the fair values at the date of acquisition of each 20% tranche.
In certain circumstances, an entity may determine that a new fair value exercise at the date the new tranche is acquired is not necessary due to materiality whereby it may conclude that it may rely on the initial or last fair value exercise. This may be the case when:

- the time lapsed between the initial investment and subsequent investment is not material
- the amount of additional subsequent investment is not material
- the nature of the associate’s or joint venture’s business is such that there is not likely to be a significant difference between book and fair value.

In these cases, although changes in the fair value of the investment in an associate or investment in a joint venture’s identifiable net assets may have occurred during the period between the original and subsequent investment, these are reflected only to the extent of the application of equity accounting. At the time of the subsequent investment, there is no revaluation of the existing interest.

This approach differs from accounting for a business combination achieved in stages (step acquisition), which is explained at IFRS 3.41 -42. In this case, the acquirer shall remeasure its previously held equity interest in the acquiree at its acquisition-date fair value and recognise the resulting gain or loss, if any, in profit or loss. In prior reporting periods, the acquirer may have recognised changes in the value of its equity interest in the acquiree in other comprehensive income (eg investments classified as available for sale). In such cases, the amount that was previously recognised in other comprehensive income shall be recognised on the same basis as if the acquirer disposed directly of the previously held equity interest.

**Example**

Entity A acquires 20% of entity B for CU50 on 31 December 20X1 and this represents significant influence. At this date, the fair value of B's identifiable net assets is CU200. The cost therefore includes notional positive goodwill of CU10 (50 - (200 x 20%)).

During 20X2 to 20X4, entity B earns net profits of CU150, in accordance with IFRS.

On 31 December 20X4, entity A acquires a further 20% of entity B for CU100. At this date, the fair value of B's identifiable net assets is CU400. Additional notional positive goodwill of CU20 arises (100 - (400 x 20%)).
The accounting entries in entity A’s consolidated financial statements are:

<table>
<thead>
<tr>
<th>Initial recognition of 20% investment on 31.12.20X1</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>CU50</td>
<td></td>
</tr>
<tr>
<td>Investment in associate (including notional goodwill of CU10)</td>
<td>CU50</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Equity accounting 20X2 to 20X4</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income statement - share of profits of associate (CU150 x 20%)</td>
<td>CU30</td>
<td></td>
</tr>
<tr>
<td>Investment in associate</td>
<td>CU30</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Additional 20% investment on 31.12.20X4</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>CU100</td>
<td></td>
</tr>
<tr>
<td>Investment in associate (including notional goodwill of CU20)</td>
<td>CU100</td>
<td></td>
</tr>
</tbody>
</table>

The 31 December 20X4 carrying value of the associate is CU180. This consists of the cost of the two investments of CU50 and CU100, along with the share of profits earned during the period of CU30. Although entity A owns 40% of entity B at 31 December 20X4, the carrying value will not equal 40% of B's net assets. The carrying value includes notional positive goodwill of CU30. In accordance with IAS 28.32(a), this goodwill is not amortised. Further, the notional goodwill is not separately tested for impairment; the overall carrying value is tested for impairment, when necessary, in accordance with IAS 28.42.

From 1.1.20X5, entity A recognizes its share of the associate’s profit or loss based on a 40% ownership interest. In determining this amount, it should take into account the fair values of the associate’s assets and liabilities at both acquisition dates (the 20% acquired on 31 December 20X1 and the additional 20% acquired on 31 December 20X4). For example, if the entity uses the associate’s own IFRS financial statements as a starting point, it would:

- determine the gross (100%) adjustments required to depreciation and amortization charges to take account of differences between carrying amounts and fair value of depreciable assets at each date; and
- apply the relevant percentages (20% and 20%) to these gross adjustments to determine the net adjustment to the associate’s reported results for equity accounting purposes.
HT 2006-06 Revenue recognition for 'multiple element arrangements'

Relevant IFRS
IAS 18 Revenue

Issue
How should revenue be recognised for arrangements involving the supply of multiple goods or services at different points in time (sometimes referred to as multiple element arrangements or MEAs)? In particular:

- When should an MEA be separated into more than one element for revenue recognition purposes?
- When goods or services are supplied with future servicing or other obligations, should an entity defer revenue until the future element is supplied, or provide for the future costs ('revenue allocation' versus 'expense recognition')?
- Does the US GAAP concept of a 'cash limit' apply under IFRS?

This Hot Topic deals with arrangements within the scope of IAS 18. It does not therefore apply (for example) to construction contracts accounted for in accordance with IAS 11 or agricultural activities within the scope of IAS 41. It deals only with the allocation of revenue and does not address IAS 18’s general conditions for recognition of revenue (see in particular IAS 18.14).

Project update
The IASB and FASB (the Boards) have been working together on a joint project to clarify the principles for recognising revenue and to develop a converged revenue standard. A revised exposure draft was published in November 2011. Consistent with the prior proposal, the guidance in the revised exposure draft would replace the current multiple sources of guidance on revenue with a single model; however, the earlier proposals had been amended to reduce disruption to established practices (eg the revised exposure draft includes additional “practical expedients” intended to simplify application in several areas). A final standard is now predicted in the first half of 2013. The areas that may be most affected include multiple-element arrangements, revenue subject to variable (eg performance-based) payments and contracts with significant financing and contract costs.

The proposed revenue recognition guidance is not considered in this Hot Topic; the Hot Topic continues to reflect the guidance in IAS 18 Revenue.

Guidance
IAS 18.13 states that the recognition criteria of the Standard are usually applied separately to each transaction. However, in certain circumstances, it is necessary to apply the recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction. Thus, revenue should be recognised separately for different elements of an MEA when:

- the MEA comprises more than one separately identifiable deliverable
- the fair values of the deliverables can be measured reliably
- the undelivered elements are not incidental post-supply obligations or incidental post-supply costs.

The allocation could be made using the relative fair value method but alternative methods may be acceptable. This involves allocating the fair value of the total revenue receivable under the arrangement to the separately identifiable deliverables in proportion to those deliverables' fair values. This approach can result in a different revenue allocation to the pricing arrangement. When the relative fair value method is used, the US GAAP concept of 'cash limit' does not apply in IFRS.
Where the elements of an MEA are not separately identifiable, or their fair values cannot be determined reliably, an entity should apply percentage-of-completion (POC) accounting, a straight line basis or should defer recognition of any revenue, depending on the facts and circumstances. If the overall outcome of the arrangement cannot be measured reliably, revenue should not be recognised.

Where goods are supplied and the supplier retains incidental post-supply obligations or will incur incidental post-supply future costs, all of the revenue is recognised on delivery of the goods and the estimated future costs are also recognised at that point (IAS 18.19). Judgement may be required to determine whether or not post-supply costs or obligations are incidental.

Service contracts
Service contracts that in substance represent more than one separately identifiable service should be separated into components based on the same criteria as other MEAs. The individual service components should then be accounted for in accordance with IAS 18.20 - 28.

Discussion

General
Arrangements involving the supply of multiple goods or services at different points in time are often referred to as multiple element arrangements (MEAs). The term MEA is not defined in IFRS and covers a wide variety of situations. Examples of possible MEAs include:

- bulk sales with delivery in more than one installment
- supply of goods with subsequent installation, servicing or support (including warranty arrangements)
- arrangements involving installation, activation or initiation followed by ongoing services
- certain customer loyalty/incentive schemes (see note below on IFRIC 13).

Note on IFRIC 13 Customer Loyalty Programmes
In June 2007 the IASB published IFRIC 13 Customer Loyalty Programmes (IFRIC 13) effective for annual periods beginning on or after 1 July 2008. The Interpretation applies to all customer loyalty reward credits that an entity grants to its customers as part of a sales transaction, whether provided directly by the entity or through a third party. The interpretation requires that an entity shall account for award credits as a separately identifiable component of the sales transaction in accordance with IAS 18.13. Award credits shall be measured by reference to their fair value, ie the amount for which they could be sold separately.

The IASB issued an amendment to IFRIC 13 as part of its Improvements to IFRS issued in May 2010 to clarify measurement of the fair value of award credits. The amendment clarifies that when the fair value of award credits are measured on the basis of the value of the awards for which they could be redeemed, the fair value of the award credits should take account of expected forfeitures as well as the discounts or incentives that would otherwise be offered to customers who have not earned award credits from an initial sale.

IAS 18’s general measurement objective is that revenue is measured at the fair value of the consideration received or receivable (IAS 18.9). IAS 18 also requires that this recognition principle is applied to the 'separately identifiable components of a single transaction' (IAS 18.13). IAS 18 therefore envisages MEAs and includes a principle for allocation of revenue. However, IAS 18 does not provide comprehensive guidance on determining whether or not components are separately identifiable, or on the method of allocation to be applied.

Separate identification
It will often be straightforward to assess whether or not an arrangement includes separately identifiable components, but judgement is sometimes necessary. In our view, the 'separately identifiable' principle covers multiple deliverables. An arrangement should not be accounted for as a multiple element arrangement simply because delivery involves multiple acts, tasks or phases. Indicators that deliverables are separately identifiable include:

- the components/deliverables are also sold separately (not necessarily by the entity concerned)
- the components/deliverables are capable of having value to the customer on a standalone basis.

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An arrangement does not in our view include separate components simply because:

- delivery requires multiple acts, phases etc or
- the pricing includes separate components (e.g., an upfront fee followed by ongoing charges).

**Revenue allocation and relative fair value**

A revenue allocation approach to accounting for MEAs is consistent with IAS 18.13 which states that:

> "when the selling price … includes an identifiable amount for subsequent servicing, that amount is deferred and recognised over the period during which the service is performed."

The relative fair value method is supported by IAS 18 Appendix paragraph 7 which states that:

> "When the items (items provided under a subscription and similar) vary in value from period to period, revenue is recognised on the basis of the sales value of the item despatched in relation to the total estimated sales value of all items covered by the subscription."

This method is also consistent with US GAAP and with the general principle of IAS 18 to recognise revenue based on the fair value of the consideration.

**Determination of reliable fair values**

Applying a relative fair value approach requires estimates of the fair values of the various components. The best evidence of fair value will usually be the standalone selling prices of the separate components. Where selling prices for one or more components are not available, a residual method can be used. Fair value can also be estimated using the expected cost of delivering the various components and adding an appropriate margin consistent with the expected margin on the arrangement as a whole. In most circumstances, where the deliverables are separately identifiable it is expected to be possible to make a sufficiently reliable estimate of fair value. If individual components are not sold separately, and their selling prices are therefore not available, this may indicate that the components are not separately identifiable.

**Cash limit**

In some MEAs, the revenue allocated to a delivered product (using relative fair value methodology) might exceed the amount charged to the customer for that product as set out in the pricing arrangement. For example, a mobile phone service provider might offer customers a 'free' phone if they enter into a 12 month airtime subscription arrangement. Under US generally accepted accounting practice (GAAP), the revenue recognised on delivery of the phone must be limited to the amount 'that is not contingent upon the delivery of additional items…’ (Accounting Standards Update (ASU) 605-25-30-5). In this example, the service provider will not collect the monthly airtime subscription revenues if it fails to provide a service subsequent to delivering the phone. The revenue allocated to the phone would therefore be nil in accordance with US GAAP. This US requirement is sometimes referred to as the 'cash limit' (since its effect is often to limit revenue for a delivered item to the cash receivable for that item).

In our view, the cash limit approach does not apply under IFRS. Hence, where applicable, entities should apply relative fair value methodology without applying a 'cash limit’. However, revenue that is partly contingent on future performance should be recognised only if it is probable that the revenue will be received.

**Incidental post-supply costs/services**

Although a revenue allocation approach is appropriate for most MEAs, IAS 18 also sets out an expense recognition approach where delivery has substantially occurred but the entity may or will incur certain post-supply expenses (IAS 18.19). The expense recognition approach involves recognition of 100% of the revenue for the goods or services supplied, and recognising (providing for) the associated post-supply costs at that point. This approach therefore differs from the revenue allocation approach.
In our view, the IAS 18.19 expense recognition principle should be applied only when:

- post-supply costs or services do not represent an additional supply to the customer within the scope of the entity's ordinary activities (e.g., the costs relate to a government imposed recycling obligation); or
- the costs are an additional product/service but are incidental to the delivered product or service.

Judgement may be required to determine whether or not post-supply cost or services are 'incidental'. The expense recognition approach is however commonly applied where goods are supplied with standard warranty arrangements. In our view a revenue allocation approach for goods with standard warranties is also acceptable provided the fair values of the two components are reliably measurable.

'Loss leader' sales
Some entities sell products at discounted amounts in the expectation that customers will make future purchases of spares, replacements etc. For example, a supplier of printers and ink cartridges might sell the printers at a loss in the expectation of profitable future sales of replacement ink cartridges. Such arrangements comprise multiple transactions rather than single transactions with separate components.

Examples

Example 1 - publication subscription
Entity A offers a subscription to a monthly publication, for an upfront annual fee of CU100. The publications are also sold separately for CU10. At period end five monthly editions have been delivered.

Analysis
This is an MEA with twelve deliverables. Each is separately identifiable and has a reliable fair value (of CU10). The total consideration of CU100 is allocated proportionately, resulting in an allocation of CU(100/12)=8.33 per edition. Revenue of CU41.67 is recognised at period end, representing the five delivered elements.

Example 2 - online information service subscription
Entity B offers an annual subscription to a web-based information service for an upfront annual fee of CU100.

Analysis
This appears to be a contract for a single service provided over a fixed period, and is not therefore an MEA. It is therefore accounted for on a percentage of completion or straight line basis in accordance with IAS 18.20 - 28. In practice, a straight line basis would probably be used since, absent evidence to the contrary, the service to the customer is likely to comprise an indeterminate number of acts over a specified period (IAS 18.25).

Example 3 - standard warranty arrangement
Entity C manufactures and sells electrical goods. In accordance with laws and regulations, a twelve month warranty is provided as standard. For a particular product, sold at CU100 per unit, past experience indicates that 5% of products sold will be subject to a warranty claim, with an average servicing cost per claim of CU20.

Analysis
Although this arrangement can be analysed into two components (product supply and a warranty service), the standard 12 month warranty is not capable of being sold separately and the associated costs are minor in relation to the sales value of the product. The sales revenue of CU100 is therefore recognised in full on delivery of the product and estimated warranty costs of CU1 (5% x 20) are recognised at the same time.
Example 4 - extended warranty/maintenance arrangement
Entity D is an auto dealer that sells and services vehicles. For a specific model sold at CU18,500, entity D offers 'free' servicing and maintenance for a three year period. Other dealers sell identical vehicles without the extended servicing/maintenance offer for CU18,000. Entity D does not sell three year servicing/maintenance contracts separately. However, management estimates that (i) 80% of customers will utilise the free services; and (ii) the individual services and repairs that will be supplied to those customers will have an average sales value of price of CU2,500.

Analysis
This arrangement includes two separately identifiable deliverables - the vehicle and the services/repairs. Vehicles and the services/repairs are sold separately in the marketplace, and have standalone value to the customer. The fair values of the components can be estimated reliably using the selling price of the vehicle without the special offer, and the estimated take up and selling prices of the subsequent services. Using the relative fair value method, the allocations of revenue are:

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of vehicle element: CU18,000</td>
<td></td>
</tr>
<tr>
<td>Fair value of services element: CU(80% x 2,500)</td>
<td>2,000</td>
</tr>
<tr>
<td>Total standalone fair value of separate components: CU20,000</td>
<td></td>
</tr>
<tr>
<td>Revenue recognised on delivery of car: CU(18,500 x 18,000/20,000)</td>
<td>16,650</td>
</tr>
<tr>
<td>Revenue allocated to servicing/maintenance: CU(18,500 x 2,000/20,000)</td>
<td>1,850</td>
</tr>
</tbody>
</table>

The CU1,850 is recognised over the three year period as services are provided. A percentage of completion approach should be used in accordance with IAS 18.20, although for practical purposes a straight-line approach might give a reasonable approximation.

Example 5a - supply and fit contract (customised equipment)
Entity E supplies bespoke fitted kitchens, including design, supply of materials and fittings, and installation. Entity E does not sell kitchen units separately (although all materials and fittings used can be purchased from other suppliers) and does not install kitchens purchased elsewhere. The materials and fittings are often delivered to customers’ premises prior to installation. Customers pay in three equal installments - on contract signing, on acceptance of the design and on completion.

Analysis
In substance, this arrangement appears to be a single deliverable - a fitted kitchen. The early delivery of equipment to the customer does not provide value to the customer and the overall risks and rewards of the supply are likely to remain primarily with Entity E until installation is complete. Although it might be possible for the customer to purchase a design service, procure equipment and arrange for installation separately, the end product is likely to be different. It is therefore doubtful that the elements are separately identifiable, and estimation of reliable fair values for the elements is likely to be problematic. Revenue should therefore be deferred until the installation is complete (consistent with IAS 18.1E2(a)). Alternatively, if the installation service extends over a period of time, the percentage of completion method may be appropriate. Either way, the terms of payment are of limited relevance.

Example 5b - supply and set-up contract (standard equipment)
Entity F supplies standard air conditioning units that require basic set up prior to use. Entity F provides this service free of charge, but about 20% of customers decide to set up the units themselves or use third party engineers. Entity F’s terms of trade state that customers are liable for the full price upon delivery regardless of whether or not Entity F carries out the set up work. For a specific unit, the selling price is CU10,000 and the equipment cost is CU6,000. Third party engineers charge an average of CU500 for the set-up; the cost to Entity F of each set-up is CU300.
Analysis

This arrangement comprises two deliverables - supply and set-up. The supplied units have standalone value, demonstrated by the fact that some customers do not use the set-up service. Sufficient information is available to reliably estimate the fair values of the components. Since the setup is straightforward and is a separately identifiable deliverable, the appropriate treatment is to allocate a portion of the CU10,000 revenue to the set up service, based on its relative fair value, and recognise this once installation is complete. However, the set up can also be regarded as an incidental post-supply cost, so an acceptable alternative would be to recognise the entire CU10,000 on delivery, and provide for the cost of set up.

The revenue and costs recognised on delivery and set up under the two approaches are:

<table>
<thead>
<tr>
<th></th>
<th>Delivery</th>
<th>Set-up</th>
</tr>
</thead>
<tbody>
<tr>
<td>a) Revenue allocation approach</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenue*</td>
<td>9,523</td>
<td>477</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>6,000</td>
<td>240</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Delivery</th>
<th>Set-up</th>
</tr>
</thead>
<tbody>
<tr>
<td>b) Cost provision approach</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenue</td>
<td>10,000</td>
<td>-</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>6,240</td>
<td>-</td>
</tr>
</tbody>
</table>

* the fair value of the setup is determined based on the third party price of CU500. Hence revenue allocated to the equipment is CU10,000 x (10,000/(10,000 + 500)) = 9,523.

Note: The fact that the customer is obliged to pay the full amount even if the supplier does not provide the set up service is not necessarily a decisive factor in determining whether or not revenue can be recognised on delivery. However, under IAS 18 revenue is recognised on 'delivered' goods or services only if the significant risks and rewards of ownership have been transferred and if receipt of the consideration is probable. The point at which the vendor becomes unconditionally entitled to the revenue may be relevant in assessing these factors but, in this case, set up is straightforward and is within Entity F's control. By contrast, under US GAAP revenue may be recognised on delivery only to the extent it is not contingent on delivery of future items.

Example 6 - cell phone supply and airtime

Entity G runs a promotion in which customers sign a twelve month airtime contract with minimum monthly spend of CU30 per month, entitling them to 60 minutes of usage each month, and receive a 'free' phone. The phone is also sold separately for CU100 (assume there are regular sales at this price). Under the promotion customers also pay a one-off connection fee of CU50. Assume that: (i) the contract terms stipulate that the connection fee is refundable if Entity G fails to provide the service for the 12 month period; (ii) the connection does not in substance represent a separately identifiable service (ie the CU50).

Analysis

The arrangement includes two separately identifiable components - the phone and the airtime service. The total consideration for the arrangement is CU(50 + 12x30)=410. The fair value of the phone is CU100. The fair value of the airtime revenue is CU360 (total fair value of the separable deliverables CU460). Using a relative fair value approach, the total revenue of CU410 is allocated proportionately to the fair values of the two separately identifiable components as follows:

Phone: CU410 x (100/460) = 89
Airtime: CU410 x (360/460) = 321

The phone revenue of CU89 is recognised on delivery of the phone, along with associated costs. The airtime revenue of CU321 is recognised on a straight line basis over the 12 month contract period.
**Note:** Under US GAAP the effect of the ‘cash limit’ is that revenue recognised on delivery of the phone would be limited to CU50 - the amount not contingent on Entity G providing future services. Under IFRS, the cash limit does not apply. However, before recognising the revenue of CU89 it will be necessary to be satisfied that the general conditions for revenue recognition in IAS 18.14 are met - in particular that receipt is probable. In practice, contingencies such as this may also be relevant in assessing whether or not components are separately identifiable.
HT 2006-07 Acquisition of investment properties - asset purchase or business combination?

Relevant IFRS
IFRS 3 Business Combinations
IAS 40 Investment Property

Issue
If one entity acquires another that holds one or more investment properties, should the transaction be accounted for as an asset purchase or as a business combination? (Similar issues can arise on purchase of other types of physical asset that generate cash flows on a standalone basis, e.g. retail outlets and hotels. The guidance in this Hot Topic is however intended to be specific to investment property.)

Additional guidance on related issues is contained in Hot Topic 2009-02. Hot Topic 2009-02 addresses the accounting in the consolidated financial statements for the:

- acquisition of assets held in a corporate shell, in particular, how to recognise any non-controlling interests; and
- disposal of assets held in a corporate shell.

Project update
The IFRIC reported to the IASB that practice differed in delineating the scope of IFRS 3 and IAS 40. As a result, in November 2012, the IASB issued its Annual Improvements to IFRSs 2011-2013 Cycle Exposure Draft which includes a proposal to amend IAS 40 to state explicitly that judgement is needed to determine whether a purchase of investment property(ies) is solely the acquisition of an asset (or group of assets) or a business combination in the scope of IFRS 3. The judgement is based on the guidance in IFRS 3 (not paragraphs 7-15 of IAS 40 as these paragraphs only relate to whether or not property is owner-occupied property or investment property). If approved, the entity would apply the amendment prospectively for acquisitions of investment property from the beginning of the first period for which it adopts the amendment. The proposed amendment would be effective for annual periods beginning on or after 1 January 2014 with early application permitted. Some of the guidance in this Hot Topic would need to be revised if the proposed amendment is finalised.

Guidance
Applying the IFRS 3 definitions of business combination and business (IFRS 3 Appendix A) to the purchase of an entity that holds one or more investment properties needs to be assessed on a case-by-case basis. In applying these definitions, consideration should be given to the specific factors that distinguish investment properties from most other non-financial assets. In particular, earning revenues (in the form of rentals) on a standalone basis is implicit in the definition of investment property (IAS 40.5). Certain activities such as property servicing and rent collection are ancillary to earning those rentals. Accordingly, in the case of investment property, revenue-generation and related activity are not necessarily strongly indicative of a business. As a general indication, we consider that:

- the purchase of a property or properties with no tenants or associated services should be accounted for as an asset purchase (in accordance with IAS 40)
- the purchase of a property or properties with tenants but no associated services should also be accounted for as an asset purchase
- the purchase of a property or properties with tenants and/or services and activities that are purely ancillary to the property and its tenancy agreements should also generally be accounted for as an asset purchase. However, it is also acceptable to account for such a transaction as business combinations if such a policy is applied consistently to all similar transactions
- the purchase of a property or properties with tenants and services/activities that extend beyond what is ancillary to the property and its tenancy agreements should generally be accounted for as a business combination (in accordance with IFRS 3).
Discussion

It is important to distinguish business combinations from asset purchases, since the IFRS requirements are very different depending on which classification is used. One area of difference (that can be significant for investment properties) is the deferred tax implications of the distinction. If the acquisition is treated as an asset purchase, no deferred tax liability is recognised because any temporary difference is covered by the 'initial recognition exemption' in IAS 12.15. If the transaction is classified as a business combination, this exemption does not apply and deferred tax is recorded for any difference between the asset's tax base and its carrying value (which will be fair value in the case of a business combination and cost in the case of an asset purchase).

IFRS 3 Appendix A defines a business combination as "a transaction or 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". A business is then defined as "an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants."

IFRS 3 Appendix B provides application guidance relating to the definition of a business. Paragraph B7 states that:

“A business consists of inputs and processes applied to those inputs that have the ability to create 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:

(a) Input: Any economic resource that creates, or has the ability to create, 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 or has the ability to create outputs. Examples include strategic management processes, operational processes and resource management processes. These processes typically are documented, but 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."

Applying this definition to the purchase of an investment property is not however always straightforward because:

- unlike most non-financial assets, investment properties (usually) generate revenues on a standalone basis (earning rentals being one of their defining characteristics - IAS 40.5). Most other non-financial assets generate returns only in combination with other assets and liabilities
- in simple asset purchases, no obligations or activities are acquired. However, investment properties are often acquired with tenants. Tenants’ leases usually include related service obligations. Servicing activities along with others such as rent collection can be regarded as integral to an investment property asset.

It is common in some jurisdictions for a single investment property to be held in a separate legal entity and for a purchaser to acquire that entity rather than the property. By contrast, most asset purchases are affected by purchasing the asset itself. Although acquiring a legal entity does not necessarily determine that a business combination has occurred, buying a legal entity brings with it all of the entity's assets, liabilities, contractual agreements and obligations.

In most cases, an asset or group of assets and liabilities that are capable of generating revenues, combined with all or many of the activities necessary to earn those revenues, would constitute a business. However, investment property is a specific case in which earning a return for investors is a defining characteristic of the asset. In our view, investment property revenue generation and activities that are specific and ancillary to the property and its tenancy agreements should therefore be given a lower 'weighting' in the classification of the transaction as a business combination.
Some commentators suggest that it may be easier to classify the purchase of an investment property in a corporate shell as a business under the revised definition of a business, as the definition is seen as wider than that in the earlier version of IFRS 3\(^1\). However, we do not believe it changes our analysis and conclusions relating to investment properties as set out in this Hot Topic. Both definitions require that there is an integrated set of activities and assets involving processes as well as inputs. In our view, ancillary activities are not strong indicators of a business. However, this is a matter of interpretation and alternative conclusions may develop in practice. Consequently, careful analysis of the facts and circumstances surrounding a purchase transaction is needed to be able to determine whether such a transaction is a purchase of an asset or a business. Judgment is required in these situations.

However, business combinations also take place in the investment property sector. Additional factors that indicate a business combination include:

- a purchase that includes separately identifiable assets and/or liabilities that would not ordinarily be considered as part of the property;
- a purchase that brings with it activities and/or staff associated with the business of investing in property (as well as activities ancillary to the properties and tenancy agreements). The business of investing in properties includes portfolio management (investment, divestments and associated activities), finance, marketing etc. Ancillary services such as accounting, billing, payroll and other administrative systems typically are not processes used to create outputs (IFRS 3.B7(b));
- the purchase of an entity (or group of entities) that previously operated independently as a property business (in contrast for example to a subsidiary with a single investment property sold by one group to another);
- the purchaser's motivation for the acquisition goes beyond adding to its property portfolio.

**Examples**

In the following scenarios property investment company A acquires company B, an entity whose only activity is to hold and administer investment property assets. Is the acquisition a business combination or the purchase of an asset (or assets)?

**Scenario 1 - single property, no tenants or services**

B holds a single investment property. The property has no tenants. B has no staff and does not undertake any services.

**Analysis**

This is an asset purchase. Company B is not revenue-generating, and no activities have been transferred to company A.

**Scenario 2 - single property with tenants**

B holds only a single investment property. The property has tenants subject to rental agreements but no support services or contracts are transferred when B is acquired.

**Analysis**

This is also an asset purchase. The acquired entity is revenue-generating, but no activities have been transferred to company A. Although the rental agreements are likely to contain servicing obligations, company A has not acquired any actual activities.

**Scenario 3 - single property with tenants and services**

B holds a single investment property. The investment property has tenants subject to rental agreements. Certain outsourced ancillary service contracts associated with obligations contained in the rental agreements are also transferred.

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\(^1\) IFRS 3 (issued 2004) defines a business as follows: An integrated set of activities and assets conducted and managed for the purpose of providing: (a) a return to investors; or (b) lower costs or other economic benefits directly and proportionately to policyholders or participants. A business generally consists of inputs, processes applied to those inputs, and resulting outputs that are, or will be, used to generate revenues. If goodwill is present in a transferred set of activities and assets, the transferred set shall be presumed to be a business.
Analysis
Our preferred view is that this is also an asset purchase. In this case support services have been transferred, even though they will be performed by external providers. However, these services are purely ancillary to the property and its lease agreements. In accordance with the guidance provided, activities ancillary to earning rentals are not considered as processes that are used to create output and are given a lower weighting in deciding on classification. However, we would also accept business combination accounting in this scenario, if such a policy is applied consistently by A in all similar transactions. This is because it would not be inconsistent with IFRS 3 definitions to conclude that this scenario amounts to purchase of a business.

Scenario 4 - multiple properties, tenants, services and staff
B holds 8 investment properties. The investment properties have tenants subject to rental agreements. B also employs several staff dedicated to the property management, the provision of services included in the rental agreements and administration such as invoicing, cash collection and management reporting.

Analysis
This is not clear cut but our preferred view is that this is a business combination. B appears to have many of the capabilities associated with a standalone business (even if it was in fact a subsidiary). It is also questionable that certain transferred activities, such as management reporting, are purely ancillary to the properties. Further, although B holding a portfolio of properties is not necessarily decisive in indicating a business combination this factor (i) makes it less likely that all of the services/activities transferred are specifically ancillary to individual properties; and (ii) meets the 'group of assets' part of the IFRS 3 Appendix A definition. Also, the fact that staff have transferred to A suggests that A might have acquired employee-related obligations. However, we might also accept asset purchase accounting if activities/services/staff transferred are ancillary to the portfolio as a whole, and such a policy is applied consistently by A in all similar transactions.

Scenario 5 - multiple properties, tenants, services and management
Facts as in scenario 4 but the transferred staff also include managers responsible for portfolio management, raising finance and marketing.

Analysis
This is a business combination. Company A has acquired a group of revenue-generating assets along with various staff and activities that clearly go beyond activities ancillary to the properties and their tenancy agreements.
**HT 2006-09 Costs of an initial public offering**

**Relevant IFRS**

IAS 32 Financial Instruments: Presentation

**Issue**

How should the costs of an initial public offering (IPO) that involves both issuing new shares and a stock market listing be accounted for?

**Guidance**

The costs of an IPO that involves both issuing new shares and a stock market listing should be accounted for as follows:

- incremental costs that are directly attributable to issuing new shares should be deducted from equity (IAS 32.37);
  - and
- costs that relate to the stock market listing, or are otherwise not incremental and directly attributable to issuing new shares, should be recorded as an expense in the income statement.

Costs that relate to both share issuance and listing should be allocated between those functions on a rational and consistent basis (IAS 32.38). In the absence of a more specific basis for apportionment, an allocation of common costs based on the proportion of new shares issued to the total number of (new and existing) shares listed is an acceptable approach.

**Project update**

The IASB issued *Annual Improvements to IFRS 2009-2011 Cycle* in May 2012 (the Amendments) and amended IAS 32.37. This addressed perceived inconsistencies between IAS 12 and IAS 32 with regards to recognising the consequences of income tax relating to distributions to holders of an equity instrument and to transaction costs of an equity transaction. The Amendments are effective for annual periods beginning on or after 1 January 2013 (earlier application is permitted). This Hot Topic has been updated for the Amendments.

**Discussion**

Entities commonly raise additional equity through a public offer of shares and concurrently list new and existing shares on a stock exchange (an exercise referred to as an IPO). The listing creates an active market in the shares and thereby provides liquidity to new and existing shareholders (along with other benefits and obligations).

IAS 32.37 requires that: "the transaction costs of an equity transaction are accounted for as a deduction from equity to the extent that they are incremental costs directly attributable to the equity transaction that otherwise would have been avoided...". Raising additional equity through the offering and issuance of new shares is an equity transaction for this purpose, but the listing procedure is not. Only costs attributable to the offer of new shares are deducted from equity.

In practice, the offering and listing are usually a combined exercise. Certain costs, such as stamp duties and underwriters' fees, are clearly attributable to raising additional equity. Other costs, such as listing fees, relate only to the listing and should be expensed. However, costs such as:

- legal fees
- accountants' fees
- other professional advisers' costs
- prospectus design and printing costs
are likely to relate to both functions. Such shared costs should be allocated on a systematic basis between the share issue and the listing and then recorded in part as an equity deduction and in part as an expense.

The following table provides a general indication as to some of the costs incurred in an IPO, and the basis on which they might be allocated. The requirements and practices for issuing and listing shares differ significantly between jurisdictions and stock markets, and the costs incurred and their allocation will also therefore vary depending on the specific facts and circumstances.

<table>
<thead>
<tr>
<th>Type of cost</th>
<th>Allocation (share-issue, listing or both)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stamp duties</td>
<td>Share issue</td>
</tr>
<tr>
<td>Underwriting fees</td>
<td>Share issue</td>
</tr>
<tr>
<td>Listing fees</td>
<td>Listing</td>
</tr>
<tr>
<td>Accountants’ fees relating to prospectus</td>
<td>Common - a prospectus type document may be required for an offer without a listing and vice versa, but in practice IPO documents typically relate both to the offer and the listing</td>
</tr>
<tr>
<td>Legal fees</td>
<td>Common - legal advice is typically required both for the offer of shares to the public and for the listing procedures to comply with the requirements established by the relevant securities regulator/exchange</td>
</tr>
<tr>
<td>Prospectus design and printing costs</td>
<td>Common - although in cases where most prospectus copies are sent to potential new shareholders the majority of such costs might relate to the share issue</td>
</tr>
<tr>
<td>Sponsor’s fees</td>
<td>Common - to the extent the sponsor’s activities relate to identifying potential new shareholders and persuading them to invest, the cost relate to the share issue. The activities of the sponsor related to compliance with the relevant stock exchange requirements should be expensed.</td>
</tr>
<tr>
<td>Public relations consultant’s fees</td>
<td>Expense - companies typically engage PR consultants to raise the company's profile which contributes to the ability to issue new shares. However, PR costs generally relate to general company promotion and are not therefore directly attributable to the share issue.</td>
</tr>
<tr>
<td>‘Roadshow’ costs</td>
<td>Expense - although the ‘roadshow’ might help to sell the offer to potential investors and hence contributes to raising equity, it is usually a general promotional activity. Hence the associated costs may not be not sufficiently directly related to the share issues to justify deduction from equity. Further, a significant portion of any costs may not be incremental (eg management time).</td>
</tr>
</tbody>
</table>

**Example**

Entity A undertakes an IPO in which 500,000 new shares are issued and a total of 750,000 new and existing shares are listed. Costs incurred include:

- underwriting fees of CU200,000
- listing fee of CU100,000
- accountant's and legal fees of CU300,000 relating to the offer and listing
- roadshow costs and fees paid to PR consultants of CU150,000

Ignoring tax effects, how should these costs be accounted for?
The underwriting fees should be deducted from equity. The listing fee and roadshow/PR consultants’ charges should be expensed. Accountants’ and legal fees should be allocated between the offer and the listing, one basis being in proportion to the new/existing shares as follows:

Allocated to new share issues (equity): \((\frac{500,000}{750,000}) \times 300,000 = 200,000\)

Allocated to listing (expense): \((\frac{250,000}{750,000}) \times 300,000 = 100,000\)

The respective entries for the IPO costs are as follows:

<table>
<thead>
<tr>
<th>Ledger entry</th>
<th>Debit 000s</th>
<th>Credit 000s</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity (underwriting = allocation of legal/accountant's fees)</td>
<td>CU400</td>
<td>CU350</td>
</tr>
<tr>
<td>Income statement (listing + allocation of legal/accountant's fees + roadshow/PR consultancy)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash/creditors</td>
<td></td>
<td>CU750</td>
</tr>
</tbody>
</table>
HT 2006-12 Contingent rent and minimum lease payments

Relevant IFRS
IAS 17 Leases

Issue
Accounting for contingent rent provisions in operating and finance leases.

Project updates
Leasing
The IASB and FASB (the Boards) have been working together to develop a new single approach to lease accounting that would ensure that all leases (other than short-term leases) would be recognised in the statement of financial position – i.e. no more operating or finance distinction. The proposed changes to the model would drastically change the accounting for contingent rent. As work continues on this project and is still subject to IASB's due process, this Hot Topic does not reflect the proposed changes within the leasing project.

Financial instruments
This Hot Topic reflects the requirements of IAS 39 Financial Instruments: Recognition and Measurement (IAS 39) and not those of IFRS 9 Financial Instruments (IFRS 9). IFRS 9 will eventually replace IAS 39 in its entirety. At this stage, IFRS 9 addresses the classification and measurement of financial assets and financial liabilities, along with derecognition. The requirements for financial liabilities and derecognition were carried forward unchanged (with the exception of some changes to the fair value option for financial liabilities to address the issue of own credit risk). On 28 November 2012, the Board issued an exposure draft proposing limited modifications to IFRS 9's financial asset classification model to address application issues. IFRS 9 is effective for annual periods beginning on or after 1 January 2015 (early adoption permitted). Work continues on Phases 2 and 3 of the project, which address impairment and hedge accounting, respectively.

Guidance
It is assumed in this guidance that the contingent rent provision is not an embedded derivative requiring to be separated in accordance with IAS 39.10-13. Many leases do contain embedded derivatives, but such derivatives are often considered 'closely related' in accordance with IAS 39.11(a) and IAS 39.AG.33(f). Closely related embedded derivatives are not separated. Embedded derivative features need to be assessed on a case by case basis with particular attention paid to embedded derivatives that are not explicitly covered by the guidance in IAS 39.AG.33(f).

(a) Operating leases - lessee and lessor
Contingent rents are recognised as income or expense on an actual or accruals basis in the periods to which they relate. However, if the contingent rent is an adjustment that relates to more than one period, the adjusted rentals are recognised prospectively, on a straight-line basis (unless another systematic basis is more representative of the consumption of the asset and/or the user's benefit).
In July 2006, the IFRIC considered whether an estimate of contingent rentals payable/receivable under an operating lease should be included in the total lease payments/lease income to be recognised on a straight-line basis over the lease term. The IFRIC noted that, although the Standard is unclear on this issue, this has not, in general, led to contingent rentals being included in the amount to be recognised on a straight line basis over the lease term. The IASB has deferred amending IAS 17 on this point in light of the Leases project noted above.

(b) Finance leases - lessee
When a lessee enters a finance lease which includes contingent rent, these contingent rents are charged as expenses by the lessee in the period in which they are incurred (IAS 17.25). No adjustment is made to the minimum lease payments which are determined at the inception of the lease (subject to any adjustments between inception and commencement - see below). The lessee’s finance charges, calculated to give a constant periodic interest rate on the outstanding liability, and the finance lease liability continue to be calculated on the basis of the minimum lease payments.

(c) Finance leases - lessor
When a lessor leases an asset under a finance lease arrangement which includes contingent rents, these contingent rents are recorded as income by the lessor in the period in which they are earned. No adjustment is made to the minimum lease payments. The lessor’s finance income, calculated to yield a constant rate of return on its net investment in the lease, is not affected by the contingent rent.

Discussion
Many leases include contingent rent provisions. Contingent rent is defined in IAS 17.4 as "that portion of the lease payments that is not fixed in amount but is based on the future amount of a factor that changes other than with the passage of time (eg percentage of future sales, amount of future use, future price indices, future market rates of interest)". Common examples of contingent rent provisions include:

- rent reviews providing for adjustment of rentals to prevailing market rates at one or more future dates;
- an index of lease payments to a specified price index; and
- rentals charged as a percentage of sales made.

A pre-determined adjustment to lease payments, such as an indexation provision that adjusts rentals by (say) 5% per annum, is not contingent rent. Instead, the additional rent is part of the minimum lease payments. Minimum lease payments are defined broadly as the payments the lessee is or can be required to make, excluding contingent rent (along with certain other items) (IAS 17.4).

It is important to distinguish contingent rentals from minimum lease payments since the latter figure is (i) important in determining the appropriate classification of the lease; and (ii) used in finance leasing calculations eg of the interest rate implicit in the lease, finance income/expense and finance lease liabilities and net investment.

Operating leases
Operating lease payments are in most cases recognised as income or expense on a straight-line basis over the lease term (IAS 17.33 and 50). IAS 17 does not explicitly address accounting for contingent rents in operating leases but we consider that the approach of recognising contingent rents prospectively is consistent with straight line recognition, which aims to recognise lease payments in the period to which they relate. Hence potential future adjustments to lease payments should not be anticipated but should be recognised in the period(s) in which they arise.

Finance leases
IAS 17.25 addresses contingent rentals in the context of lessee accounting for finance leases. IAS 17.25 requires that contingent rents are charged as expenses by the lessee in the period in which they are incurred. A consequence of this approach is that the contingent rent does not affect the allocation of minimum lease payments between finance costs and reduction of the outstanding finance lease liability.
IAS 17 does not address contingent rentals in the context of lessor accounting for finance leases. In the absence of specific guidance, we consider that the IAS 17.25 accounting approach should also be applied by lessors. On this basis the lessor recognises the contingent rentals in the period(s) in which they are earned. The lessor's net investment in the lease, and its recognition of finance income, continue to be determined in accordance with the minimum lease payments (as determined at lease inception), subject to any other adjustments that may be required (eg for changes in estimated unguaranteed residual value).

It should be noted that the effect of contingent rents will often be that the lessor retains significant risks and rewards incidental to ownership, and that the lease is therefore an operating lease (IAS 17.12). Finance lease classification of a lease with contingent rents is appropriate only if other indicators determine that substantially all the risks and rewards have been transferred.

**Adjustments between inception and commencement**
IAS 17.5 covers lease agreements or commitments that include a provision to adjust lease payments for changes in measures of the underlying property's cost or value during the period between inception (ie signing the lease) and commencement (the beginning of the lease term). Such changes are deemed to have taken place at inception and are therefore included in minimum lease payments.

**Examples**

**Operating lease - contingent rent**
A six year operating lease commences on 1 Jan 20X1. It includes an 'upward only' rent review clause that may increase the rentals with effect from 1 Jan 20X4. Initial annual rental is CU1,000. During 20X3 the rent review is concluded and the rental is increased to CU1,100 per annum.

**Analysis**
The additional rent arising from the rent review is contingent rent and is recognised over the period to which it relates. The lessee therefore recognises lease expenses of CU1,000 per annum in years 20X1 to 20X3, and CU1,100 per annum in years 20X4 to 20X6*. The lessor recognises the same amounts as income*.

* unless another systematic basis is more representative of the time pattern in which use benefits are derived/diminished.

**Operating lease - pre-determined adjustment**
A six year operating lease commences on 1 Jan 20X1. Initial annual rental is CU1,000 and this increases by 3% each year.

**Analysis**
The additional rent is not contingent, since it is pre-determined at lease inception and arises through passage of time. Hence the lease payments are all included in minimum lease payments. Total rentals over the six year term are CU6,468, equivalent to CU1,078 per annum. The lessee therefore recognises lease expenses of CU1,078 in each of years 20X1 to 20X6. The lessor recognises the same annual amounts as income.

**Finance lease - contingent rent**
A lessee enters into a 10 year leasing arrangement with a lessor. The lease is classified as a finance lease. The key terms of the lease are as follows:

<table>
<thead>
<tr>
<th>Inception and commencement</th>
<th>1 January 20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost and fair value of leased asset</td>
<td>CU90,000</td>
</tr>
<tr>
<td>Lease term</td>
<td>10 years</td>
</tr>
<tr>
<td>Annual rental</td>
<td>CU10,000 indexed to local consumer price index (CPI)</td>
</tr>
<tr>
<td>Initial payment</td>
<td>On commencement and every 12 months thereafter</td>
</tr>
</tbody>
</table>
Estimated residual value (unguaranteed) CU25,000, assumed to be realised on 1 Jan 20Y1.

CPI at 1 Jan 20X1 to 1 Jan 20Y0 is: 155.8, 159.9, 162.3, 165.4, 170.8, 176.6, 178.9, 183.3, 187.6, 193.2.
To simplify the calculations it is also assumed that the residual value estimate is not revised and that there are no initial direct costs.

Analysis
The lease includes contingent rents since the inflation adjustments are not pre-determined. The contingent amounts are therefore recognised in the periods to which they relate. The finance lease calculations are carried out using the minimum lease payments of CU10,000 per annum and other key terms.

The first step is to calculate the interest rate implicit in the lease. Since there are no initial costs, this is the discount rate that, when applied to the future minimum lease payments and estimated residual value, gives a present value equal to the fair value of the asset (IAS 17.4). In this case the applicable rate is 6.471%.

(a) Lessee accounting
The lessee recognises a finance lease obligation equal to the fair value of the leased asset or, if lower, the future minimum lease payments discounted at the rate of return implicit in the lease if this is practical to determine (IAS 17.20). In this case the discounted minimum lease payments give the lower figure (CU76,645 at inception, immediately reduced to CU66,645 by the first lease payment). Each lease payment is then apportioned between finance charge and reduction of the liability, to give a constant periodic charge on the remaining liability balance. The contingent rentals are recognised in the period in which they are incurred (IAS 17.25). The amounts recognised as expense in each period are summarised in the following table:

<table>
<thead>
<tr>
<th>Year</th>
<th>Obligation at start of year (A) (note 1)</th>
<th>Minimum rental paid in year (B) (note 1)</th>
<th>Finance charge at 6.471% (C) (note 2)</th>
<th>Obligation at end of year D=(A+C-B)</th>
<th>Contingent rental expense in year (E) (note 3)</th>
<th>Total income statement effect (C+E) (note 4)</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X1</td>
<td>66,645</td>
<td>-</td>
<td>4,312</td>
<td>70,958</td>
<td>-</td>
<td>4,312</td>
</tr>
<tr>
<td>20X2</td>
<td>70,958</td>
<td>10,000</td>
<td>3,944</td>
<td>64,902</td>
<td>263</td>
<td>4,207</td>
</tr>
<tr>
<td>20X3</td>
<td>64,902</td>
<td>10,000</td>
<td>3,553</td>
<td>58,454</td>
<td>417</td>
<td>3,970</td>
</tr>
<tr>
<td>20X4</td>
<td>58,454</td>
<td>10,000</td>
<td>3,135</td>
<td>51,590</td>
<td>616</td>
<td>3,751</td>
</tr>
<tr>
<td>20X5</td>
<td>51,590</td>
<td>10,000</td>
<td>2,691</td>
<td>44,281</td>
<td>963</td>
<td>3,654</td>
</tr>
<tr>
<td>20X6</td>
<td>44,281</td>
<td>10,000</td>
<td>2,218</td>
<td>36,499</td>
<td>1,335</td>
<td>3,553</td>
</tr>
<tr>
<td>20X7</td>
<td>36,499</td>
<td>10,000</td>
<td>1,715</td>
<td>28,214</td>
<td>1,444</td>
<td>3,159</td>
</tr>
<tr>
<td>20X8</td>
<td>28,214</td>
<td>10,000</td>
<td>1,179</td>
<td>19,932</td>
<td>1,765</td>
<td>2,944</td>
</tr>
<tr>
<td>20X9</td>
<td>19,932</td>
<td>10,000</td>
<td>608</td>
<td>10,000</td>
<td>2,041</td>
<td>2,649</td>
</tr>
<tr>
<td>20Y0</td>
<td>10,000</td>
<td>10,000</td>
<td>-</td>
<td>0</td>
<td>2,401</td>
<td>2,401</td>
</tr>
<tr>
<td>Total</td>
<td>90,000</td>
<td>23,355</td>
<td>-</td>
<td>11,245</td>
<td>34,600</td>
<td>-</td>
</tr>
</tbody>
</table>
Notes
1. The obligation at the start of the lease of CU66,645 excludes the first payment, as this is paid at inception. The first payment is therefore excluded from the 'minimum rental paid in year column' but is included in minimum rentals for the supporting calculations.
2. The finance charge is calculated to give a constant rate of return on the outstanding balance during each year. The outstanding balance for this purpose in each period is the closing balance at the end of the preceding period less the minimum rental of CU10,000 paid at the beginning of each year.
3. The contingent rent is the effect of the increase in CPI on the rent is each year, determined as the base rent of CU10,000 multiplied by percentage increase in CPI since inception.
4. The lessee is also required to record a depreciation charge in respect of the underlying asset if it is depreciable - IAS 17.27.
(b) Lessor accounting
The lessor recognises an asset (receivable) equal to the net investment in the finance lease (IAS 17.36). The net investment is determined as the minimum lease payments plus unguaranteed residual value, discounted at the rate of return implicit in the lease (IAS 17.4). Finance income is recognised in each future period so as to give a constant periodic rate of return on the net investment (IAS 17.39). The contingent rentals are recognised as income in the period to which they relate. The amounts recognised as income in each period are summarised in the following table:

<table>
<thead>
<tr>
<th>Year</th>
<th>Net investment start of year</th>
<th>Minimum rental received in year</th>
<th>Finance income at 6.471% (note 1)</th>
<th>Net investment end of year (note 2)</th>
<th>Contingent rental income in year</th>
<th>Total income statement effect</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X1</td>
<td>80,000</td>
<td>-</td>
<td>5,177</td>
<td>85,177</td>
<td>-</td>
<td>5,177</td>
</tr>
<tr>
<td>20X2</td>
<td>85,177</td>
<td>10,000</td>
<td>4,864</td>
<td>80,041</td>
<td>263</td>
<td>5,127</td>
</tr>
<tr>
<td>20X3</td>
<td>80,041</td>
<td>10,000</td>
<td>4,532</td>
<td>74,573</td>
<td>417</td>
<td>4,949</td>
</tr>
<tr>
<td>20X4</td>
<td>74,573</td>
<td>10,000</td>
<td>4,178</td>
<td>68,751</td>
<td>616</td>
<td>4,794</td>
</tr>
<tr>
<td>20X5</td>
<td>68,751</td>
<td>10,000</td>
<td>3,802</td>
<td>62,553</td>
<td>963</td>
<td>4,765</td>
</tr>
<tr>
<td>20X6</td>
<td>62,553</td>
<td>10,000</td>
<td>3,401</td>
<td>55,954</td>
<td>1,335</td>
<td>4,736</td>
</tr>
<tr>
<td>20X7</td>
<td>55,954</td>
<td>10,000</td>
<td>2,974</td>
<td>48,927</td>
<td>1,444</td>
<td>4,418</td>
</tr>
<tr>
<td>20X8</td>
<td>48,927</td>
<td>10,000</td>
<td>2,519</td>
<td>41,446</td>
<td>1,765</td>
<td>4,284</td>
</tr>
<tr>
<td>20X9</td>
<td>41,446</td>
<td>10,000</td>
<td>2,035</td>
<td>33,481</td>
<td>2,041</td>
<td>4,076</td>
</tr>
<tr>
<td>20Y0</td>
<td>33,481</td>
<td>10,000</td>
<td>1,519</td>
<td>25,000</td>
<td>2,401</td>
<td>3,920</td>
</tr>
<tr>
<td>Total</td>
<td>90,000</td>
<td>35,000</td>
<td></td>
<td>11,245</td>
<td></td>
<td>46,245</td>
</tr>
</tbody>
</table>

Notes
1. Calculated as 6.471% of the net investment during each period. The net investment is the discounted future minimum lease payments and residual value. In this case the finance income each year is 6.471% of (net investment at the end of the preceding period less the CU10,000 received on 1 Jan each year).
2. The lessor’s closing net investment on 31 Dec Y0 of CU25,000 equals the residual value which is assumed to be realised by the lessor on 1 Jan Y1. If the estimated residual value were to decline the income allocation and net investment amounts would need to be revised in accordance with IAS 17.41.
HT 2006-13 Uncertain tax positions

Relevant IFRS
IAS 12 Income Taxes
IAS 37 Provisions, Contingent Liabilities and Contingent Assets

Issue
In measuring income taxes payable (or recoverable), how should an entity reflect uncertainty over whether specific tax positions will be sustained under challenge from the relevant tax authorities?

Guidance
When an entity’s income taxes payable (or recoverable) might be affected by the outcome of uncertain tax positions, the measurement of the liability or asset:

- should be based on the best estimate of tax due for the period in accordance with the applicable laws and regulations
- should not be reduced to take account of the possibility that tax positions will escape detection or will not be challenged.

The best estimate should be revised in future periods if appropriate, as the entity's tax due for the period becomes more certain. This may occur as the various steps in the process of determination and settlement of the tax liability are completed.

Discussion
Entities generally seek to reduce their income taxes payable, aiming to pay the minimum due under the relevant tax laws. This might include organising aspects of their business and structuring certain transactions to achieve a more favourable tax treatment. However, due to the complexities of many business transactions and the uncertainties inherent in tax laws, entities frequently face uncertainty as to the tax consequences of some transactions and arrangements ("uncertain tax positions"). For example, it might be uncertain as to whether items of income are taxable or expenses deductible. Frequently such uncertain tax positions reflect the potential for differing interpretations of tax laws when applied to specific transactions and arrangements.

IAS 12.5 defines taxable profit (or tax loss) in terms of the rules established by the taxation authorities, upon which income taxes are payable (recoverable). Current tax is the amount of income taxes payable or recoverable in respect of taxable profit or tax loss for a period. One consequence of this definition is that entities need to make a best estimate of the taxes payable or recoverable, on the basis that the relevant tax rules will be enforced. It is not therefore appropriate to reduce the amount of taxes payable on the grounds that the authorities might overlook or decide not to investigate/challenge a tax position (sometimes described as 'detection risk'). In effect, the entity should assume that its tax positions will be detected and challenged, and make its estimates on the basis of the expected outcome of the challenge.

A best estimate approach involves making a judgment as to the interpretation (of the relevant tax laws in the circumstances) that is most likely to be sustained. Taxes payable are then estimated according to that interpretation. In some situations tax authorities might notify the entity or market of their interpretation of certain tax laws. The entity might intend to challenge that position but the tax authority’s view is likely to indicate the most likely outcome until it is successfully challenged. Specialist tax/legal advice may be needed to determine the best estimate.

The best estimate of the taxes payable should be revised if appropriate, as facts and circumstances change. The uncertainty will be removed once taxes payable have been substantially agreed by the relevant authority. Before that, the steps and procedures for the final determination of taxes payable might provide additional evidence that makes it appropriate to revise the estimate. Typically, those steps include:

- filing a tax return
• the tax authority either accepting or querying the return
• tax audit or investigation
• legal or other proceedings for the resolution of disputed positions.

It should be noted that income taxes are not within the scope of IAS 37 (IAS 37.5(b)). Accordingly, income tax-related liabilities (or contingent liabilities) are not subject to a 'probability recognition threshold'. However, fines and penalties levied by tax authorities (e.g., late-filing penalties) are not income taxes as defined in IAS 12 and, accordingly, should be recognised and measured in accordance with IAS 37.

Example
An entity is preparing its 20X0 financial statements and has incurred a specific item of expenditure whose tax deductibility is uncertain. The entity's professional advisors estimate that there is a 60% chance that the deductibility of this expenditure would not be sustained under challenge. However, it is also estimated that the authority scrutinises only 50% of returns. If the expenditure is deductible, the entity's 20X0 current tax liability is CU1,000. This increases to CU1,200 if the expenditure is disallowed.

In 20X1 (after the 20X0 financial statements have been approved) the entity files its 20X0 tax return. The return shows the expenditure as a deductible item but includes adequate disclosure of its nature. Later in 20X1 the tax authority agrees the return without challenge.

Analysis
In its 20X0 financial statements the entity makes an estimate of its current tax liability based on its assessment of the most likely effect of the relevant tax laws. The entity's expectation is that, if challenged, the expenses are more likely than not to be disallowed. The liability is therefore computed on the basis that the expenses are non-deductible. This would result in a liability of CU1,200. No 'discount' is applied for the possibility that the tax return will not be scrutinised.

In 20X1 the tax return is agreed without challenge. Since the entity has disclosed the uncertainty and has not been challenged, the tax payable for 20X0 is substantially agreed at an amount of CU1,000. Accordingly, the 20X1 current tax income or expense includes a credit of CU200.
HT 2006-16  Contracts for purchase or sale of non-financial items denominated in a foreign currency

Relevant IFRS
IAS 39 Financial Instruments: Recognition and Measurement
IAS 21 The Effects of Changes in Foreign Exchange Rates

Project updates
This Hot Topic reflects the requirements of IAS 39 Financial Instruments: Recognition and Measurement (IAS 39) and not those of IFRS 9 Financial Instruments (IFRS 9). IFRS 9 will eventually replace IAS 39 in its entirety. At this stage, IFRS 9 addresses the classification and measurement of financial assets and financial liabilities, along with derecognition. The requirements for financial liabilities and derecognition were carried forward unchanged (with the exception of some changes to the fair value option for financial liabilities to address the issue of own credit risk). On 28 November 2012, the Board issued an exposure draft proposing limited modifications to IFRS 9’s financial asset classification model to address application issues. IFRS 9 is effective for annual periods beginning on or after 1 January 2015 (early adoption permitted). Work continues on Phases 2 and 3 of the project, which address impairment and hedge accounting, respectively.

Issues
a) When does an embedded foreign currency derivative in a host contract for the sale or purchase of a non-financial item need to be separated?
b) If separation is required, how is this done?

Note: In this Hot Topic, it is assumed throughout that the host sale or purchase contract is outside the scope of IAS 39. Contracts that can be settled net (rather than by physical delivery and gross settlement) are within the scope of IAS 39 unless they are for the entity’s expected sale, purchase or usage requirements (IAS 39.5).

Guidance
(a) When does an embedded foreign currency derivative in a host contract for the sale or purchase of a non-financial item need to be separated?

Any contract for the sale or purchase of a non-financial item that is denominated in a foreign currency (ie a currency other than the functional currency of the reporting entity) is likely to contain an embedded derivative. The embedded derivative must be separated when its economic characteristics and risks are not closely related to those of the host contract (IAS 39.11). The embedded derivative is closely related if, and only if, the contract is denominated in:

- the functional currency of any substantial party to that contract (IAS 39.AG33(d)(i)) - normally the buyer or seller
- the currency in which the related non-financial item is routinely denominated around the world (IAS 39.AG33(d)(ii))
- a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (IAS 39.AG33(d)(iii)).

In the first case, it is important to note that the functional currency of any substantial party to the contract may not be the currency of that party's country of domicile. The functional currencies of the parties should be determined in accordance with the definition and guidance in IAS 21.9-13. This may require judgement, and will require a specific determination when one or more of the parties does not apply IFRS.

Currency of denomination of the non-financial item (IAS 39.AG33(d)(iii))
The IAS 39.AG33(d)(ii) exception applies only to products and services in which a large majority of trading throughout the world is in the same currency. This is consistent with the guidance in IAS 39.IG.C9. It does not apply to products and services that are:
commonly bought and sold in multiple currencies throughout the world (eg items traded throughout the world either in US dollars or in euros) or
• predominantly traded in a specific currency in some regions or countries but other currencies are used elsewhere in the world (items traded in US dollars in the Americas and euros in Europe).

In January 2008, the Canadian Emerging Issues Committee (EIC) published guidance on the application of these requirements: EIC 169 Determining Whether a Contract is Routinely Denominated in a Single Currency (EIC 169). Canada has since adopted IFRS for most listed entities. The applicable requirements of Canadian GAAP (still in effect for those Canadian entities not required to adopt IFRS) are consistent with IAS 39 in this area. Accordingly, we consider that EIC 169 is also useful guidance in the context of IFRS. EIC 169 explains that:

“For certain types of commodity transactions, contracts may be based on a dominant currency (such as the US dollar) but may be denominated in local currencies in certain markets for regulatory or other reasons where such local currency transactions are based on the dominant currency price of that commodity translated at the spot rate into local currencies (a “convenience translation” mechanism). For example, although the dominant currency for crude oil transactions … is the US dollar, some contracts for crude oil may be denominated in Canadian dollars in Canada, where the Canadian dollar price is a convenience translation of the US dollar crude oil price. The Committee noted that a simple convenience translation into local currencies of a commodity that is routinely denominated in a dominant currency would not negate the view that the commodity is routinely denominated in a single currency in commercial transactions around the world. On the other hand, if a commodity transaction is regularly denominated in various currencies in commercial transactions around the world where such foreign currency prices are not convenience translations of a dominant currency price, that commodity would not be considered to be routinely denominated in a particular currency. For example, if cross-border transactions in natural gas in North America are routinely denominated in US dollars and such transactions are routinely denominated in Euros in Europe, neither the US dollar nor the Euro is a currency in which the goods or services are routinely denominated in commercial transactions around the world.”

The key point in this extract is that a so-called convenience translation into other currencies does not of itself mean that the commodity is not routinely denominated in a single currency. We concur with this view.

The Canadian guidance referred to above includes a listing (not intended to be exhaustive) of commodities that are considered to be routinely denominated in US dollars. This is reproduced in the Appendix to this Hot Topic for convenience. Preparers and auditors should consider all facts and circumstances arising subsequent to the publication date of EIC 169 (January 2008) that might impact whether an item should remain on the list provided in the Appendix.

In practice, we expect that the IAS 39.AG 33(d)(ii) principle will be applied mainly to US dollar denominated sales and purchases of:
• crude oil and
• certain commodities, subject to demonstrating that the commodity is mainly traded in US dollars throughout the world.

**Currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment (IAS 39.AG33(d)(iii))**

The IAS 39.AG33(d)(iii) exception applies to a currency that is commonly used in the economic environment in general. This does not mean that the majority of business transactions must be denominated in that currency. However, a specific currency should not normally be considered commonly used if its usage is limited to a single or small number of industries.

In our view, the 'economic environment' can be that of the reporting entity or the counter-party. In other words, if an entity based in Country X transacts in US dollars with an entity based in Country Y, and US dollars are commonly used in Country X but not Country Y, the exception applies (to both entities).
In some jurisdictions, the local currency is commonly used in domestic transactions, and another currency is commonly used in international trade (cross-border transactions). The currency commonly used in international trade may be driven primarily by the location of the main trading partners (i.e., countries to or from which companies in the relevant jurisdiction export or import goods and services). In assessing whether a specific currency is commonly used, both local and cross-border transactions should be considered. For example, if the US dollar is commonly used in cross-border transactions in a country, it may be considered a commonly used currency for all transactions in that country, including local transactions.

Business operating in hyperinflationary environments may decide to price transactions in a 'hard' currency to protect against inflation. Entities operating in small countries with relatively illiquid local currencies also sometimes denominate transactions with entities from other small countries in a more liquid currency. These factors are indicators that a non-local currency might be commonly used.

Application of these indicators might result in more than one non-local currency being considered commonly used in some economic environments. Making this assessment requires obtaining up-to-date information and evidence on business practices in the economic environment(s) in question.

In the absence of suitable evidence that a non-local currency is commonly used, the embedded derivative should not be considered closely related. It must therefore be separated from the host contract.

(b) If separation is required, how is this done?
Separation of embedded derivatives can be complex. The following guidance applies to a straightforward contract with the following characteristics:

- the sale or purchase of a fixed quantity of a non-financial item
- delivery at a set future date
- price fixed in a foreign currency (the contract currency).

The main steps in separating this combined contract are as follows:

- the host contract is a sale or purchase contract denominated in the **functional currency of the reporting entity**
- the amount of functional currency is determined using the relevant **forward exchange rate** (to the date of delivery) at the date the contract is entered into
- the embedded derivative is a forward currency contract to buy or sell the applicable amount of the contract currency for the functional currency, at the same forward exchange rate. The effect is that the fair value of the embedded derivative is initially zero (as required by IAS 39,AG28 for 'non-option derivatives')
- subsequent changes in the fair value of the embedded derivative are recorded in profit or loss
- on delivery of the non-financial item, the host contract is fulfilled and the embedded derivative is effectively settled. A foreign currency debtor or creditor is recognised for the contract amount, translated at the closing rate in accordance with IAS 21.23(a). The closing carrying amount of the embedded derivative is added to the functional currency amount of the host contract to give the initial carrying amount of the debtor or creditor.

These steps are illustrated in the example.

Separating the embedded derivative requires a detailed understanding of the contractual terms. Terms such as cancellation provisions, options to defer delivery and an ability to alter the volume of goods and services can all affect the determination.

Delivery of products or services is often delayed or accelerated compared to the original contract date. This should be dealt with by measuring the fair value of the derivative to the estimated delivery date (until delivery takes place).
Discussion
An embedded derivative is a component of a combined (or hybrid) contract that also includes a non-derivative host contract. The embedded derivative requirements of IAS 39 apply both to financial and non-financial host contracts. The embedded derivative causes some or all of the cash flows of the combined contract to vary in a way similar to a standalone derivative (IAS 39.10), according to an 'underlying' (eg interest rate, commodity price or foreign exchange, or other variable). This variation would not occur in the same contract without the embedded derivative.

Applying the concept of embedded derivatives in practice can be challenging. It is necessary to:

- determine whether or not the contract includes an embedded derivative
- determine whether or not the economic characteristics of the embedded derivative are closely related to those of the host contract
- if they are not closely related, separate the contract. This involves identifying the terms and conditions of the host component and the embedded. This in turn can require judgement, since the terms of the two components are not normally stated expressly.

IAS 39.AG.27-33 sets out numerous examples of host contracts and embedded derivatives, and provides guidance on whether or not they are closely related. IAS 39.IG.C1-C11 address various specific implementation issues.

This Hot Topic provides guidance on foreign currency sale and purchase contracts, which are a common type of hybrid contract. Such contracts give rise to a currency exposure. IAS 39 aims to ensure that this exposure is recognised unless it is closely related to the economic characteristics of the host contract.

It is clear from the Basis for Conclusions to IAS 39 that the IASB believes that, in principle, all embedded currency derivatives should be separated (IAS 39.BC37). The scenarios in IAS 39.AG33(d) in which the embedded derivative is closely-related are therefore exceptions to the general requirement for separation. Accordingly, these exceptions should be used only when there is convincing evidence that they apply.
**Example**

Entity A (a UK sterling functional currency entity) enters into a US$1,000,000 purchase contract on 1 January 20X1 with Entity B (a euro functional currency entity), to take delivery of inventory on 30 June 20X1. Assume the embedded derivative does not meet the criteria in IAS 39.AG33(d) to be considered closely related.

Assume the following exchange rates:

- Spot rate on 1 January 20X1: US$/UK£ = 1.7
- Six month forward rate on 1 January 20X1: US$/UK£ = 1.68
- Spot rate on 30 June 20X1: US$/UK£ = 1.6

**Analysis**

The contract should be separated into a UK sterling denominated purchase order with an embedded currency forward to pay dollars and receive sterling. This is on the basis that the embedded derivative creates a dollar exposure for an entity with sterling functional currency. A case can be made for analysing the contract into a euro purchase order with an embedded dollar/euro forward. However, this approach creates a euro exposure for a sterling functional currency entity, which is not implied in the contract. This would also make the accounting more complex.

The contract should be separated using the 6 month dollar/sterling forward exchange rate, as at the date of the contract (US$/UK£ = 1.68). The two components of the contract are therefore:

- a purchase contract for £595,239 (US$1m/1.68)
- a six month currency forward to sell US$1m at 1.68.

Subsequently, the host contract is not accounted for until delivery (unless it becomes an onerous contract). The embedded derivative is recorded at fair value through profit or loss (unless designated as a cash flow hedging instrument, if appropriate). This gives rise to a gain or loss on the derivative, and a corresponding derivative asset or liability.

On delivery Entity A records the inventory at the amount of the host contract (£595,239). The embedded derivative is considered to expire. The derivative asset or liability (ie the cumulative gain or loss) is settled by becoming part of the financial liability that arises on delivery. In this case the carrying value of the currency forward at 30 June 20X1 on maturity is £(1,000,000/1.6 - 595,239) = £29,761 (liability/loss).

The accounting entries are as follows (all in £s):

<table>
<thead>
<tr>
<th>Ledger entry</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loss on currency forward (P&amp;L)</td>
<td>29,761</td>
<td></td>
</tr>
<tr>
<td>Currency forward liability</td>
<td></td>
<td>29,761</td>
</tr>
</tbody>
</table>

To record loss on currency forward to 30 June 20X1

<table>
<thead>
<tr>
<th>Ledger entry</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>595,239</td>
<td></td>
</tr>
<tr>
<td>Financial liability</td>
<td></td>
<td>595,239</td>
</tr>
</tbody>
</table>

To record receipt of inventory based on implied terms of host contract.
To reclassify currency forward liability as a component of the financial liability.

The effect is that the financial liability at the date of delivery is £625,000 (= 595,239 + 29,761), equivalent to US$1,000,000 at the spot rate on 30 June 20X1. Going forward, the financial liability is a US$ denominated financial instrument. It is retranslated at the dollar spot rate in the normal way, until it is settled.

This example illustrates the accounting when the embedded derivative is required to be separated. If the embedded is not separated (ie it is considered to be closely related) the inventory would be recorded at £625,000, the US$ dollar amount translated at the spot rate at the date of delivery. No derivative loss would be recorded in the income statement.

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Appendix

Extract from Canadian Emerging Issues Committee Abstract EIC 169 Determining Whether a Contract is Routinely Denominated in a Single Currency (January 2008)

This Appendix reproduces the EIC 169 examples of commodities and certain other items that are considered to be routinely denominated in US dollars. It is included here for convenience and as a starting point for conducting the necessary analysis. Grant Thornton International has not verified the list, which is based on consideration of the factors discussed in EIC 169. The list is not intended to be exhaustive. Rather, it is a listing of commodities and certain other items that are routinely denominated in US dollars that have been identified at the date of publication (January 2008). Preparers and auditors should consider all facts and circumstances arising subsequent to January 2008 that might impact whether an item should remain on this list.

- Aluminium
- Coal (coking and thermal)
- Copper
- Crude oil
- Diamonds [rough/raw and polish (wholesale market)]
- Gold
- Iron ore
- Jet fuel
- Lead
- Nickel
- NBSK pulp
- Palladium
- Platinum
- Silver
- Tin
- Titanium
- Uranium
- Wide-bodied aircraft
- Zinc
HT 2006-17 Financial instruments with payments based on profits of the issuer

Relevant IFRS
IAS 32 Financial Instruments: Presentation
IAS 39 Financial Instruments: Recognition and Measurement

Issue
How should financial instruments that include an obligation to pay dividends/interest linked to the profits of the issuer be classified and measured by the issuer?

Project update
This Hot Topic reflects the requirements of IAS 39 Financial Instruments: Recognition and Measurement (IAS 39) and not those of IFRS 9 Financial Instruments (IFRS 9). IFRS 9 will eventually replace IAS 39 in its entirety. At this stage, IFRS 9 addresses the classification and measurement of financial assets and financial liabilities, along with derecognition. The requirements for financial liabilities and derecognition were carried forward unchanged (with the exception of some changes to the fair value option for financial liabilities to address the issue of own credit risk). On 28 November 2012, the Board issued an exposure draft proposing limited modifications to IFRS 9’s financial asset classification model to address application issues. IFRS 9 is effective for annual periods beginning on or after 1 January 2015 (early adoption permitted). Work continues on Phases 2 and 3 of the project, which address impairment and hedge accounting, respectively.

Guidance
Classification
A contractual obligation to pay interest or dividends linked to profits of the issuer should be classified as a liability (rather than as equity) by the issuer.

Some instruments that include this type of obligation also include an equity component. The instrument is then a compound instrument. The equity component is determined as the difference between the fair value of the liability component (ie the obligatory payments) and the total fair value of the instrument (IAS 32.32). The liability component is measured in accordance with the guidance below. The equity component is recorded with equity, with no subsequent re-measurement.

In some countries entities may be required under national legislation to pay a dividend equal to a certain percentage of their profits or a certain proportion of their share capital. Application of IAS 32 in this situation requires the issuer to consider whether the statutory imposition is part of the contractual terms of the instrument, or should alternatively be viewed as a separate, non-contractual obligation that is outside IAS 32’s scope. This is a point of interpretation.

Measurement
On initial recognition, the instrument is recorded at its fair value. For instruments with no equity component that are issued to non-related parties, the initial fair value will usually equal the issue proceeds. If the instrument includes an equity component, it is necessary to estimate the liability component.

Subsequently, the instrument is recorded at amortised cost using the effective interest method. The effective interest method is applied using estimated cash flows. This in turn requires estimating the future profits on which the dividend/interest payments will be based. If profit projections subsequently change, the liability is reassessed to reflect the new estimate (IAS 39.AG8). The re-assessment is based on present value of estimated future cash flows, discounted using the original effective interest rate. Changes in the amount of the liability resulting from a changes in estimated cash flows are recorded in profit or loss (IAS 39.AG8). They are presented as an additional finance charge or credit.
Discussion
Classification
Financial instruments that include obligations to make payments linked to the profits of the issuer are common. An example of such an instrument is a bond or share that pays a fixed percentage of profits of the issuer each period. The terms of the instrument usually include a definition of ‘profit’ for this purpose. The instrument might be either fixed term or perpetual.

An obligation to pay interest or dividends linked to profits of the issuer is a contractual obligation to deliver cash. Such an obligation therefore meets the definition of a financial liability (IAS 32.11(a)(i)). This is the case even if the issuer has not yet earned sufficient profits to pay any interest or dividend. IAS 32 also makes clear that the ability of the issuer to influence its profits does not alter this classification (IAS 32.AG26(f)). In other words, the profits of the issuer should not be regarded as within the control of the issuer.

Some instruments that include such an obligation also include an equity component. For example, the contractual arrangements might make clear that the obligatory payments are a minimum and that additional, discretionary dividends might be paid. Such a feature meets the definition of an equity component since:
- there is no obligation to deliver cash; and
- it represents an interest in the residual assets of the issuer, after deducting all of the liabilities (IAS 32.11).

An equity component should be identified only if the discretionary feature has substance. It should not be presumed to exist (since, in theory, the issuer of any instrument could decide to make additional, discretionary payments).

Note
In July 2009, the IFRS team issued the Liability or Equity Guide - a practical guide to the classification of financial instruments under IAS 32. The guide includes a summary of the discussion contained in this Hot Topic. This guide is available in the IFRS section of the GTInet website under ‘external publications’. The guide includes a discussion of the implications of statutory obligations to pay a dividend on the classification of instruments as a liability or as equity.

Measurement
As with all financial instruments within the scope of IAS 39, the liability should initially be recorded at its fair value (plus transaction costs for items not subsequently measured at fair value through profit or loss) (IAS 39.43). Subsequently, the instrument is measured at amortised cost, using the effective interest method (IAS 39.47). This assumes that the instrument is not designated at fair value through profit or loss.

The effective interest method involves:
- estimating the instrument's future cash flows;
- determining the interest rate that exactly discounts those cash flows to the instrument's carrying value (ie its fair value plus any transaction costs at inception). This rate is termed the effective interest rate (EIR).
- determining periodic interest expense (or income) using the EIR (IAS 39.9).

It is presumed that future cash flows can be estimated reliably. Clearly, with instruments whose cash flows are linked to future profits there will be a wide range of estimation uncertainty. However, a sufficiently reliable estimate should be possible in all but rare cases. Where these estimates are considered to be a key source of estimation uncertainty, the disclosures required by IAS 1.125 should be given.

Because estimated cash flows in turn depend on projected profits of the issuer, these estimates will need to be revised regularly. IAS 39.AG8 sets out that changes in estimated payments and receipts are dealt with as follows:
- the carrying amount of the instrument is adjusted based on the new estimate of payments and receipts;
- the EIR is not revised; and
- the effect of the adjustment is recorded in profit or loss.
As a consequence of applying these requirements, instruments with payments linked to profits are likely to give rise to income statement volatility.

An alternative approach to measuring these instruments is to treat the profit-linking feature as an embedded derivative. On this analysis, an instrument with an obligation to pay a fixed percentage of profits would be considered a fixed rate debt instrument with an embedded 'receive fixed, pay percentage of profits' interest swap. The fixed interest rate would be imputed such that the initial fair value of the non-option derivative is zero (based on IAS 39.IG.C1). However, in our view, separating the instrument in this manner involves imputation of cash flows that are not implied by the contract. For this reason, this is not our preferred approach.

Example
Entity A issues a 10 year, fixed term instrument on 1 Jan 20X1 for CU1,000,000. The instrument pays a 'dividend' of 10% earnings before interest, tax, depreciation and amortisation (EBITDA) on 31 Dec each year, calculated by reference to EBITDA for that year. The instrument is repayable at CU1,000,000 on 31 Dec 20X0.

The instrument does not contain any equity component. The proceeds of CU1,000,000 are assumed to equal the fair value of the instrument on 1 Jan 20X1. Transaction costs are ignored.

Analysis
Entity A should first estimate the cash flows that will be required under the terms of this instrument. This will require estimating EBITDA over the 10 year term. The effective interest rate (EIR) is then determined as the rate that exactly discounts the future cash flows to the initial fair value. Entity A's estimates, and the resulting cash flows, are set out in the following table:

<table>
<thead>
<tr>
<th>Year</th>
<th>Estimated EBITDA</th>
<th>Cash flows based on EBITDA at 10%</th>
<th>Proceeds and repayment</th>
<th>Total estimated cash flows</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Jan 20X1</td>
<td>1,000,000</td>
<td>1,000,000</td>
<td>0</td>
<td>1,000,000</td>
</tr>
<tr>
<td>20X1</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>20X2</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>20X3</td>
<td>400,000</td>
<td>(40,000)</td>
<td>(40,000)</td>
<td>(40,000)</td>
</tr>
<tr>
<td>20X4</td>
<td>800,000</td>
<td>(80,000)</td>
<td>(80,000)</td>
<td>(80,000)</td>
</tr>
<tr>
<td>20X5</td>
<td>1,100,000</td>
<td>(110,000)</td>
<td>(110,000)</td>
<td>(110,000)</td>
</tr>
<tr>
<td>20X6</td>
<td>1,400,000</td>
<td>(140,000)</td>
<td>(140,000)</td>
<td>(140,000)</td>
</tr>
<tr>
<td>20X7</td>
<td>1,700,000</td>
<td>(170,000)</td>
<td>(170,000)</td>
<td>(170,000)</td>
</tr>
<tr>
<td>20X8</td>
<td>2,000,000</td>
<td>(200,000)</td>
<td>(200,000)</td>
<td>(200,000)</td>
</tr>
<tr>
<td>20X9</td>
<td>2,500,000</td>
<td>(250,000)</td>
<td>(250,000)</td>
<td>(250,000)</td>
</tr>
<tr>
<td>20Y0</td>
<td>2,500,000</td>
<td>(250,000)</td>
<td>(1,000,000)</td>
<td>(1,250,000)</td>
</tr>
<tr>
<td>EIR</td>
<td>10.007%</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
This yields an EIR of 10.007%. If actual EBITDA and the resulting cash flows are exactly as estimated, the resulting interest charges are as set out in the following table:

<table>
<thead>
<tr>
<th>Year</th>
<th>Opening liability (A)</th>
<th>Total cash flows (B)</th>
<th>Interest expense (at EIR of 10.007%) (C)</th>
<th>Closing liability (=A+B+C)</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X1</td>
<td>1,000,000</td>
<td>0</td>
<td>100,068</td>
<td>1,100,068</td>
</tr>
<tr>
<td>20X2</td>
<td>1,100,068</td>
<td>0</td>
<td>110,082</td>
<td>1,210,151</td>
</tr>
<tr>
<td>20X3</td>
<td>1,210,151</td>
<td>(40,000)</td>
<td>121,098</td>
<td>1,291,248</td>
</tr>
<tr>
<td>20X4</td>
<td>1,291,248</td>
<td>(80,000)</td>
<td>129,213</td>
<td>1,340,462</td>
</tr>
<tr>
<td>20X5</td>
<td>1,340,462</td>
<td>(110,000)</td>
<td>134,138</td>
<td>1,364,599</td>
</tr>
<tr>
<td>20X6</td>
<td>1,364,599</td>
<td>(140,000)</td>
<td>136,553</td>
<td>1,361,153</td>
</tr>
<tr>
<td>20X7</td>
<td>1,361,153</td>
<td>(170,000)</td>
<td>136,208</td>
<td>1,327,361</td>
</tr>
<tr>
<td>20X8</td>
<td>1,327,361</td>
<td>(200,000)</td>
<td>132,827</td>
<td>1,260,188</td>
</tr>
<tr>
<td>20X9</td>
<td>1,260,188</td>
<td>(250,000)</td>
<td>126,105</td>
<td>1,136,293</td>
</tr>
<tr>
<td>20Y0</td>
<td>1,136,293</td>
<td>(1,250,000)</td>
<td>113,707</td>
<td>0</td>
</tr>
</tbody>
</table>

The actual outcome will of course differ from the estimates. The estimates will also be revised regularly, as circumstances change. To illustrate this, assume that the original estimates remain valid in 20X1 and 20X2. However, in 20X3 Entity A earns EBITDA of CU500,000. At that point Entity A also revises its estimates of EBITDA in future years.

<table>
<thead>
<tr>
<th>Year</th>
<th>Actual &amp; estimated EBITDA</th>
<th>Cash flows based on EBITDA at 10%</th>
<th>Proceeds and repayment</th>
<th>Total actual &amp; estimated cash flows</th>
<th>PV of estimated future cash flows at 10.007%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Jan 20X1</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>1,000,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>20X1</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>1,000,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>20X2</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>20X3</td>
<td>500,000</td>
<td>(50,000)</td>
<td>(50,000)</td>
<td>(1,336,599)</td>
<td></td>
</tr>
<tr>
<td>20X4</td>
<td>900,000</td>
<td>(90,000)</td>
<td>(90,000)</td>
<td>(1,336,599)</td>
<td></td>
</tr>
<tr>
<td>20X5</td>
<td>1,200,000</td>
<td>(120,000)</td>
<td>(120,000)</td>
<td>(1,336,599)</td>
<td></td>
</tr>
<tr>
<td>20X6</td>
<td>1,500,000</td>
<td>(150,000)</td>
<td>(150,000)</td>
<td>(1,336,599)</td>
<td></td>
</tr>
<tr>
<td>20X7</td>
<td>2,000,000</td>
<td>(200,000)</td>
<td>(200,000)</td>
<td>(1,336,599)</td>
<td></td>
</tr>
<tr>
<td>20X8</td>
<td>2,000,000</td>
<td>(200,000)</td>
<td>(200,000)</td>
<td>(1,336,599)</td>
<td></td>
</tr>
<tr>
<td>20X9</td>
<td>2,500,000</td>
<td>(250,000)</td>
<td>(250,000)</td>
<td>(1,336,599)</td>
<td></td>
</tr>
<tr>
<td>20Y0</td>
<td>2,500,000</td>
<td>(250,000)</td>
<td>(1,000,000)</td>
<td>(1,250,000)</td>
<td></td>
</tr>
</tbody>
</table>

When the estimates are revised, Entity A determines the present value (PV) of the newly estimated cash flows. PV is always determined using the original EIR. The table shows the actual EBITDA for 20X3 and the new projections (in the boxed part of the second column).

The new cash flow estimates result in a PV of CU1,336,599 at 31 Dec X3. The carrying amount of the liability must be adjusted to this amount. This adjustment is recorded in profit or loss. The interest charges are revised, again using the original EIR, such that the newly estimated carrying value is amortised to the amount repayable at maturity. This is illustrated in the following table, with the revised amounts shown in the boxed section.
The accounting entries recorded at 20X3 are as follows:

<table>
<thead>
<tr>
<th>31 Dec 20X3</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash (interest payment)</td>
<td></td>
<td>CU50,000</td>
</tr>
<tr>
<td>Interest expense</td>
<td>CU121,098</td>
<td></td>
</tr>
<tr>
<td>Other finance charge</td>
<td>CU55,351</td>
<td></td>
</tr>
<tr>
<td>Loan carrying amount</td>
<td></td>
<td>CU126,449</td>
</tr>
</tbody>
</table>

It should be noted that:

- the interest expense (excluding the adjustment) continues to equal the liability outstanding in the year multiplied by the original EIR, and does not equal the cash payment
- the liability amount at each reporting date equals the expected future cash flows discounted at the original EIR
- the adjustment arises each time actual cash flows differ from the forecast and/or each time the estimates are updated. In reality, an adjustment is therefore likely to arise every year.
HT 2006-18 Parent entity financial guarantee contracts

Relevant IFRS
IAS 39 Financial Instruments: Recognition and Measurement
IFRS 4 Insurance Contracts
IAS 37 Provisions, Contingent Liabilities and Contingent Assets
IAS 18 Revenue

Issue
Accounting for a financial guarantee contract issued by a parent entity in relation to a third party loan to a subsidiary.

Project updates
IFRS 9
This Hot Topic reflects the requirements of IAS 39 Financial Instruments: Recognition and Measurement (IAS 39) and not those of IFRS 9 Financial Instruments (IFRS 9). IFRS 9 will eventually replace IAS 39 in its entirety. At this stage, IFRS 9 addresses the classification and measurement of financial assets and financial liabilities, along with derecognition. The requirements for financial liabilities and derecognition were carried forward unchanged (with the exception of some changes to the fair value option for financial liabilities to address the issue of own credit risk). On 28 November 2012, the Board issued an exposure draft proposing limited modifications to IFRS 9’s financial asset classification model to address application issues. IFRS 9 is effective for annual periods beginning on or after 1 January 2015 (early adoption permitted). Work continues on Phases 2 and 3 of the project, which address impairment and hedge accounting, respectively.

Revenue
The IASB and FASB (the Boards) have been working together on a joint project to clarify the principles for recognising revenue and to develop a converged revenue standard. A revised exposure draft was published in November 2011. Consistent with the prior proposal, the guidance in the revised exposure draft would replace the current multiple sources of guidance on revenue with a single model; however, the earlier proposals had been amended to reduce disruption to established practices (eg the revised exposure draft includes additional “practical expedients” intended to simplify application in several areas, including embedded financing and onerous obligations). A final standard is now predicted in the first half of 2013. The areas that may be most affected include multiple-element arrangements, revenue subject to variable (eg performance-based) payments, contracts with significant financing and contract costs.

Insurance contracts
The Insurance Contracts project aims at providing a single source of principle-based guidance to account for all types of insurance contracts. The current IFRS 4 is an interim standard that allows insurers to continue using various existing accounting practices that have developed in a piecemeal fashion over many years. In July 2012, the IASB posted a working draft to implement its tentative decisions on the Insurance Contract project. A revised ED is expected in Q1 or Q2 2013.

Guidance
General
Financial guarantee contracts are defined in IAS 39.9. These contracts are within the scope of IAS 39, in accordance with IAS 39.2(e) and 103B. This also specifies the required accounting. However, entities are permitted to apply an alternative, 'IFRS 4 approach’ in some circumstances, as discussed below.

The IAS 39 definition of financial guarantee contracts is quite narrow. In particular, the definition applies only where the guarantee relates to a debt instrument. The definition does not therefore capture product warranties, performance bonds and non-specific ‘comfort letters’ of the type sometimes issued by parent entities to subsidiaries (for example).

IFRS 4 approach
If, and only if, an issuer of a financial guarantee contract has previously:
• explicitly asserted that it regards financial guarantee contracts as insurance contracts and
• applied an accounting policy applicable to insurance contracts

it is permitted to apply IFRS 4 rather than IAS 39 (IAS 39.2(e)) (the IFRS 4 election). The assertion (ie statement) will typically be made in the entity's previous financial statements but could also be made in other documents or communications with customers and regulators (IAS 39.AG4A). The IFRS 4 election may be made on a contract by contract basis, but cannot be revoked for a contract after it has been made.

IFRS 4 does not set out detailed requirements on accounting for financial guarantee contracts, or for insurance contracts in general. Broadly, it allows entities to continue with their existing accounting policies subject to certain conditions such as a liability adequacy test (IFRS 4.15 - 19). IFRS 4 also sets out certain limitations and principles to be followed if an entity changes its accounting policy (IFRS 4.21 - 23).

IAS 39 approach
Entities that do not make an IFRS 4 election should account for financial guarantee contracts as follows:
• on initial recognition, the guarantee is recorded at its fair value
• subsequently the guarantee is re-measured to the higher of (i) the amount that would be required in accordance with IAS 37; and (ii) the initial fair value amount less amortisation, when appropriate, in accordance with IAS 18 (IAS 39.47(c)).

Application to parent entity guarantees
The following paragraphs discuss the application of this guidance to a common situation in which:
• a subsidiary S borrows money from a third-party lender (eg a bank)
• a parent entity P issues a financial guarantee to the lender in respect of those borrowings.

(i) Consolidated financial statements
At group level, the guarantee has no separate accounting implications. In effect, the fair value of the guarantee is part of the fair value of the third party loan to S.

(ii) P’s separate financial statements
The guarantee should be recorded as a liability, at its fair value. There is unlikely to be an active market in this type of guarantee, so fair value will usually need to be estimated. If the effect of the guarantee is that S pays interest on the loan at a lower rate, one way of estimating the fair value is to determine the present value of the reduction in S’s interest payments.

The debit entry should be to P’s cost of investment in S.

Subsequently, assuming that payment under the guarantee is not probable, the initial fair value should be amortised to income. This should be on a straight-line basis over the period of the guarantee unless an alternative method is a better approximation of the extent to which P has discharged its obligations.

(iii) S’s separate financial statements
S is not a party to the guarantee contract and does not therefore account for it directly. However, if the loan is an off-market loan when viewed from S’s perspective, it should be recorded at its fair value based on the terms that would have been available without the guarantee from P. If this results in a fair value that differs from the loan amount, the difference should be recorded in equity. Subsequently, the loan is measured at amortised cost using the effective interest method. This approach is consistent with the guidance in Hot Topic 2006-03 Inter-company loans for parent entity loans.
In some cases the guarantee might not have a determinable effect on the terms of the loan. For example, the bank might require a parent guarantee as a condition for extending the loan (rather than in exchange for reducing the interest rate). In such cases, the loan to the subsidiary might well be 'at market' such that the initial fair value is equal to the loan amount.

If the loan is repayable on demand (e.g. a typical overdraft), it must be recorded at no less than the amount repayable on demand (IFRS 13.47).

Discussion

IFRS 4 and IAS 39 approaches

Financial guarantee contracts meet the general definition of a financial instrument. Before the issuance of IFRS 4 in early 2004, such contracts were clearly within the scope of IAS 39 (IAS 39.BC21). However, IFRS 4 created uncertainty as to whether such contracts also meet the definition of insurance contracts and should therefore be accounted for in accordance with that standard. IFRS 4 does not specify exactly how financial guarantee contracts (or insurance contracts in general) should be accounted for.

The IASB amended IAS 39 in 2005 to address these uncertainties. Broadly, the amendment (i) clarifies that financial guarantee contracts are generally within the scope of IAS 39; and (ii) sets out the required accounting.

However, the amendment also permits entities that regard guarantee contracts as insurance contracts (and have accounted for them as such) to apply IFRS 4 rather than IAS 39. This will allow some entities to continue with their existing accounting practices for financial guarantee contracts. Although IFRS 4 does not specify any particular accounting method, the IASB notes that credit insurers typically record a liability on issuance of an insurance contract. This might be based either on the premium received, or on estimated expected losses (IAS 39.BC23A).

The discussion in IAS 39.BC21-23 indicates that the IFRS 4 election is intended primarily as a compromise to allow insurance entities to maintain existing accounting practices. However, the election is available to any entity that has asserted that it regards financial guarantee contracts as insurance contracts and has established an accounting policy applicable to insurance contracts. Entities that do not meet those conditions will apply IAS 39.

Parent entity guarantees - initial recognition

Parent entities sometimes issue financial guarantee contracts to third party lenders in respect of borrowings of a subsidiary (parent guarantees). There is no scope exception in IAS 39 for parent guarantees. This is a difference between IFRS and US GAAP (ASC 460-10-15-7 includes a scope exception for parent guarantees). The IASB concluded that scoping out parent guarantees could lead to the omission of material liabilities. Given this focus on the completeness of liability recognition, it is important that parent guarantees are properly assessed and that a supportable fair value is determined.

Determining fair value for parent guarantees will usually require the use of an estimation technique. There is unlikely to be an available quoted price in an active market. Various estimation techniques are possible, including:

- the price for an equivalent credit insurance policy, if available
- expected losses under the guarantee (i.e. the probability-weighted outcomes) or
- if applicable, the present value of the reduction in the subsidiary’s interest payments.

The third approach is appropriate when it is evident that the parent guarantee has enabled the subsidiary to borrow at a lower interest rate, when compared to the market rate without the guarantee. This might be clear from bank negotiations or other borrowing transactions. This approach is relatively straightforward to apply and is likely to provide a reasonable estimate (since the inputs are based on known cash flows and market interest rates).
Parent entity guarantees - subsequent measurement

After initial recognition a guarantee is re-measured to the higher of (i) the amount that would be required in accordance with IAS 37; and (ii) the initial fair value amount less amortisation, when appropriate, in accordance with IAS 18 (IAS 39.47(c)).

In the case of a single guarantee, IAS 37 would require recognition of a liability only when it is probable (ie more likely than not) that the guarantee will result in a payment. The liability would then be based on the most likely outcome (which may be the full amount guaranteed). For a portfolio of guarantees, an expected value approach should be applied (IAS 37.14 and 40).

When a payment under the guarantee is not probable, the guarantee is measured at its initial fair value less amortisation. We consider that amortisation is appropriate when: (i) consideration is received by the guarantor; and (ii) the guarantee is for a fixed period over which the associated risk diminishes. Amortisation on a time proportion basis over the guarantee period may be appropriate (partly by analogy with loan commitment fees - see IAS 18.1E14(b)(ii)). An alternative pattern of amortisation should be used if it is a better approximation of the extent to which the guarantor has discharged its obligations.

The consideration received in exchange for a parent guarantee is often not in the form of cash. Rather, the parent benefits indirectly because the lender:

- makes a loan to the subsidiary that would not be made without the guarantee or
- offers improved loan terms to the subsidiary (eg a lower interest rate).

Subsidiary's separate financial statements

If a parent entity issues a guarantee directly to a lender, the subsidiary is not party to the guarantee contract. It does not therefore account for the guarantee directly. However, the terms of the loan need to be considered. The loan, viewed from the subsidiary's perspective, might not be at 'market' terms (eg because it has an interest rate that is lower than would be available on a non-guaranteed basis). In that situation the obligations under the loan should be recorded at fair value based on the terms that would have been available without the guarantee. Consistent with the approach suggested for the parent, this fair value amount could be estimated based on the actual payments under the loan discounted at the subsidiary's arm's length cost of borrowing.

This will result in a carrying amount that is less than the amount of the loan. The difference should be credited to equity, since in substance the parent has made a capital contribution to the subsidiary by issuing a 'free' guarantee.

In many cases banks (and other lenders) require parent guarantees as a pre-condition for making loans to subsidiaries (rather than in exchange for reducing the interest rate). This is because lenders wish to protect themselves against a controlling party acting in a way that adversely affects creditors' interests. In this situation, the parent guarantee might not have a determinable effect on the terms of the loan. In these cases, the actual terms of the loan are likely to be the best indicator of 'at-market' terms, such that the fair value is equal to the loan amount.

Example

Subsidiary S borrows CU1,000,000 from a bank on 1 Jan X0. The loan bears interest at 8% and is repayable in five equal installments of CU200,000, plus interest, from 31 Dec X0 to 31 Dec X4. S's parent entity P provides the bank with a guarantee that would require P to pay the loan instalments in the event of default by S. The bank has indicated that, without the P's guarantee, it would charge an interest rate of 10% (S's cost of borrowing).

Assume that payment under the guarantee is assessed throughout the five year term as not probable. Transaction costs are ignored in this example, and it is assumed that the fair value option does not apply. P has not asserted that it regards financial guarantees as insurance contracts.
Analysis

(i) Consolidated financial statements
From a group perspective, the guarantee is not accounted for separately. The loan to S is also a liability of the group. The guarantee does not create any additional obligation. The loan is accounted for based on its stated interest rate of 8%, which also represents a market rate of interest from a group perspective. Hence the loan amount of CU1,000,000 is also the fair value on initial recognition. Subsequently, the loan is accounted for at amortised cost using an effective interest rate of 8%.

(ii) P’s separate financial statements
On initial recognition the guarantee is recorded at its fair value in P’s separate financial statements. This can be estimated based on the present value of the reduction in S’s interest payments. The present value is determined using S’s stand-alone borrowing cost of 10%. This gives an estimated fair value of CU48,369, calculated below:

<table>
<thead>
<tr>
<th>Year</th>
<th>Loan amount outstanding during year</th>
<th>Actual interest at 8%</th>
<th>Notional interest at 10%</th>
<th>Reduction in interest attributable to guarantee</th>
<th>Present value of reduction in interest at 10%</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X0</td>
<td>1,000,000</td>
<td>80,000</td>
<td>100,000</td>
<td>20,000</td>
<td>18,182</td>
</tr>
<tr>
<td>20X1</td>
<td>800,000</td>
<td>64,000</td>
<td>80,000</td>
<td>16,000</td>
<td>13,223</td>
</tr>
<tr>
<td>20X2</td>
<td>600,000</td>
<td>48,000</td>
<td>60,000</td>
<td>12,000</td>
<td>9,016</td>
</tr>
<tr>
<td>20X3</td>
<td>400,000</td>
<td>32,000</td>
<td>40,000</td>
<td>8,000</td>
<td>5,464</td>
</tr>
<tr>
<td>20X4</td>
<td>200,000</td>
<td>16,000</td>
<td>20,000</td>
<td>4,000</td>
<td>2,484</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>240,000</td>
<td>300,000</td>
<td>60,000</td>
<td>48,369</td>
</tr>
</tbody>
</table>

Subsequently, the initial carrying amount of CU48,369 should be amortised to the income statement on a basis that reflects the extent to which P has discharged its obligations. A straight-line basis is reasonable in this example, since the guarantee is for a fixed period and P’s exposure reduces as S repays the loan instalments.

The accounting entries in P’s separate financial statements are as follows:

<table>
<thead>
<tr>
<th>Initial recognition on 1 Jan X0</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in S</td>
<td>CU48,369</td>
<td></td>
</tr>
<tr>
<td>Guarantee liability</td>
<td></td>
<td>CU48,369</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Entries in each of years X0 to X4</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Guarantee liability</td>
<td>CU9,674</td>
<td></td>
</tr>
<tr>
<td>Income (48,369/5)</td>
<td></td>
<td>CU9,674</td>
</tr>
</tbody>
</table>

(iii) S’s separate financial statements
S is not party to the guarantee contract. No accounting is therefore required for the guarantee itself. However, it is apparent that from S’s perspective the loan bears interest at an off-market rate. The loan obligations must be recorded at fair value to S. This is estimated based on the total future payments (principal plus interest), discounted at S’s cost of borrowing of 10%. Subsequently, the loan is accounted for at amortised cost using an effective interest rate of 10%.
The initial fair value using this approach is CU951,631 (equal to the loan amount less the fair value of the guarantee). The amortised cost is subsequently derived based on the effective interest rate and this initial carrying amount. The calculations are shown below:

<table>
<thead>
<tr>
<th>Year</th>
<th>Loan repayments including actual interest (A)</th>
<th>Present value of payments at 10%</th>
<th>Amortised cost of loan: beginning of year (B)</th>
<th>Interest expense recorded (C = 10% x B)</th>
<th>Amortised cost of loan: end of year (B + C - A)</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X0</td>
<td>280,000</td>
<td>254,545</td>
<td>951,631</td>
<td>95,163</td>
<td>766,795</td>
</tr>
<tr>
<td>20X1</td>
<td>264,000</td>
<td>218,182</td>
<td>766,795</td>
<td>76,679</td>
<td>579,474</td>
</tr>
<tr>
<td>20X2</td>
<td>248,000</td>
<td>186,326</td>
<td>579,474</td>
<td>57,947</td>
<td>389,421</td>
</tr>
<tr>
<td>20X3</td>
<td>232,000</td>
<td>158,459</td>
<td>389,421</td>
<td>38,942</td>
<td>196,364</td>
</tr>
<tr>
<td>20X4</td>
<td>216,000</td>
<td>134,119</td>
<td>196,364</td>
<td>19,636</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>1,240,000</td>
<td>951,631</td>
<td>288,369</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The difference between the proceeds of the loan and its initial carrying amount (CU48,369) is in substance a capital contribution to S from P. It is therefore recorded in equity.

The accounting entries S's separate financial statements are as follows:

### Initial recognition on 1 Jan X0

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash (loan proceeds)</td>
<td>CU1,000,000</td>
</tr>
<tr>
<td>Loan obligations</td>
<td>CU951,631</td>
</tr>
<tr>
<td>Equity (contribution from P)</td>
<td>CU48,369</td>
</tr>
</tbody>
</table>

### Cumulative subsequent entries in years X0 to X4

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>CU288,369</td>
</tr>
<tr>
<td>Loan obligation</td>
<td>CU951,631</td>
</tr>
<tr>
<td>Cash</td>
<td>CU1,240,000</td>
</tr>
</tbody>
</table>
HT 2006-19 Impact of synergies and tax amortisation benefits on fair values in a business combination

Relevant IFRS
IFRS 3 Business Combinations
IAS 38 Intangible Assets
IFRS 13 Fair Value Measurement

Issue
When estimating fair values of assets acquired in a business combination, should the acquirer take account of synergies and tax amortisation benefits that might be available to some buyers but not others?

Notes
In May 2008, the IFRS team issued a guide - Intangible Assets in a Business Combination - Identifying and valuing intangible assets under IFRS 3. The guide includes a summary of the discussion in this Hot Topic. This guide is available in the IFRS section of the GTInet website under ‘external publications’.

The IASB issued IFRS 13 Fair Value Measurement (IFRS 13) in May 2011 which is effective for annual periods beginning on or after 1 January 2013 (early application permitted). IFRS 13 defines fair value, sets out in a single framework for measuring fair value and requires disclosures about fair value measurements. IFRS 13 does not determine when an asset, a liability or an entity’s own equity instrument is measured at fair value. Rather, the measurement and disclosure requirements of IFRS 13 apply when another IFRS requires or permits the item to be measured at fair value (with limited exceptions).

IFRS 13 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (ie an exit price). The definition of fair value emphasises that fair value is a market-based measurement, not an entity-specific measurement. When measuring fair value, an entity uses the assumptions that market participants would use when pricing the asset or liability under current market conditions, including assumptions about risk.

Guidance
Fair value estimates should take account of synergies and tax amortisation benefits to the extent that they increase the amount that market participants would pay in an orderly transaction for an asset if acquired separately. This applies even if the actual acquirer does not expect to receive those benefits. However, fair value should not take account of synergies, tax amortisation benefits or other factors that are unique to the specific acquirer or transaction.

Discussion
Fair value
The definition of fair value in IFRS 13 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". In a business combination, the acquirer shall measure the identifiable assets acquired and the liabilities assumed at their acquisition-date fair values (IFRS 3.18) with limited exceptions specified in IFRS 3.22-31. In general, goodwill is recognised as the excess of (a) the aggregate of the consideration transferred measured at acquisition-date fair value, and if applicable the amount of any non-controlling interest measured in accordance with IFRS 3 and fair value of acquirer's previously held equity interest in the acquiree; over (b) the net acquisition-date amounts of identifiable assets acquired and the liabilities assumed measured under IFRS 3 (IFRS 3.32).

Fair value for items traded in an active market should be determined as the quoted price in that market (IFRS 13.69). If fair value is based on quoted prices, there is no need to consider synergies or tax amortisation benefits separately. The quoted prices already factor in such matters.
When quoted prices are not available, a valuation model (estimation technique) should be used. Valuation techniques are usually necessary for intangible assets such as customer relationships and trademarks, since these tend to be unique.

In applying an estimation technique, it is necessary to consider the following matters, which follow from the definition of fair value:

- fair value of an asset is determined based on the price that would be received to sell the asset
- the definition of fair value emphasises that fair value is a market-based measurement, not an entity-specific measurement. When measuring fair value, an entity uses the assumptions that market participants would use when pricing the asset under current market conditions, including assumptions about risk. Therefore, factors unique to the specific acquirer, or the manner in which the business combination is structured, do not alter the fair value.

Application to synergies

'Synergies' is a term widely used to describe expected benefits from combining an acquired group of assets or a business with an existing business. These include (for example):

- additional revenues from marketing the acquirer's products and services to the acquiree's customers (cross-selling)
- cost savings and economies of scale from integration of operating facilities
- defensive synergies, such as preventing a competitor from gaining a dominant market share.

Synergies are not themselves identifiable assets. Similarly, the price paid in a business combination might reflect benefits such as access to new markets or improved purchasing power that are not identifiable assets. Any purchase price attributable to such factors will form part of goodwill - see below.
However, the availability of synergies might nonetheless affect the fair value of an asset. This is the case if those synergies are:

- intrinsic to the asset; and
- available to market participants (eg other potential buyers).

For example, businesses normally have customer relationships whose value to the business reflects the cash flows generated from those customers. However, the value of the relationships to potential buyers might also reflect incremental cash flows from marketing the buyers' products to the expanded customer base. Although each potential buyer might expect different cross-selling benefits, an expectation of some benefits is likely to be common to a number of buyers and will therefore affect the price that would be received to sell the asset (ie the fair value).

Other synergies might be unique to one buyer. Also, one buyer might be in a position to achieve far greater synergies than others. IFRS 13 requires an entity to measure the fair value of an asset or a liability using the assumptions that market participants would use when pricing the asset or liability, assuming that market participants act in their economic best interests (IFRS 13.22). Therefore, unique synergies and synergies in excess of amounts available to other buyers do not affect fair value. For example, an entity operating in the financial services industry might acquire a fund management business in order to fill a perceived gap in its product range. If all other market participants already offer this service, those participants would probably be unwilling to pay an incremental amount for cross-selling synergy benefits. Alternatively, the strategy of expanding the service offering to include fund management might be unique to the specific buyer.

In practice, this is a difficult area in which considerable judgement may be required. Management will often require input from valuation specialists. In evaluating the work of specialists, it is recommended that audit teams consider the approach adopted for synergy benefits and evaluate its appropriateness in the specific circumstances of the transaction.

Application to tax amortisation benefits

Tax amortisation benefits are tax deductions allowed by tax authorities for the use or sale of an asset. They are commonly based on the cost of the asset.

In many jurisdictions, taxable profits (including deductions) are based on the individual financial statements or tax filing of the individual entity. In business combination accounting, assets are frequently recognised that are not recorded in the acquiree’s individual financial statements. This is especially the case for intangible assets that were internally generated by the acquiree (eg customer relationships, trademarks and patented technology).

In this situation, the acquiree may not obtain any tax amortisation benefit from the asset. However, in estimating fair value, it is necessary to consider:

- whether market participants could realise a tax benefit if acquiring the asset separately; and
- how this might affect the price that would be received to sell the asset.

A tax amortization benefit should not be included in the fair value if (unusually) it is available only to one buyer. Tax benefits should also be excluded if they would not be available to any buyer (because, for example, the tax authority would not permit any tax deduction even if the asset was acquired separately).

In some cases, the availability of a tax benefit is dependant on the tax jurisdiction of the buyer. The fair value of an asset should not be affected by the jurisdiction of the specific buyer. Rather, the fair value should be determined based on the tax laws of the jurisdiction of the market participants identified for the asset in question.
Goodwill

In addressing these issues, it is also useful to consider whether the total amount paid in a business combination is represented by identifiable assets and liabilities, or is part of goodwill. IFRS 3.BC.316 states that goodwill relates to the acquiree and the acquirer jointly and reflects the excess assembled value that is created by the combination - the synergies that are expected from combining those businesses.

IFRS 3.BC.316 further identifies the components (components 3 and 4 described in IFRS 3.BC.313) of core goodwill, as follows:

- "The fair value of the going concern element of the acquiree's existing business. The going concern element represents the ability of the established business to earn a higher rate of return on an assembled collection of net assets than would be expected if those net assets had to be acquired separately. That value stems from the synergies of the net assets of the business, as well as from other benefits (such as factors related to market imperfections, including the ability to earn monopoly profits and barriers to market entry - either legal or because of transaction costs - by potential competitors).
- The fair value of the expected synergies and other benefits from combining the acquirer's and acquiree's net assets and businesses. Those synergies and other benefits are unique to each business combination, and different combinations would produce different synergies and, hence, different values."

Network effects and unique synergies are properly part of goodwill. However, if expected synergies would increase the amount willing buyers in general would pay for an asset, they represent part of the fair value of the asset.

Examples

Note: in each of the examples below, it is assumed that fair value is estimated using a discounted cash flow technique.

Example 1 - synergies and customer relationships

Entity A, a venture capital company, acquires Entity B, a professional services entity. Entity B has contractual and non-contractual customer relationships that meet the criteria for separate recognition (ie they are either separable and/or arise from contractual or legal rights and fair value is reliably measurable - IFRS 3.B31-B34). Entity A has no existing business in this sector and will not therefore realise any synergy benefits from the acquired relationships (such as the ability to market its own products and services to those customers). However, it was apparent during the bidding process that a number of other possible buyers are trade buyers (ie entities operating in the professional services industry). These other possible buyers are identified as the market participants for IFRS 13 purposes.

Analysis

The value to Entity A of Entity B's customer relationships relates to the expected cash flows to be generated by selling Entity B's services to those customers. Entity A is not in a position to 'cross-sell' its own services. However, it is apparent that there are other willing buyers, some of whom would be in a position to realise cross-selling benefits. In estimating the fair value of the acquired relationships, the estimated cash flows should include a 'normal' level of incremental cash flows to reflect this synergy, consistent with assumptions market participants would use to value those relationships.

Example 2 - access to new markets

Entity C, a consumer goods company in a developed economy, acquires Entity D, a distributor in an emerging market economy. Entity D has an established distribution network (including property, plant and equipment) as well as contractual and non-contractual customer relationships in its jurisdiction. Entity C's motivation for acquiring D is to gain access to the developing market. This strategy is considered unique to Entity C amongst its international competitors; the other potential purchasers of D are local businesses that already have access to the market and to D's customers. These other potential purchases are identified as the market participants for IFRS 13 purposes. The acquirer determines that the highest and best use for the tangible and intangible assets is their current use in combination with other assets.
Analysis
The fair value of the property, plant and equipment should be determined based on the fair value of the individual items (ie land, operating facilities such as warehouses, vehicles etc) but taking into account that their highest and best use is their current use in combination with other assets.

The cash flows used to estimate the fair value of D’s customer relationships should not be increased for the incremental cash flows arising from selling C’s products to D’s customers. Those benefits are unique to C and the other potential buyers already have relationships with the customers in question.

Example 3 - tax amortisation benefits and a trademark
Entity E acquires Entity F. Entity F’s trademark is identified as an asset that meets the IFRS 3 recognition criteria. Entity F has not recorded the trademark in its own financial statements, and neither entity expects to receive any future tax amortisation benefits from its use. However, had the trademark been acquired separately by the identified market participants, the purchase price would be allowed as a tax deduction on a straight-line basis over 5 years. Entity E estimates the fair value of the acquired trademark as CU100 excluding any tax benefit, using a discounted cash flow method.

The relevant tax rate is 30%, and a discount rate of 10% is applied in the valuation model.

Analysis
The fair value of the trademark should take account of the tax benefits that would be realised if the asset was purchased separately by market participants. Hence the fair value exceeds CU100. E’s estimate of CU100 can be used as a starting point if (apart from the tax effects) the underlying assumptions are market-consistent. This amount is then 'grossed-up' as follows:

Fair value = 100 + (present value of 20% annual tax allowances based on fair value, using a tax rate of 30% and discounted at 10%)

(This results in a fair value estimate of CU129, since the present value of five payments of 30% of (CU129/5), discounted at 10% is CU29. The calculation can be performed using Excel's 'goal seek' function).
HT 2006-20 Inventory discounts and rebates

Relevant IFRS
IAS 2 Inventories
IAS 18 Revenue

Issue
Accounting by the purchaser for discounts and rebates on inventory purchases.

Guidance

Project update
The IASB and FASB (the Boards) have been working together on a joint project to clarify the principles for recognising revenue and to develop a converged revenue standard. A revised exposure draft was published in November 2011. Consistent with the prior proposal, the guidance in the revised exposure draft would replace the current multiple sources of guidance on revenue with a single model; however, the earlier proposals had been amended to reduce disruption to established practices (eg the revised exposure draft includes additional “practical expedients” intended to simplify application in several areas). A final standard is now predicted in the first half of 2013. The areas that may be most affected include multiple-element arrangements, revenue subject to variable (eg performance-based) payments, contracts with significant financing and contract costs.

Trade discounts should be deducted from the cost of inventories (IAS 2.11).

Settlement discounts (ie discounts for prompt payment) should also be deducted from the cost of inventories, such that the inventory and related liability are initially recorded at the net (lower) amount. If the purchaser does not take advantage of the discount, the additional amount paid should be recorded as a finance charge.

Contractual rebates that are related to inventory purchases (eg retrospective, volume-based rebates) should be recognised once receipt is probable. Once recognised, the rebate should be recorded as a reduction to the cost of the related inventory. To the extent that the inventories have already been sold (or used in production that has been sold) that part of the rebate is recorded in the income statement (as a reduction of cost of sales in a presentation of expenses by function). The rebate is recognised to the extent that the related volume target has been met.

Other rebates that do not in substance relate to inventory purchases (eg contributions to promotional costs) should not be deducted from the cost of inventories. There are many types of rebate arrangements, and the appropriate accounting treatment will depend on the specific arrangement. Rebates received in exchange for services rendered in the course of the entity’s ordinary activities are within the scope of IAS 18 (IAS 18.1 and 7). Certain other rebates give rise to ‘other income’ rather than revenue. In those cases, the principles of IAS 18 are useful guidance in developing an accounting policy. It is not generally appropriate to offset income from rebates against promotional costs (IAS 1.32 and 1.33).

Discussion
IAS 2.11 requires that ‘trade discounts, rebates and other similar items are deducted in determining the cost of purchase’. The treatment of trade discounts is therefore clear. The IFRIC has considered the application of this requirement to settlement discounts and other rebates. In November 2004, the IFRIC concluded that:

- settlement discounts received should be deducted from the cost of inventories
- rebates that specifically and genuinely refund selling expenses should not be deducted from the costs of inventories

The IFRIC’s comments on settlement discounts could also be read as permitting initial recognition of inventories at the gross amount, and then recording the discount as a reduction in cost if received. However, we consider that the approach set out in the guidance section is more appropriate, because:

- a settlement discount is effectively a financing arrangement and should be accounted for accordingly; and
the amount recorded for the related liability on initial recognition should be its fair value, which should not exceed the amount that would be paid to settle the liability at that date.

The IFRIC did not express a view on when volume-based rebates should be recognised. We consider that it is appropriate for the purchaser to recognise such rebates when they are probable. In other words, when the 'cost' for IAS 2 purposes is subject to uncertainties, the most likely cost should be used. Hence, once a reduction in cost is probable (ie more likely than not) it should be taken into account. Any adjustment should be reversed if circumstances change such that the rebate becomes less than probable. Since the accounting is driven by the best estimate of unit cost, the rebate should be recognised only to the extent of the units purchased.

It is also common in some industries for 'rebates' to be paid by suppliers that are not related to inventory purchases. For example, in the retail industry suppliers often pay the retailer to promote the supplier's products. These arrangements should be analysed carefully, as they are sometimes referred to as promotional rebates but payments are determined by reference to purchases. Arrangements that are genuinely unrelated to inventory purchases are outside the scope of IAS 2. We consider that the principles of IAS 18 provide the most appropriate guidance on when to recognise income in these cases. However, judgement may be required to determine whether the amounts receivable are revenue or other income. As mentioned above, certain rebates may give rise to ‘other income’ rather than revenue. For example, a supplier may agree to reimburse a retailer for certain promotional costs. In these circumstances, the appropriate presentation will also require management judgement. Should the entity be able to demonstrate that the income from rebates relates to specific and actual costs incurred by the retailer (and therefore offsetting reflects the substance of the transaction in accordance with IAS 1.33) it may be appropriate to offset in profit or loss the income against the directly related costs that have been incurred by the entity.

This Hot Topic does not address accounting by the supplier for discounts and rebates allowed. IAS 18 specifies that the amount of revenue recognised should take account of those factors (IAS 18.10).

**Examples**

**Example 1- settlement discount**

Purchaser P buys inventory from supplier S on 1 Jan 20X1. The price is CU1,000 with a 2.5% discount for settlement within 30 days. P decides not to take advantage of the discount, and settles at CU1,000 on 28 Feb 20X1.

**Analysis**

P records the inventory net of the discount entitlement. The ultimate payment of the discount is recorded as a finance cost. The respective entries are as follows:

<table>
<thead>
<tr>
<th>1 Jan 20X1 - initial recognition</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>CU700</td>
<td>CU700</td>
</tr>
<tr>
<td>Current liability</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Period 1 Jan 20X1 - 28 Feb 20X1 - accrue finance cost and record settlement</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Finance cost</td>
<td>CU25</td>
<td>CU25</td>
</tr>
<tr>
<td>Current liability</td>
<td>CU75</td>
<td></td>
</tr>
<tr>
<td>Current liability</td>
<td>CU1,000</td>
<td>CU1,000</td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Note:** In principle, the finance charge should be accrued evenly over the period of the liability, based on estimated cash flows.
Example 2- volume rebate

Purchaser P buys inventory from supplier S at a basic unit price of CU10 per unit, fixed for the year 20X1. S agrees that if P makes total purchases of at least 10,000 in 20X1, it will pay a rebate of CU5,000 (maximum). At the beginning of the year P's forecast purchases are 8,000 units for the year. However, at 30 June 20X1 P revises its forecast to 11,000 units.

At 30 June 20X1 P has purchased 5,200 units, of which 3,900 have been used/sold. The remaining 1,300 are held in inventory at a cost of CU13,000.

Analysis

At 30 June 20X1, the adjustment to inventory cost has become probable. The revised best estimate of cost per unit for the first 10,000 units is:

\[
\frac{\text{CU10 \times 10,000 units } - \text{ CU5,000}}{10,000 \text{ units }} = \text{ CU9.50}
\]

(Nota - this calculation is made based only on the first 10,000 units because any purchases in excess of that figure do not attract any further rebate.)

The cost of the 5,200 units purchased at 30 June 20X1 should therefore be adjusted downwards by CU0.5/unit. Because 75% of the units have been sold, a proportion of the rebate recognised should be recorded in the income statement (cost of sales). The respective entries are as follows:

<table>
<thead>
<tr>
<th>30 June 20X1 - record probable rebate</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prepayment (rebate receivable)</td>
<td>CU2,600</td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td></td>
<td>CU650</td>
</tr>
<tr>
<td>Cost of sales</td>
<td></td>
<td>CU1,950</td>
</tr>
</tbody>
</table>

Note: subsequent inventory purchases up to the first 10,000 units are recorded at CU9.5/unit as long as the rebate continues to be probable. Once the 10,000 threshold is exceeded the cost per unit reverts to CU10.
HT 2006-21 Common control business combinations

Relevant IFRS
- IFRS 3 Business Combinations
- IFRS 10 Consolidated Financial Statements

Issue
How should a business combination involving entities under common control be accounted for?

Guidance
Business combinations involving entities under common control are outside the scope of IFRS 3 (IFRS 3.2(c)), and there is no other specific IFRS guidance. Accordingly, management should use its judgement to develop an accounting policy that is relevant and reliable, in accordance with IAS 8.10 - 12. In our view, the most relevant and reliable accounting policies are:

- a predecessor value method (including a pooling of interests-type method and merger accounting); or
- the acquisition method in accordance with IFRS 3.

Background
The IASB added a project to its agenda in December 2007 for ‘Common control transactions’ but no deliberations have occurred to date as the project was placed on hold pending the reprioritisation of work by the IASB.

The IFRIC has considered numerous issues related to common control transactions, but has often declined to add these matters to its agenda in favour of referring the issues to the IASB for consideration.

Finally, the EFRAG issued a Discussion Paper Accounting for Business Combinations Under Common Control in October 2011. Acknowledging that diversity exists in practice when accounting for business combinations under common control, the paper identifies three different views and aims to stimulate discussion and debate on the topic.

At this time, no further authoritative guidance has been issued to clarify the issue at hand and therefore we have not altered the positions taken in this Hot Topic.

Predecessor value method
Under a predecessor value method, the acquirer accounts for the combination as follows:

- the assets and liabilities of the acquiree are recorded at book value, not fair value (although adjustments should be recorded to achieve uniform accounting policies)
- intangible assets and contingent liabilities are recognised only to the extent that they were recognised by the acquiree in accordance with applicable IFRS (in particular, IAS 38)
- no goodwill is recorded. The difference between the acquirer’s cost of investment and the acquiree’s equity is presented as a separate reserve within equity on consolidation
- any non-controlling interest is measured as a proportionate share of the book values of the related assets and liabilities (as adjusted to achieve uniform accounting policies)
- any expenses of the combination are written off immediately in the income statement
- comparative amounts are restated as if the combination had taken place at the beginning of the earliest comparative period presented.

Some commentators also consider that:

- the comparative periods should also be restated only to the later of the beginning of the earliest comparative period and the date on which the combining entities first came under common control or
- the comparatives should not be restated and the results of the acquiree are recognised only from the date of the combination and
• the acquiree's book values to be used in the consolidation are those from the perspective of the controlling party rather than the amounts in the acquiree's separate financial statements.

These are variations on the basic approach. We consider them to be acceptable but not mandatory.

**Acquisition method in accordance with IFRS 3**

Although common control combinations are outside the scope of IFRS 3, we consider IFRS 3’s principles can be applied by analogy. If an entity adopts this policy, IFRS 3’s principles should be applied in full. This includes identification of the correct acquirer. As a general indication, if one of the pre-combination entities has significantly greater net assets or revenues than the other, the larger entity is probably the acquirer for IFRS 3 purposes. In a common control combination, the acquirer for IFRS 3 purposes is often **not** the legal acquirer.

When the IFRS acquirer is not the legal acquirer, the principles of reverse acquisition accounting should be applied - see IFRS 3.B19-B27 and IFRS 3.IE1-IE15. When the legal acquirer is a new entity, 'shell' or near-dormant entity, and the other combining entity is the IFRS 3 acquirer, the effect of reverse acquisition accounting is very similar to a pooling-type method.

This Hot Topic does not discuss the requirements of IFRS 3 in detail.

**Discussion**

**Common control combinations**

A business combination is a 'common control combination' if:

• the combining entities are ultimately controlled by the same party (or parties - see below) both before and after the combination **and**

• common control is not transitory (IFRS 3.B1) - see below.

Common control combinations are widespread. Examples include:

• combinations between subsidiaries of the same parent
• the acquisition of a business from an entity in the same group
• some transactions involving the insertion of a new parent company at the top of a group. (Some commentators would not regard a transaction in which a new parent company is added by means of a 'shell' company issuing shares to the existing shareholders as a business combination at all. This is because there is no substantive change in the reporting entity or its assets and liabilities. Under this view, the purchase method is inappropriate because, in substance, there is no purchase).

IFRS 3.B1 specifies that to qualify as a common control transaction, common control is not transitory. This means that the same party should have the ultimate control over the combining entities both before and after the business combination. Judgement is required to assess whether the common control is transitory or not. The conclusion that common control is transitory may lead to the inclusion of the business combination in the scope of IFRS 3 so that it may be accounted for using the acquisition method rather than an alternative method. For example, an acquirer and vendor might structure a transaction such that for a brief period before and after the combination, the entity to be acquired/sold is under common control. This transaction would fall within the scope of IFRS 3, because common control is transitory. However, common control should not be considered transitory simply because a combination is carried out in contemplation of an initial public offering or sale of the combining entities.

Common control combinations are not restricted to combinations between entities that are part of the same group. Entities controlled by the same individual shareholder (or group of shareholders acting together in accordance with a contractual arrangement) are also regarded as under common control (IFRS 3.B3).
Predecessor value method
Some form of predecessor value method is widely accepted in accounting for common control combinations under IFRS. A carryover basis method (using historical cost from a parent entity perspective, where applicable) is prescribed under US GAAP. Merger accounting is permitted under UK GAAP. We consider that these approaches are therefore available through application of IAS 8.12. This allows management to consider the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework in developing an accounting policy (where IFRS has no specific requirements).

Under a predecessor value method, the comparative periods are commonly restated as if the combination had taken place at the beginning of the earliest comparative period presented. However, alternative methods are seen in practice (see guidance section above).

Acquisition method in accordance with IFRS 3
Accounting using the acquisition method has some important differences compared to a pooling of interests-type approach. Features of the IFRS 3 purchase method include:

- identification of an acquirer
- determination of the acquisition date
- recognition and measurement of the identifiable assets (including intangible assets that are either separable and/or arise from contractual or legal rights and fair value is reliably measurable) acquired and the liabilities assumed at the acquisition-date fair value (with few exceptions)
- any non-controlling interest in the acquiree is measured either at fair value or at the non-controlling interest's proportionate share of the acquiree's identifiable assets
- recognition as of the acquisition date of the fair value of 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
- recognition and measurement of goodwill or a gain from a bargain purchase, measured as the difference between the consideration transferred and the net acquisition-date amounts of identifiable assets acquired and liabilities assumed (and value of non-controlling interest, if applicable)
- no restatement of comparatives.

In any business combination it is important to identify an acquirer for accounting purposes in order to determine which entity prepares consolidated financial statements for the combined group and so accounts for the business combination in those financial statements (IFRS 3.6-7, IFRS 3.B13-18).

In common control transactions, the 'accounting acquirer' is often not the 'legal acquirer'. Determination of the correct acquirer involves identifying the entity that has, in substance, obtained control of the acquiree (IFRS 3.7).

Project update
In May 2011 the IASB issued three new standards (IFRS 10 Consolidated Financial Statements, IFRS 11 Joint Arrangements, and IFRS 12 Disclosures of Interests in Other Entities) and amended two (IAS 27 Separate Financial Statements and IAS 28 Investments in Associates and Joint Ventures) – sometimes referred to as the consolidation package. IFRS 10 redefines ‘control’ and provides extensive new guidance on applying the revised definition. The new model applies to both traditional entities and to special purpose entities (replacing IAS 27 and SIC-12 Consolidation – Special Purpose Entities). The guidance in IFRS 10 applies only to consolidated financial statements. The requirements for separate financial statements are unchanged and remain in IAS 27. The new guidance is effective for annual periods beginning on or after 1 January 2013.

IFRS 3 refers to the guidance in IFRS 10 in determining control.

IFRS 10 states that an investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee (IFRS 10.6). Thus, an investor controls an investee if and only if the investor has all the following:
In addition, if after applying the guidance above, it is still not clear which of the combining entities is the acquirer, IFRS 3.B14-B18 provides factors that should be considered in making such determination. In an arm's length situation where equity interests are exchanged, the factors that will assist in identifying the acquirer include:

- the acquirer is usually the combining entity whose owners as a group retain or receive the largest portion of voting rights in the combined entity (IFRS 3.B15(a))
- if there is a large minority voting interest in the combined entity and 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 (IFRS 3.B15(b))
- 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 (IFRS 3.B15(c))
- the acquirer is usually the combining entity whose former management dominates the management of the combined entity (IFRS 3.B15(d)) and
- 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 (IFRS 3.B15(e)).

The above factors may not be generally relevant in a common control situation (since the same party controls the combining entities both before and after). Hence other indicators should be used, including:

- the relative sizes of the combining entities
- the combining entity who initiated the combination, together with the relative size of the combining entities.

IFRS 3 is also explicit in stating that a new entity formed to effect a business combination is not necessarily the acquirer. In this situation, one of the combining entities that existed before the business combination shall be identified as the acquirer by applying the guidance in IFRS 3.B13-B17 (IFRS 3.B18). In our view, any newly formed (or previously dormant) entity used to effect a combination is unlikely to be the acquirer. A new ultimate parent entity added to an existing group is therefore unlikely to be the IFRS 3 acquirer. The effect of identifying the new ultimate parent entity as the acquirer would be to ‘step-up’ the reported values of the assets and liabilities of the existing group, including recognition of internally generated goodwill and other intangibles. This is inconsistent with the requirements of IAS 38.

**Example**
The following example illustrates the application of a predecessor value method.

Entity P has three subsidiaries, Entities X, Y and A. Entity P acquired 100% of Entity X for CU18,000 many years ago. Entity's X's accumulated profits at that time were CU5,000. Entity P recorded goodwill of CU3,000 and fair value of identifiable assets acquired of CU15,000. The goodwill continues to be carried at CU3,000.

Entity P formed Entity Y with another investor, Shareholder S, also many years ago. Entity P's cost of investment in Entity Y was CU15,000, being 75% of Y's share capital.

On 1 Jan 20X0, Entity P formed Entity A with a share capital subscription of CU10,000.

On 31 Dec 20X1, Entity A acquired Entity P's and Shareholder S's shareholdings in X and Y. The consideration was 7,000 and 3,000 of Entity A's shares with issue value of CU1 each to Entity P and Shareholder S, respectively. Entity X and Entity Y have financial year ends of 31 December.
The 'before' and 'after' structures are:

![Diagram showing the before and after structures of entities A, X, and Y.]

The income statements of Entities A, X and Y for the year ended 31 Dec 20X1 are:

<table>
<thead>
<tr>
<th></th>
<th>Entity A</th>
<th>Entity X</th>
<th>Entity Y</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>2,000 CU</td>
<td>40,000 CU</td>
<td>50,000 CU</td>
</tr>
<tr>
<td>Profit (loss)</td>
<td>(4,000)</td>
<td>20,000 CU</td>
<td>20,000 CU</td>
</tr>
</tbody>
</table>

The statements of financial position of Entities A, X and Y at 31 Dec 20X1 are:

<table>
<thead>
<tr>
<th></th>
<th>Entity A (before issue of shares)</th>
<th>Entity A (after issue of shares*)</th>
<th>Entity X</th>
<th>Entity Y</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in subsidiaries</td>
<td>-</td>
<td>223,000</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Other assets</td>
<td>5,000</td>
<td>5,000</td>
<td>100,000</td>
<td>120,000</td>
</tr>
<tr>
<td>Net assets</td>
<td>5,000</td>
<td>228,000</td>
<td>100,000</td>
<td>120,000</td>
</tr>
<tr>
<td>Capital (including share premium)</td>
<td>10,000</td>
<td>233,000</td>
<td>10,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Accumulated profits (losses)</td>
<td>(5,000)</td>
<td>(5,000)</td>
<td>90,000</td>
<td>100,000</td>
</tr>
<tr>
<td></td>
<td>5,000</td>
<td>228,000</td>
<td>100,000</td>
<td>120,000</td>
</tr>
</tbody>
</table>

*The 10,000 new shares issued by Entity A as consideration are recorded at a value equal to the deemed cost of acquiring Entity X and Entity Y (CU223,000). The deemed cost of acquiring Entity X is CU103,000, being the existing book values of net assets of Entity X as at 31 Dec 20X1 (CU100,000) plus remaining goodwill arising on the acquisition of Entity X by Entity P (CU3,000). The deemed cost of acquiring Entity Y is CU120,000, being the existing book values of net assets of Entity Y as at 31 Dec 20X1.

The income statements of Entities A, X and Y for the year ended 31 Dec 20X0 are:

<table>
<thead>
<tr>
<th></th>
<th>Entity A</th>
<th>Entity X</th>
<th>Entity Y</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>1,000 CU</td>
<td>38,000 CU</td>
<td>45,000 CU</td>
</tr>
<tr>
<td>Profit (loss)</td>
<td>(2,000)</td>
<td>15,000</td>
<td>12,000</td>
</tr>
</tbody>
</table>

The statements of financial position of Entities A, X and Y at 31 Dec 20X0 are:
## Analysis

As Entity A, Entity X and Entity Y are under the common control of Entity P before and after the business combination, the business combination is scoped out of IFRS 3. Entity A's accounting policy for common control business combinations is to apply a pooling-of-interests type method. In applying this method, A also adopts a 'controlling party perspective'. The assets and liabilities of X and Y are therefore consolidated in the financial statements of A using the book values as stated in the consolidated financial statements of Entity P. This requires recognition of the remaining goodwill on the original acquisition of Entity X by Entity P and non-controlling interests in Entity Y, as stated in the consolidated financial statements of Entity P. There is no recognition of any additional goodwill. (If A does not adopt a controlling party perspective, the remaining goodwill on the original acquisition of X by P would not be recognised by A.)

The consolidated income statement of Entity A for the year ended 31 Dec 20X1 is:

<table>
<thead>
<tr>
<th></th>
<th>Entity A CU</th>
<th>Entity X CU</th>
<th>Entity Y CU</th>
<th>Adjustments CU Adj</th>
<th>Consolidated CU</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>2,000</td>
<td>40,000</td>
<td>50,000</td>
<td>92,000</td>
<td></td>
</tr>
<tr>
<td>Profit (loss)</td>
<td>(4,000)</td>
<td>20,000</td>
<td>20,000</td>
<td>36,000</td>
<td></td>
</tr>
<tr>
<td>Attributable to the former NCI in Y</td>
<td>5,000 (Y1)</td>
<td></td>
<td></td>
<td>(5,000)</td>
<td></td>
</tr>
<tr>
<td>Attributable to the equity holders of A</td>
<td></td>
<td></td>
<td></td>
<td>31,000</td>
<td></td>
</tr>
</tbody>
</table>

**Adjustment**

(Y1) Adjustment to reflect the profit attributable to the non-controlling interest (NCI) in Entity Y prior to the combination.

The consolidated statement of financial position of Entity A as at 31 Dec 20X1 is:
IFRS Hot Topic 2006-21

| Goodwill | 3,000 (X1) | 3,000 |
| Investments in X and Y | (103,000) (X3) | |
| Other assets | (120,000) (Y5) | |
| **Net assets** | 228,000 | 100,000 | 120,000 | 228,000 |
| Capital (include share premium) | (10,000) (X3) | (20,000) (Y5) | 233,000 |
| Other reserve | (85,000) (X3) | (75,000) (Y5) | (160,000) |
| Accumulated profits (losses) | (5,000) (X2) | (25,000) (Y4) | 155,000 |

<p>| Entity A | Entity X | Entity Y | Adjustments | Consolidated |</p>
<table>
<thead>
<tr>
<th>CU</th>
<th>CU</th>
<th>CU</th>
<th>CU Adj</th>
<th>CU</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue</strong></td>
<td>1,000</td>
<td>38,000</td>
<td>45,000</td>
<td>84,000</td>
</tr>
<tr>
<td><strong>Profit (loss)</strong></td>
<td>(2,000)</td>
<td>15,000</td>
<td>12,000</td>
<td>25,000</td>
</tr>
<tr>
<td>Attributable to the former NCI</td>
<td></td>
<td></td>
<td>3,000 (Y1)</td>
<td>(3,000)</td>
</tr>
<tr>
<td>Attributable to the equity holders of A</td>
<td></td>
<td></td>
<td></td>
<td>22,000</td>
</tr>
</tbody>
</table>

**Adjustments**

**Relating to Entity X:**

(X1) Adjustment to record goodwill arising on the original acquisition of Entity X by Entity P as stated in the consolidated financial statements of Entity P immediately prior to the combination (CU3,000).

(X2) Adjustment to eliminate the accumulated profits of Entity X prior to the original acquisition of Entity X by Entity P (CU5,000).

(X3) Adjustment to eliminate the share capital of Entity X against the related investment cost of Entity A. An adjustment of CU85,000 is made to a separate reserve in the consolidated financial statements of Entity A.

**Relating to Entity Y:**

(Y4) Adjustment to reflect the profits attributable to the non-controlling interest in Entity Y prior to the combination.

(Y5) Adjustment to eliminate the share capital of Entity Y against the related investment cost of Entity A. An adjustment of CU75,000 is made to a separate reserve in the consolidated financial statements of Entity A.

The consolidated income statement of Entity A for the year ended 31 Dec 20X0 is:

(Y1) Adjustment to reflect the profit attributable to the non-controlling interest in Entity Y.
The consolidated statement of financial position of Entity A as at 31 Dec 20X0 is:

<table>
<thead>
<tr>
<th></th>
<th>Entity A</th>
<th>Entity X</th>
<th>Entity Y</th>
<th>Adjustments</th>
<th>Consolidated</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>CU</td>
<td>CU</td>
<td>CU</td>
<td>CU Adj</td>
<td>CU</td>
</tr>
<tr>
<td>Goodwill</td>
<td></td>
<td></td>
<td></td>
<td>3,000 (X1)</td>
<td>3,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(193,000) (1)</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(103,000)</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(X3)</td>
<td></td>
</tr>
<tr>
<td>Investments in X and Y</td>
<td></td>
<td></td>
<td></td>
<td>(90,000)</td>
<td></td>
</tr>
<tr>
<td>Other assets</td>
<td>9,000</td>
<td>80,000</td>
<td>100,000</td>
<td></td>
<td>189,000</td>
</tr>
<tr>
<td>Net assets</td>
<td><strong>9,000</strong></td>
<td><strong>80,000</strong></td>
<td><strong>100,000</strong></td>
<td></td>
<td><strong>192,000</strong></td>
</tr>
<tr>
<td>Capital (including share premium)</td>
<td>10,000</td>
<td>10,000</td>
<td>20,000</td>
<td>193,000 (1)</td>
<td>203,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(10,000)</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(X3)</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(20,000)</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(Y4)</td>
<td></td>
</tr>
<tr>
<td>Other reserve</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td></td>
<td>(160,000)</td>
</tr>
<tr>
<td>Non-controlling interests</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>25,000 (Y4)</td>
<td>25,000</td>
</tr>
<tr>
<td>Accumulated profits (losses)</td>
<td>(1,000)</td>
<td>-</td>
<td>-</td>
<td>(5,000) (X2)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>70,000</td>
<td>80,000</td>
<td>(20,000)</td>
<td>(Y4)</td>
<td>124,000</td>
</tr>
<tr>
<td></td>
<td><strong>9,000</strong></td>
<td><strong>80,000</strong></td>
<td><strong>100,000</strong></td>
<td></td>
<td><strong>192,000</strong></td>
</tr>
</tbody>
</table>

**Note:** The comparative figures are restated as if the entities had been combined at the previous reporting date. The consolidated share capital represents the share capital of Entity A adjusted for the share capital issued for the purposes of the business combination.

**Adjustments:**

1. Adjustment to push back the capital issued for the purposes of the business combination (CU193,000 of which CU103,000 relates to X and CU90,000 to Y). The aim of the consolidated financial statements in a pooling-type method is to show the combining entities' results and financial positions as if they had always been combined. Consequently, the 7,000 shares issued for the purposes of the business combination are presented as if they had always been in issue.

Relating to Entity X:

(X1) Adjustment to record remaining goodwill that arose on the original acquisition of Entity X by Entity P (as stated in the consolidated financial statements of Entity P immediately prior to the combination (CU3,000)).

(X2) Adjustment to eliminate the accumulated profits of Entity X earned prior to the original acquisition of Entity X by Entity P (CU5,000).

(X3) Adjustment to eliminate the share capital of Entity X against the related cost of investment in Entity A. An adjustment of CU85,000 is made to a separate reserve in the consolidated financial statements of Entity A.
Relating to Entity Y:

(Y4) Adjustment to eliminate the share capital of Entity Y against the cost of investment in Entity A. Prior to the business combination, Entity P had a 75% equity interest in Entity Y. Non-controlling interest of CU25,000 is therefore recognised as at 31.12.20X0. An adjustment of CU75,000 is made to a separate reserve (within equity).
HT 2006-22  Construction contracts with costs or revenues in more than one currency

Relevant IFRS
IAS 11 Construction Contracts
IAS 21 The Effects of Changes in Foreign Exchange Rates
IAS 39 Financial Instruments: Recognition and Measurement

Issue
If a construction contract has costs or revenues denominated in more than one currency, what exchange rate(s) should be used in estimating total contract costs and/or revenues?

Guidance

Note - A construction contract with costs or revenues denominated in more than one currency should first be assessed for embedded derivatives. Any embedded derivatives might need to be separated from the contract. Guidance on making this assessment is set out in Hot Topic 2006-16 Contracts for purchase or sale of non-financial items denominated in foreign currency. The remainder of this Hot Topic is prepared on the basis that there are no embedded derivatives requiring separation.

For the purposes of estimating total contract costs and revenues, future costs and revenues denominated in foreign currencies should be translated into the contractor's functional currency using the applicable spot rate(s). It is also acceptable to use the applicable forward market rate(s). Costs and revenues previously incurred or recognised should be translated at the actual exchange rates at the dates the transactions occurred (IAS 21.21). If estimated total costs exceed contract revenue, the expected loss should be recognised in accordance with IAS 11.36.

If the entity's policy is to estimate the stage of completion by reference to the proportion of costs incurred to total contract costs (see IAS 11.30(a)), foreign currency costs are translated using actual rates for costs incurred and spot rates for estimated future costs.

Although future exchange rate fluctuations may affect the final outcome of a contract, the estimated outcome should not be considered unreliable solely on the basis of uncertainty over future exchange rates.

Although some contractors use foreign currency derivatives to hedge their exposure to exchange rate risk, it is not appropriate to record contract costs/revenues at a hedged rate, or to use the hedged rate to estimate future costs/revenues.

Discussion
IAS 11 specifies the accounting for construction contracts in the financial statements of contractors. For 'in progress' fixed price contracts, contract revenues and costs are recognised according to the stage of completion when the outcome of the contract can be estimated reliably and the other criteria are met (IAS 11.22). Determination of the appropriate amount of contract revenue, costs and profit to recognise requires reliable estimation of:

- total contract revenue and costs (and therefore future revenue and costs); and
- the stage of completion of the contract.
Foreign currency costs and revenues are a source of uncertainty as to the final outcome of a contract. Future foreign currency costs and revenues need to be converted into the contractor's functional currency to estimate the contract outcome. Also, the stage of completion might be determined by reference to the proportion of costs incurred to date to total contract costs. If so, a single currency amount is required for costs to date and estimated future costs. (Other approaches to estimating the stage of completion include surveys of work performed, physical completion and labour hours incurred (IAS 11.30 and the Appendix to IAS 11)).

In our view, the translation of future revenues and cost into functional currency should be at the applicable spot (ie closing) exchange rate(s). Spot rates represent the market's view of the relative value of the currencies. Expectations about relevant future developments are taken into account by the market. The spot rate is therefore also the most reliable prediction of future rates. It is not appropriate to use management estimates of future exchange rates. We consider that it is acceptable to use appropriate forward market rates. However, forward market rates to the estimated dates of the expected cash flows might be difficult to find.

Because the spot rate is a market rate, it is also sufficiently reliable for the purpose of recognition of revenues and (if applicable) profits. In other words, if the foreign currency estimates of cost and revenue are considered reliable, the estimated outcome of a contract should not be considered unreliable because of exchange rate uncertainty.

The discussion above relates mainly to estimating future contract revenues, costs and stage of completion. These estimates are used to determine the contract revenues and costs to be recognised. To the extent that recognised revenue and costs are denominated in a foreign currency, they are converted into the contractor's functional currency in accordance with IAS 21. In particular:

- foreign currency revenues and costs should be converted at the spot rate at the date of each transaction. However, an average exchange rate over a longer period (such as a week or a month) can be used as a practical approximation if rates do not fluctuate significantly over that period (IAS 21.21 and 22); and
- foreign currency receivables and payables arising from the contract are monetary items and should be retranslated using the applicable spot rate at each reporting date (IAS 21.23(a)). For this purpose, we consider that gross amounts due and from customers for contract work (see IAS 11.42-44) are monetary items.

Some contractors use derivatives to hedge exchange rate risk. Derivatives should be accounted for in accordance with IAS 39 Financial Instruments: Recognition and Measurement. It is not appropriate to record contract costs/revenues at a hedged rate, or to use the hedged rate to estimate future costs/revenues. This is because the construction contract and any derivatives are separate contracts. They should therefore be accounted for separately in accordance with applicable IFRS. It may be possible to use hedge accounting in respect of the exchange risk in a construction contract, if the strict criteria in IAS 39.88 are met.

**Example**

Entity A, a euro functional currency entity, enters into a contract to construct a building 1 Jan X1. The contract value is euro 1,200,000. The contract costs will be incurred partly in euros and partly in US$. The US$ costs will be incurred with subcontractors whose functional currency is US$ (such that the embedded currency derivatives are regarded as closely-related and do not require separation - see Hot Topic 2006-16).

On 31 Dec X1, entity A's actual costs incurred and expected costs to complete are:

<table>
<thead>
<tr>
<th></th>
<th>Costs incurred</th>
<th>Estimate to completion</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Euro costs</td>
<td>250,000</td>
<td>175,000</td>
<td>425,000</td>
</tr>
<tr>
<td>US$ costs</td>
<td>300,000</td>
<td>190,000</td>
<td>490,000</td>
</tr>
</tbody>
</table>

Estimated total contract revenue is unchanged at Euro 1,200,000. These estimates are considered reliable, and the criteria in IAS 11.22 and 23 are all met.

Applicable exchange rates are:
Spot rate on 1 Jan X1: US$1 = euro 1.2
Spot rate on 31 Dec X1: US$1 = euro 1.4
Average rate for 20X1: US$1 = euro 1.3*

Analysis

The expected outcome of the contract and the stage of completion should be determined using spot Euro/US$ exchange rates for future costs. The calculation is as follows:

<table>
<thead>
<tr>
<th>Costs incurred</th>
<th>Estimate to complete</th>
<th>Total</th>
<th>Stage of completion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Euro costs (euros)</td>
<td>250,000</td>
<td>175,000</td>
<td>425,000</td>
</tr>
<tr>
<td>US$ costs (US$)</td>
<td>300,000</td>
<td>190,000</td>
<td>490,000</td>
</tr>
<tr>
<td>Exchange rate for US$ costs</td>
<td>1.3 (average*)</td>
<td>1.4 (spot)</td>
<td></td>
</tr>
<tr>
<td>US$ costs (euros)</td>
<td>390,000</td>
<td>266,000</td>
<td>656,000</td>
</tr>
<tr>
<td>Total costs (euros)</td>
<td>640,000</td>
<td>441,000</td>
<td>1,081,000</td>
</tr>
<tr>
<td>Total revenue</td>
<td>1,200,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Estimated profit</td>
<td>119,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* in this case, the average rate is considered a sufficiently accurate approximation to the actual rates when the costs were incurred.

On the basis of these estimates, the amount of revenue to be recorded is (59.2% x 1,200,000) = euro 710,453. Costs incurred to date are euro 640,000. This gives a contact profit to date of euro 70,453.

If none of the US$ costs have been paid at 31 Dec X1, the statement of financial position at that date will include a contract-related creditor (or accrual) of US$300,000. This needs to be re-translated at the spot rate of 1.4 (euro 420,000). This gives rise to an exchange difference (loss) of euro 30,000 when compared to the US$ costs recognised in the income statement (euro 390,000).

The respective entries are as follows:

<table>
<thead>
<tr>
<th>31 Dec X1 (euros)</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contact revenue</td>
<td></td>
<td>710,453</td>
</tr>
<tr>
<td>Contract costs</td>
<td>640,00</td>
<td></td>
</tr>
<tr>
<td>Gross amount due from customers for contract work</td>
<td>710,453</td>
<td></td>
</tr>
<tr>
<td>Creditors (accruals) (250,000 + 420,000)</td>
<td>670,000</td>
<td></td>
</tr>
<tr>
<td>Exchange loss (income statement)</td>
<td>30,000</td>
<td></td>
</tr>
</tbody>
</table>

Note: this assumes that no progress billings have been made or costs settled at the reporting date.
**HT 2006-23 Debt modifications**

**Issue**
Accounting for a modification to the terms of a financial liability, eg bank borrowings. The Hot Topic does not address 'debt for equity' swaps, the accounting for which is dealt with by IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments*, or amendments to the terms of a convertible instrument that are designed to induce early conversion, which are dealt with by IAS 32 *Financial Instruments: Disclosure and Presentation*.

**Guidance**

**Note:** it is assumed throughout this IFRS Hot Topic that the liabilities in question are not derivatives and have not been designated at fair value through profit or loss.

A modification to the terms of a financial liability should be accounted for as follows:

- a substantial modification should be accounted for as an extinguishment of the existing liability and the recognition of a new liability (IAS 39.40) (*extinguishment accounting*);
- a non-substantial modification should be accounted for as an adjustment to the existing liability (*modification accounting*).

A modification is always substantial if the present value of the cash flows under the new terms, including net fees paid or received, differs by 10% or more from the present value of the remaining cash flows of the existing liability. This calculation should be carried out using the original effective interest rate (EIR) (IAS 39.AG62).

In circumstances where the above quantitative analysis indicates a less than 10% cash flow change, consideration should still be given to whether there have been qualitative changes to the terms of the instrument that indicate there has been a substantial change.

**Project updates**
This Hot Topic reflects the requirements of IAS 39 *Financial Instruments: Recognition and Measurement* (IAS 39) and not those of IFRS 9 *Financial Instruments* (IFRS 9). IFRS 9 will eventually replace IAS 39 in its entirety. At this stage, IFRS 9 addresses the classification and measurement of financial assets and financial liabilities, along with derecognition. The requirements for financial liabilities and derecognition were carried forward unchanged (with the exception of some changes to the fair value option for financial liabilities to address the issue of own credit risk). On 28 November 2012, the Board issued an exposure draft proposing limited modifications to IFRS 9’s financial asset classification model to address application issues. IFRS 9 is effective for annual periods beginning on or after 1 January 2015 (early adoption permitted). Work continues on Phases 2 and 3 of the project, which address impairment and hedge accounting, respectively.

**Extinguishment accounting**
Extinguishment accounting is covered by IAS 39.40 and involves:

- de-recognition of the existing liability
- recognition of the new or modified liability at its *fair value*
- recognition of a gain or loss equal to the difference between the carrying value of the old liability and the fair value of the new one
- recognising any incremental costs or fees incurred, and any consideration paid or received, in profit or loss
- calculating a new EIR for the modified liability, which is then used in future periods.
The fair value of the modified liability will usually need to be estimated. It cannot be assumed that fair value equals the book value of the existing liability. Fair value can be estimated based on the expected future cash flows of the modified liability, discounted using the interest rate at which the entity could raise debt with similar terms and conditions in the market.

**Modification accounting**

The mechanics of modification accounting are not discussed in IAS 39 apart from a brief reference in IAS 39.AG62. In the absence of detailed guidance, our preferred approach is to apply modification guidance by:

- adjusting the carrying value of the existing liability for fees paid or costs incurred;
- amending the EIR at the modification date. The EIR is amended such that the adjusted carrying amount equals the present value of the revised estimate of future cash flows over the revised, estimated life of the liability (IAS 39.9).

No gain or loss is recorded on modification.

An alternative approach would be to recognise the difference in the present value of the liability arising from the modification of the instrument immediately in profit or loss on the basis of IAS 39.AG8. We do not favour this approach however, as recognising any net gain or loss immediately (the approach taken for extinguishment accounting) seems inconsistent with a conclusion that the instrument has not been substantially modified.

**Discussion**

Entities quite often modify the terms of loans by agreement with their creditors. This is sometimes referred to as debt restructuring. Debt restructuring can take various legal forms including:

- an amendment to the terms of a debt instrument (e.g., the amounts and timing of payments of interest and principal); or
- a notional repayment of existing debt with immediate re-lending of the same or a different amount.

The borrower will usually incur costs in a debt restructuring, and other fees might also be paid or received.

The accounting treatment of a debt restructuring depends on whether the modified terms (or new debt instrument) are "substantially different" to the previous terms (or debt instrument). IAS 39 determines whether the new or modified debt is substantially different based primarily on a "10% test". This test requires a calculation of whether the present value of the revised cash flows plus any costs/fees paid (less any fees received) differs by 10% or more from the present value of the remaining cash flows of the existing debt. IAS 39.AG62 requires this calculation to be performed using the original EIR. The EIR is a constant rate determined at inception of the original debt (unless the debt is floating rate debt - IAS 39.AG7).

If the 10% threshold is met or exceeded, IAS 39 requires the debt restructuring to be accounted for as a repurchase of the existing loan, and recognition of a new loan (this is sometimes referred to as extinguishment accounting). If the 10% threshold is not met or exceeded, consideration should still be given to any qualitative changes in the risk profile of the modified instrument that may indicate that the modification is substantial. For example, a change in the currency of denomination of debt might be regarded as a substantial change even if the effect at the modification date is less than 10%.

The main issue that arises with extinguishment accounting is the amount at which to record the new or modified loan. In our view the new or modified loan should be recorded at fair value. This is in order to be consistent with the initial recognition requirements of IAS 39 (IAS 39.43). A gain or loss on modification is also recognised (see guidance and examples sections).
One effect of extinguishment accounting can therefore be the accelerated "expensing" of transaction costs. This is because the unamortised portion of any transaction costs deducted from the original loan are included in the determination of the gain or loss on extinguishment. Any additional fees or costs incurred on modification are also included in the gain or loss in most circumstances. The difference between the way transaction costs are treated under extinguishment and under modification accounting may be a significant item for many entities.

Where modifications to an instrument are not substantial either quantitatively or qualitatively, modification accounting should be applied. In modification accounting, any costs or fees adjust the carrying value of the liability (IAS 39.AG62). The main issue with modification accounting is that the original EIR will not (usually) exactly discount the revised cash flows to the adjusted carrying value. This conflicts with the general definition of the effective interest method in IAS 39.9. In our view, it is therefore appropriate to amend the EIR.

Examples
1. Modification accounting (preferred approach)
On 1 Jan X1 entity A issues 10 year bonds for CU1,000,000, bearing interest at 10% (payable annually on 31 Dec each year). The bonds are redeemable on 31 Dec X10 for CU1,000,000. No costs or fees are incurred. The effective interest rate is therefore 10%. On 1 Jan X6 (ie after 5 years) Entity A and the bondholders agree to a modification in accordance with which:
- no further interest payments are made;
- the bonds are redeemed on the original due date (32 Dec X10) for CU1,600,000; and
- legal and other fees of CU50,000 are incurred.

Other than these quantitative changes, there are no other modifications to the terms of the instrument.

Analysis
The first step is to determine whether the "10% test" is met. In this example, the present value of the remaining cash flows of the existing debt is CU1,000,000. This amount is compared to the total of fees paid on modification (CU50,000) and the present value of the future payment(s) under the modified terms. The present value in this example is CU1,600,000 discounted at 10% (the original EIR) over 5 years (CU993,474). This sum of this amount and fees incurred is CU1,043,474, which is within 10% of CU1,000,000. Given that there have been no substantial qualitative changes to the risk profile of the instrument, modification accounting therefore applies.

On this basis:
- the fees paid of CU50,000 are netted against the existing liability, resulting in an adjusted carrying amount of CU950,000;
- the EIR is recalculated. This is the rate which discounts the future cash flows (CU1,600,000 in five years’ time) to the adjusted carrying amount of CU950,000. The adjusted EIR is 10.99%
- the adjusted EIR is used to determine the amortised cost and interest expense in future periods (see table below).

The accounting entries on the modification date are therefore:

<table>
<thead>
<tr>
<th>Date</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Jan X6</td>
<td>Liability</td>
<td>CU50,000</td>
</tr>
<tr>
<td></td>
<td>Cash (costs and fees paid)</td>
<td>CU50,000</td>
</tr>
</tbody>
</table>

The table below shows pre-and post-modification amortised cost and interest expense amounts:
2. **Extinguishment accounting**

Assume the same facts as above with respect to the original bonds. On 1 Jan X6 (ie after 5 years) Entity A and the bondholders agree to a modification in accordance with which:

- the term is extended to 31 Dec X12;
- interest payments are reduced to CU50,000;
- the bonds are redeemable on 31 DecX12 for CU1,500,000; and
- legal and other fees of CU50,000 are incurred.

Entity A determines that the market interest rate at which it could issue new bonds with similar terms is 11% (on 1 Jan X6).

**Analysis**

The present value of the remaining cash flows of the existing debt on the modification date is CU1,000,000. This is compared to the total of fees paid (CU50,000) and the present value of the future payment(s) under the modified terms. The present value in this example is CU1,500,000 discounted at 10% (the original EIR) over 7 years (CU769,737), plus the present value of the seven interest payments of CU50,000 (CU293,421). The total of these amounts is CU1,113,158. This differs from CU1,000,000 by more than 10%. Hence extinguishment accounting is required.

The next step is to estimate the fair value of the modified liability. This is determined as the present value of the future cash flows (interest and principal), using an interest rate of 11% (the market rate at which Entity A could issue new bonds with similar terms). The estimated fair value on this basis is CU958,097. A gain or loss on modification is then determined as:

\[
\text{Gain (loss)} = \text{carrying value of existing liability} - \text{fair value of modified liability} - \text{fees and costs incurred}
\]

The loss in this case is CU1,000,000 - 958,097 - 50,000 = CU8,097.

The accounting entries recorded on 1 Jan X6 are:

<table>
<thead>
<tr>
<th>Year</th>
<th>Opening liability</th>
<th>Cash flows (interest and principal)</th>
<th>Interest expense (at EIR of 10%/10.99%)</th>
<th>Closing liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Jan X1</td>
<td>1,000,000</td>
<td>1,000,000</td>
<td>100,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>20X1</td>
<td>1,000,000</td>
<td>(100,000)</td>
<td>100,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>20X2</td>
<td>1,000,000</td>
<td>(100,000)</td>
<td>100,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>20X3</td>
<td>1,000,000</td>
<td>(100,000)</td>
<td>100,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>20X4</td>
<td>1,000,000</td>
<td>(100,000)</td>
<td>100,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>20X5</td>
<td>1,000,000</td>
<td>(100,000)</td>
<td>100,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Adjustment on 1 Jan X6</td>
<td>50,000</td>
<td></td>
<td></td>
<td>50,000</td>
</tr>
<tr>
<td>20X6</td>
<td>950,000</td>
<td></td>
<td>104,394</td>
<td>1,054,394</td>
</tr>
<tr>
<td>20X7</td>
<td>1,054,394</td>
<td></td>
<td>115,866</td>
<td>1,170,259</td>
</tr>
<tr>
<td>20X8</td>
<td>1,170,259</td>
<td></td>
<td>128,598</td>
<td>1,298,857</td>
</tr>
<tr>
<td>20X9</td>
<td>1,298,857</td>
<td></td>
<td>142,729</td>
<td>1,441,587</td>
</tr>
<tr>
<td>20X10</td>
<td>1,441,587</td>
<td>(1,600,000)</td>
<td>158,413</td>
<td>-</td>
</tr>
</tbody>
</table>

**1 Jan X6**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>New liability</td>
<td>CU1,000,000</td>
</tr>
<tr>
<td>Existing liability</td>
<td>CU958,097</td>
</tr>
<tr>
<td>Cash (costs and fees paid)</td>
<td>CU50,000</td>
</tr>
<tr>
<td>Loss on extinguishment (income statement)</td>
<td>CU8,097</td>
</tr>
</tbody>
</table>
The modified liability is subsequently accounted for using a new EIR. The new EIR in this case is 11% (the rate used in the present value calculation to estimate the fair value of the modified loan). The table below shows the amortised cost and interest expense amounts for the original and modified loans:

<table>
<thead>
<tr>
<th>Year</th>
<th>Opening liability</th>
<th>Cash flows (interest and principal)</th>
<th>Interest expense (at EIR of 10%/11%)</th>
<th>Closing liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Jan X1</td>
<td>1,000,000</td>
<td>1,000,000</td>
<td>100,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>20X1</td>
<td>1,000,000</td>
<td>(100,000)</td>
<td>100,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>20X2</td>
<td>1,000,000</td>
<td>(100,000)</td>
<td>100,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>20X3</td>
<td>1,000,000</td>
<td>(100,000)</td>
<td>100,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>20X4</td>
<td>1,000,000</td>
<td>(100,000)</td>
<td>100,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>20X5</td>
<td>1,000,000</td>
<td>(100,000)</td>
<td>100,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>De-recognition of existing loan</td>
<td>(1,000,000)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Recognition of modified loan</td>
<td>958,097</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>20X6</td>
<td>958,097</td>
<td>(50,000)</td>
<td>105,391</td>
<td>1,013,488</td>
</tr>
<tr>
<td>20X7</td>
<td>1,013,488</td>
<td>(50,000)</td>
<td>111,484</td>
<td>1,074,972</td>
</tr>
<tr>
<td>20X8</td>
<td>1,074,972</td>
<td>(50,000)</td>
<td>118,247</td>
<td>1,143,219</td>
</tr>
<tr>
<td>20X9</td>
<td>1,143,219</td>
<td>(50,000)</td>
<td>125,754</td>
<td>1,218,973</td>
</tr>
<tr>
<td>20X10</td>
<td>1,218,973</td>
<td>(50,000)</td>
<td>134,087</td>
<td>1,303,060</td>
</tr>
<tr>
<td>20X11</td>
<td>1,303,060</td>
<td>(50,000)</td>
<td>143,336</td>
<td>1,396,396</td>
</tr>
<tr>
<td>20X12</td>
<td>1,396,396</td>
<td>(1,550,000)</td>
<td>153,604</td>
<td>-</td>
</tr>
</tbody>
</table>
HT 2006-24 Share-based contingent consideration

Relevant IFRS
- IFRS 3 Business Combinations
- IAS 32 Financial Statements: Presentation

Issue
This Hot Topic addresses the following aspects of accounting for contracts to issue share-based contingent consideration in a business combination:

- the presentation (as a liability or equity) of the estimated number of shares to be issued
- the measurement of post-acquisition adjustments to the estimated number of shares to be issued.

Users of this Hot Topic should also consider Hot Topic 2007-02 which discusses accounting for written put and purchased call options relating to shares in a subsidiary held by non-controlling interest shareholders.

Project update
The IFRIC received a request to clarify guidance on the accounting in accordance with IFRS 3 for contingent payments to selling shareholders in circumstances in which those selling shareholders become, or continue as, employees. The specific request was to clarify whether IFRS 3.B55(a) is conclusive in determining that payments to an employee that are forfeited upon termination of employment are remuneration for post-combination services and not part of the consideration for an acquisition. IFRS 3.B55 introduces subparagraphs (a) – (h) as indicators, but paragraph B55(a) uses conclusive language stating that the arrangement described is remuneration for post-combination services.

In its September 2012 meeting, the IFRIC observed that an arrangement in which contingent payments are automatically forfeited if employment terminates should lead to a conclusion that the arrangement is compensation for post-combination services rather than additional consideration for an acquisition, unless the arrangement is not substantive. IFRS 3 is a converged standard with the US FASB whereby the FASB is conducting its post-implementation review of its equivalent Standard. Due to these two facts, the IFRIC decided not to add the issue to its agenda as the opportunity to coordinate work on this issue would arise after the conclusion of the post-implementation review by the FASB.

Payments for post-acquisition services is discussed below.

Guidance
A contract to issue share-based contingent consideration (shares) should be measured at its fair value on the acquisition date for the purpose of determining the consideration transferred in exchange for the acquiree. It should be presented as:

- a liability, if the contract requires the issuance of a variable number of shares equal to a fixed or contingent monetary amount or
- equity, if at the date of the business combination, the contract requires a fixed number of shares or the number of shares to be issued is predetermined based on the outcome of a contingency or
- for arrangements that include more than one contingency or performance target, it must be determined whether the unit of account is the overall contract or separate contracts for each contingency or performance target within that overall contract. If separable, these contracts may then individually result in the delivery of a fixed number of shares and as a result be classified as equity. If not separable, the arrangement is viewed as one contract that results in the delivery of a variable number of shares (and would be classified as a liability) because the number of shares that will be delivered depends upon which performance target is met.

Any subsequent adjustment to the number of shares expected to be issued should be measured based on the fair value at the acquisition date. Accounting for changes in fair value will depend on how the contingent consideration is presented (ie equity or liability). IFRS 3.58 provides that:
- contingent consideration classified as equity shall not be remeasured and its subsequent settlement shall be accounted for within equity
- contingent consideration classified as an asset or a liability within the scope of IAS 39 shall be measured at fair value, with any resulting gain or loss recognised in profit or loss or, for financial assets classified as available for sale, in other comprehensive income. Any liability not within the scope of IAS 39 shall be accounted for in accordance with IAS 37 or other IFRSs as appropriate.

**Project updates**

**Annual Improvements**

In the Exposure Draft Annual Improvements to IFRS 2010-2012 Cycle the Board proposed minor amendments to IFRS 3’s requirements on the classification and measurement of contingent consideration. If finalized, this would clarify that contingent consideration is always either an equity instrument or a financial liability by removing references to other applicable IFRSs. The proposed changes would be applied at the same time as IFRS 9 and would also affect the presentation of certain gains and losses (see below).

**IFRS 9**

This Hot Topic reflects the requirements of IAS 39 Financial Instruments: Recognition and Measurement (IAS 39) and not those of IFRS 9 Financial Instruments (IFRS 9). IFRS 9 will eventually replace IAS 39 in its entirety. At this stage, IFRS 9 addresses the classification and measurement of financial assets and financial liabilities, along with derecognition. The requirements for financial liabilities and derecognition were carried forward unchanged (with the exception of some changes to the fair value option for financial liabilities to address the issue of own credit risk). On 28 November 2012, the Board issued an exposure draft proposing limited modifications to IFRS 9’s financial asset classification model to address application issues. IFRS 9 is effective for annual periods beginning on or after 1 January 2015 (early adoption permitted). Work continues on Phases 2 and 3 of the project, which address impairment and hedge accounting, respectively.

In certain situations where the determination of the fair value of the contingent consideration is provisional (and the entity has stated such fact in the notes to its financial statements) and where the change in the fair value of contingent consideration is a result of additional information that the acquirer obtained after the acquisition date about facts and circumstances that existed at such date, this is considered as a measurement period adjustment. Accordingly, the corresponding adjustment to the fair value of the contingent consideration is either charged or credited to goodwill. IFRS 3.45 to 3.49 provides guidance on measurement period adjustments.

Contingent consideration arrangements (including share-based and cash-based arrangements) should be assessed to determine if, in substance, they include consideration for post-acquisition employment or other services. This issue is considered in more detail in the discussion section.

**Discussion**

Appendix A of IFRS 3 defines contingent consideration as follows:

"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."

Typically, contingent consideration arrangements involve the payment of more or less consideration dependent on (for example):

- the outcome of identified contingencies such as litigation against the acquiree or
- the financial performance of the acquiree over a specific period (sometimes referred to as 'earn-out' arrangements).

In a business combination, IFRS 3.39 requires that "the acquirer shall recognise the acquisition-date fair value of contingent consideration as part of the consideration transferred in exchange for the acquiree."
The effect of IFRS 3.39 is that the acquirer estimates, at the acquisition date, the fair value of the contingent consideration. This estimate is based on the expected future outflow, which should reflect the probability of whether such outflows will be made and can be determined generally using a valuation technique. Contingent consideration might include cash, shares, other assets or a mixture. When the arrangement may result in a variable number of shares being issued to the vendor, a question arises as to whether the contract should be classified by the acquirer as equity or as a financial liability. IFRS 3.40 provides that contingent consideration shall be classified either as an equity instrument or as a financial liability based on the definitions of an equity instrument and a financial liability in IAS 32.11. Once shares have been issued, they will be classified as equity.

In our view, a contract that provides for the issuance of a predetermined number of shares that is dependent on the outcome of a single contingency (such as meeting a financial or non-financial target) should be classified as equity by the acquirer, so long as the number of shares to be issued does not vary depending on the value of the shares.

An example of such an arrangement is a contract that requires the acquirer to issue 1,000 additional shares if profits of the acquiree meet at least 50% of a certain performance target. Such a contract does not include any obligation to transfer cash or another financial asset and does not include any requirement to exchange financial assets or liabilities under potentially unfavourable conditions to the acquirer. Thus, the conditions in IAS 32.16(a) are met.

IAS 32.16(b)(i) states however that the instrument should not contain an obligation to deliver a variable number of shares. Due to the varying number of shares (nil or 1,000) that can be issued, it can be argued that such criterion is not met. However, in our view, it is reasonable to regard the terms of the arrangement as meeting the fixed-number criterion. The number of shares to be issued is fixed and predetermined (ie known in advance) at any time and will only change based on the outcome of the contingency, ie it will be nil or 1,000, depending on the performance results. However, the number will not vary depending in relation to the share value.

By contrast, a contract that provides for the issuance of a variable number of shares equal to a fixed or contingent monetary amount should in our view be classified as a financial liability. An example of such an arrangement is a contract that requires the acquirer to issue shares to the value of CU1,000 if profits of the acquiree meet a certain target. Such a contract again contains no obligation to transfer cash. However, this contract does not evidence a residual interest in the net assets of the acquirer. The acquirer is, in effect, using its own shares as "currency" to settle a financial liability.

A more difficult assessment arises in arrangements where there are multiple performance targets and a fixed number of shares will be issued when each of those performance targets are met. In these situations, an understanding of the terms of the arrangement is necessary to determine whether the unit of account is the overall contract or whether the overall contract can be separated into multiple contracts for each performance target. If the performance targets are readily separable and independent of each other and relate to different risk exposures then they should be treated as separate contracts (IAS 39.AG29). In this case, each separable target is assessed to determine its classification as equity or liability. Conversely, if the unit of account is the contract as a whole, it will be classified as a liability because the number of shares to be issued varies depending on which target is met.

**Payments for post-acquisition services**

Some contingent consideration arrangements may, in substance, include an element of payment for post-acquisition services. This can apply, for example, when the acquiree retains the services of a vendor who is also a manager of the acquired business. An arrangement that results in additional payment to that vendor based on post-acquisition performance might in substance represent post-acquisition management compensation (bonus or profit share) rather than additional payment for the acquired business. To the extent that contingent consideration includes an element for post-acquisition services, that element should be recorded as an expense in the post-acquisition period rather than as an adjustment to the cost of the combination. If part of the arrangement is, in substance, a share-based payment for services, it should be accounted for in accordance with IFRS 2 Share-based Payment.
Determination of whether or not contingent consideration contracts include an element of payment for post-acquisition services may require careful judgement and analysis to assess the underlying substance of the arrangement. IFRS 3.B54 and B55 provide guidance on this topic. Payments that are automatically forfeited on termination of employment are remuneration for post-combination services (IFRS 3.B55(a)).

**Example 1: Fixed number of shares based on single performance target**

On 31 Dec 20X1, acquirer A agrees with vendor V to acquire business B. The consideration is 80,000 shares of A, plus an additional 20,000 shares if the average profits of B in 20X2 and 20X3 exceed a target level. The additional shares will be issued on 31 March 20X4, if applicable. There are no other costs of the combination. The fair value of B's assets, liabilities and contingent liabilities is determined to be CU750,000. At the acquisition date, A's management consider that it is 40% probable that B will achieve its average profit target. However, during 20X2, B's performance exceeds forecasts such that, at 31 Dec 20X2, A's management considers that it is 80% probable that B will achieve its target.

At 31 Dec 20X1 the fair value of A's shares is CU10. At the same date, A estimates that the current fair value of a contract to issue a share on 31 Mar 20X4 is CU9.

At 31 Dec 20X2, the fair value of A's shares has increased to CU15. At that date, A estimates that the fair value of a contract to issue a share on 31 Mar 20X4 is CU14.

On 31 Dec 20X3 it is confirmed that B has achieved its target. At that date, the fair value of A's shares has increased to CU17 and A estimates that the fair value of a contract to issue a share on 31 Mar 20X4 is CU15.

The additional 20,000 shares are issued on 31 Mar 20X4. The fair value of A's shares on 31 Mar 20X4 is CU16.

**What is the reported consideration transferred in exchange for the acquiree?**

At 31 Dec 20X1, the contingent consideration should be included in determining the total consideration transferred related to the purchase of B. The reported consideration is equal to CU872,000 which consists of the fixed amount of shares to be issued of CU800,000 (80,000 x CU10) plus the fair value of the contingent consideration of CU72,000* (20,000 x CU9 x 40%). The contingent consideration is based on a fixed number of shares and is only contingent on the outcome of the single future event; as such, it is classified as equity.

* The determination of acquisition-date fair value of the contingent consideration should take account of the expected outcome of the contingency. The example illustrates one possible approach to estimating the fair value of the arrangement.

The entry to record the acquisition of B is as follows:

<table>
<thead>
<tr>
<th>31 Dec 20X1</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>B's assets, liabilities and contingent liabilities</td>
<td>CU750,000</td>
<td></td>
</tr>
<tr>
<td>Goodwill</td>
<td>CU122,000</td>
<td></td>
</tr>
<tr>
<td>Equity</td>
<td></td>
<td>CU872,000</td>
</tr>
</tbody>
</table>

At 31 Dec 20X2, the fair value of the contract to issue additional shares has changed from 40% to 80%. Since, the contingent consideration is classified as equity, subsequent remeasurement of such consideration is not permitted.

When the shares are issued on 31 Mar 20X4, the shares to be issued may be reclassified within equity, for example into issued share capital.
Example 2: Variable number of shares of a fixed monetary value based on single performance target

The facts are the same as in example 1 except that the consideration is 80,000 shares of A, plus an additional number of shares equivalent to CU100,000 (based on the fair value of A shares) if the average profits of B in 20X2 and 20X3 exceed the target level.

The additional 6,250 (CU100,000 / CU16) shares are issued on 31 Mar 20X4.

What is the reported cost of the business combination?

At 31 Dec 20X1, the contingent consideration should be included in determining the total consideration transferred related to the purchase of B. The reported consideration is equal to CU836,000 which consists of the fixed amount of shares to be issued of CU800,000 (80,000 x CU10) plus the fair value of the contingent consideration of CU36,000* (CU100,000 /CU10 x CU9 x 40%). The contingent consideration requires the issuance of shares equal to a fixed monetary amount, as such, it is classified as a financial liability.

* The determination of acquisition-date fair value of the contingent consideration should take account of the expected outcome of the contingency. The example illustrates one possible approach to estimating the fair value of the arrangement

The entry to record the acquisition of B is as follows:

<table>
<thead>
<tr>
<th>31 Dec 20X1</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>B's assets, liabilities and contingent liabilities</td>
<td>CU750,000</td>
<td></td>
</tr>
<tr>
<td>Goodwill</td>
<td>CU86,000</td>
<td></td>
</tr>
<tr>
<td>Liability</td>
<td>CU36,000</td>
<td></td>
</tr>
<tr>
<td>Equity</td>
<td>CU800,000</td>
<td></td>
</tr>
</tbody>
</table>

At 31 Dec 20X2, the probability of the issuance of shares has changed from 40% to 80%. Since the contingent consideration is classified as a financial liability, it should be remeasured at each reporting date. The fair value of the contingent consideration is CU74,667 (CU100,000 /CU15 x CU14 x 80%)

The entry to record the remeasurement of the contingent consideration on 31 Dec 20X2 is as follows:

<table>
<thead>
<tr>
<th>31 Dec 20X2</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expense (74,667 - 36,000)</td>
<td>CU38,667</td>
<td></td>
</tr>
<tr>
<td>Liability</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The change in estimate results from changed circumstances during 20X2 (B's performance was better than anticipated) rather than arising from additional information relating to conditions at the combination date. Consequently, the adjustment is recognised in profit or loss (IFRS 3.58).

At 31 Dec 20X3, it was confirmed that the shares will be issued. At that date, the fair value of A's shares has increased to CU17 and A estimates that the fair value of a contract to issue a share on 31 Mar 20X4 is CU15. Since the contingent consideration is classified as liability, it should be remeasured at each reporting date. The fair value of the contingent consideration is CU88,235 (CU100,000 /CU17 x CU15 x 100%)

The entry to record the remeasurement of the contingent consideration on 31 Dec 20X3 is as follows:

<table>
<thead>
<tr>
<th>31 Dec 20X3</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expense (88,325 - 74,667)</td>
<td>CU13,568</td>
<td></td>
</tr>
<tr>
<td>Liability</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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The adjustment of the contingent consideration is after the measurement period; as such the change in the fair value of the contingent consideration is recognised in profit or loss.

When the shares are issued on 31 Mar 20X4, the number of shares issued is determined by dividing CU100,000 by the fair value of the shares.

The entry to record the issuance of shares at fair value of CU100,000 on 31 Mar 20X4 is as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>31 Mar 20X4</td>
<td>Expense (100,000 - 88,325)</td>
<td>CU11,675</td>
</tr>
<tr>
<td></td>
<td>Liability</td>
<td>CU88,325</td>
</tr>
<tr>
<td></td>
<td>Equity</td>
<td>CU100,000</td>
</tr>
</tbody>
</table>

**Example 3: Fixed number of shares based on multiple performance targets in the same period**

On 31 Mar 20X1, acquirer A agrees with vendor V to acquire business B. The consideration is 80,000 shares of A, plus an additional 20,000 shares if the average profit of B in 20X2 and 20X3 exceeds CU2m or an additional 50,000 shares if the average profit exceeds CU3m. The additional shares will be issued on 31 Mar 20X4, if applicable. Depending on which profit target is met, A could issue zero, 20,000 or 50,000 additional shares.

**Is the contingent consideration classified as equity or liability?**

The arrangement must be assessed to determine whether each of the profit targets represents a separable contract. Since the number of A’s shares that could be issued under the arrangement is variable and relates to the same risk exposure (ie the number of shares to be delivered will vary depending on which performance target is achieved in the two-year period following the acquisition), the contingent consideration arrangement would be considered one contractual arrangement under IAS 39.AG29. Since the arrangement will result in the issuance of a variable number of shares, it should be classified as a financial liability in accordance with IAS 32.11.

**Example 4: Fixed number of shares based on multiple performance targets in different periods**

On 31 Dec 20X1, acquirer A agrees with vendor V to acquire business B. The consideration is 80,000 shares of A, plus an additional 20,000 shares if the profits of B exceed CU2m in 20X2 and a further 30,000 shares if the profits of B exceed CU3m in 20X3. The additional shares will be issued on 31 Mar 20X4, if applicable. The achievement of the profit-targets are independent of each other (ie A could issue zero, 20,000, 30,000 or 50,000 additional shares).

**Is the contingent consideration classified as equity or liability?**

The arrangement must be assessed to determine whether each of the profit targets represents a separable contract. Since the 20X2 and 20X3 arrangements are independent of each other and relate to different risk exposures under IAS 39.AG29, each profit target can be viewed as a separate contract (see discussion section) that would individually result in the issuance of a fixed number of equity shares of Company A. Therefore, each individual contract within the contingent consideration arrangement would be classified as equity under IAS 32.
HT 2006-25 Investment property held under a lease

Relevant IFRS
IAS 17 Leases
IAS 40 Investment Property

Issue
Accounting for investment property held under a lease.

Project update
The IASB and FASB (the Boards) have been working together to develop a new single approach to lease accounting that would ensure that all leases (other than short-term leases) would be recognised in the statement of financial position – ie no more operating or finance distinction. A revised exposure draft is expected in Q1 2013. This Hot Topic does not consider or discuss the new proposals.

Guidance
The main considerations in accounting for leased investment property are as follows:

- the lease should be classified as a finance lease or operating lease at its inception in accordance with the criteria in IAS 17.17-19
- for this purpose, any premium paid to the lessor or to the previous lessee on entering into a new lease should be included in the minimum lease payments (MLPs) (IAS 40.26)
- if the leased property is classified as a finance lease and meets the definition of investment property, it must be accounted for in accordance with IAS 40. The investor/lessee has the choice in IAS 40 to apply either the fair value model (IAS 40.33) or the cost model (IAS 40.56)
- if the leased property is classified as an operating lease and meets the definition of investment property, the investor/lessee may account for the property in accordance with IAS 40. If the IAS 40 classification alternative is selected (i) the lease is accounted for as a finance lease; and (ii) investor/lessee must apply the fair value model (IAS 40.6)
- the initial cost of the property is determined as the lower of its fair value or the present value of the MLPs (IAS 40.25). For this purpose, any premium paid is again included in the MLPs
- separate measurement of the land and buildings elements is not required if the investor/lessee classifies both elements of the property as investment property and applies the fair value model (IAS 17.18).

Discussion
Investment property is defined in IAS 40.5. In summary, a property is an investment property if it is held to earn rentals and/or for capital appreciation rather than for use or sale in the ordinary course of business. Property investors commonly invest in leased properties as well as owned properties. Investments in leased properties are made both by leasing a new property and by purchasing an existing leasehold interest in a property from another investor/lessee. In the second case, the new investor/lessee often makes a payment to the previous lessee (sometimes referred to as a premium) to acquire the leasehold interest.

IAS 17 establishes the main requirements for lease accounting. There are however a number of specific requirements (in both IAS 17 and IAS 40) for investment properties held under a lease. In broad terms, IAS 40 must be applied to finance-leased investment properties and may be applied to operating-leased investment properties. When IAS 40 is applied, that standard determines the accounting treatment of the asset whilst IAS 17 determines the accounting treatment of the liability. In more detail, important points to note include the following:

- an investor/lessee should classify the lease as operating or finance based on IAS 17's criteria. This is necessary in part because (as noted above) the investor/lessee must apply IAS 40 for a finance lease but can choose whether or not to do so for an operating lease (provided, of course, that the property meets the definition of investment property)
the classification as an operating or finance lease should be made at the inception of the lease. If the entity acquires an interest in a leasehold property, a determination should be made as to whether this is in substance a new lease. For this purpose, a sub-lease is regarded as a new lease. A legal assignment of a lease, resulting in the entity becoming party to its terms, may also represent a new lease in substance depending on the specific facts and circumstances. The acquisition of an entity with an existing leasehold property interest does not result in a new lease.

- if the investor/lessee chooses to apply IAS 40 to a property held under an operating lease, it must apply the fair value model to that property interest and to all of its other investment properties (including owned property) - IAS 40.6. There is however one exception to this rule: either model may be applied to properties backing liabilities (ie liabilities that are linked to the fair value or returns from specified properties) (IAS 40.32A).
- if IAS 40 is applied to a property held under an operating lease, the lease is then accounted for as a finance lease. Consequently a lease liability is recognised, calculated as the MLPs discounted at the interest rate implicit in the lease (see IAS 17.4 for definition). It is however often impractical to determine this interest rate, especially as the lease is an operating lease. If so, the investor/lessee’s incremental borrowing rate is used (IAS 17.20).
- the normal requirements of IAS 17.15A and 16 for the separation of leases of land and buildings are relaxed for leased property if both elements are classified as investment property and the fair value model in IAS 40 is applied (IAS 17.18).
- if the investor/lessee does not wish to apply the fair value model to both the land and buildings elements, it must separate the lease unless the land element is immaterial. The land element is frequently an operating lease. In determining whether the land element is an operating or a finance lease, an important consideration is that the land normally has an indefinite economic life (IAS 17.15A). The investor/lessee has the accounting policy choice outlined above for any operating lease element(s). For any element(s) classified as a finance lease, the investor/lessee applies IAS 40 and can choose between the cost model and the fair value model.
- in applying these requirements, any premium paid to the lessor or to the previous lessee to enter into the lease should be included in the MLPs both in determining the appropriate classification and in calculating the present value of the MLPs. However, the premium element is not part of the lease liability (because it has already been paid).
- if the IAS 40 fair value model is applied, the asset to be recorded at fair value is the leased interest not the underlying property (IAS 40.26). The leased interest at initial recognition is the cost, net of the related finance lease liability. The fair value is the amount the lessee would expect to receive (ie the premium) for this interest. This will reflect the expected cash flows, discounted at a market rate. The expected cash flows include the rentals to be received from tenants and the rentals payable to the owner/lessor.

The requirements described above are summarised in a decision tree in the Appendix to this Hot Topic.

Example
An office building was constructed several years ago and leased by its owner to a property investor. The investor/lessee has sub-let parts of the property to tenants. The head-lease expires on 31 Dec X20 and the sub-leases on various earlier dates. The sub-leases were classified as operating leases by the original investor/lessee. A second property investment entity, A, acquires the interest in the head-lease from the current lessee on 1 Jan X1 by way of a legal assignment. This is considered to give rise to a new lease. Entity A pays a premium of CU500,000 to the existing lessee for the interest. There is no transfer of title and no purchase options exist. Rentals payable under the head-lease are CU50,000 per annum, due on 31 Dec each year.

A intends to hold this property interest to earn rental income and for possible appreciation in the value of the leasehold interest.

The estimated fair value of the underlying property is CU2,000,000. Its estimated remaining useful life is 40 years. The land element of the lease is determined to be immaterial.

A’s incremental borrowing rate is 9%.

The transaction is determined not to be a business combination.
Analysis

Lease classification

In this example, the land element is immaterial. The lease is therefore classified as an operating or finance lease in its entirety. (Note - in most real property leases, the land element is not immaterial. The lease will then need to be analysed into the land and buildings element unless the investor/lessee decides to classify both elements as investment property and apply the fair value model).

The lease classification is assessed using a range of indicators. One important indicator is the relationship between the present value of the MLPs and the fair value of the underlying property. The present value of the MLPs is the sum of the premium (CU500,000) and the present value of the twenty annual payments of CU50,000 (CU456,427, using a 9% discounted rate based on A’s incremental borrowing cost). This totals CU956,427. This is 48% of the fair value of the underlying property, which is not 'substantially all the fair value' (IAS 17.10(d)). This indicates that the lease is probably an operating lease. Other indicators of operating lease classification are that:

- the lease does not transfer ownership at the end of the lease term (see IAS 17.10(a))
- there is no bargain purchase option (IAS 17.10(b))
- the lease term is not for the major part of the economic life of the asset (IAS 17.10(d))
- the asset is not of such a highly specialised nature that only the lessee can use it without major modifications (IAS 17.10(e)).

These indicators are conclusive as to operating lease classification.

Entity A therefore has a choice between:

- accounting for the lease as a normal operating lease or
- applying the IAS 40 fair value model and accounting for the lease as a finance lease.

Accounting for the lease as an operating lease

If this option is chosen the annual rentals of CU50,000 are recognised on a straight-line basis over the remaining 20 year lease term. The premium is recorded as a prepayment and also amortised straight-line over the term of the lease.

Applying the IAS 40 fair value model

If this option is chosen, a finance lease liability is recorded. This is initially determined as the present value of the future lease payments, discounted at 9% (as above). This is CU456,427. The initial cost of the leasehold interest is that amount plus the premium ie CU956,427.

The entries are:

<table>
<thead>
<tr>
<th>Date</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Jan X1</td>
<td>Investment property - leasehold interest</td>
<td>CU956,427</td>
</tr>
<tr>
<td></td>
<td>Finance lease liability</td>
<td>CU456,427</td>
</tr>
<tr>
<td></td>
<td>Cash (premium)</td>
<td>CU500,000</td>
</tr>
</tbody>
</table>

Subsequently:

- interest on the finance lease liability is accrued at 9% of the outstanding creditor and the creditor is reduced by the annual payments of CU50,000
- the leasehold interest (ie the carrying value net of the related finance lease liability) is re-measured to fair value at every reporting date, with fair value changes recorded in profit and loss.

Because entity A has chosen to report this operating lease interest as an investment property, it should apply the IAS 40 fair value model to all of its owned and leased investment properties.
Appendix
Decision Tree for Leased Investment Property

Investor/lessee becomes party to a property lease

Does leased property meet the definition of investment property?

Yes

Does property include both a (non-immatricial) land element and a buildings element?

No (eg land only)

Classify entire lease as operating or finance under IAS 17

Yes

Does investor wish to apply IAS 40 fair value model to both elements?

No (eg land only)

Classify components separately as operating or finance lease

Yes

Apply IAS 17 only

Operating lease

Does investor/lessee wish to apply IAS 40?

Yes

Apply IAS 40 fair value model. Account for lease as finance lease.

No

Finance lease

Apply IAS 17 only

Apply IAS 40 cost or fair value model. Account for lease as finance lease.
HT 2006-26 Pre-opening operating lease expenses

Relevant IFRS
IAS 16 Property, plant and equipment
IAS 17 Leases
IAS 23 Borrowing Costs

Issue
Accounting for 'pre-opening' operating lease expenses.

Guidance
Pre-opening operating lease expenses are start-up costs and should therefore be expensed as incurred. They are not part of the cost of an item of property, plant and equipment (PP&E) (IAS 16.19).

Operating lease expenses should be recognised on a straight-line basis unless another method is more representative of the time pattern of the user's benefit (IAS 17.33). The user derives benefits as soon as it has access to the leased property. It is therefore inappropriate to use an expense recognition method that defers or suspends expense recognition during the pre-opening period.

Project update
The IASB and FASB (the Boards) have been working together to develop a new single approach to lease accounting that would ensure that all leases (other than short-term leases) would be recognised in the statement of financial position – ie no more operating or finance distinction. A revised exposure draft is expected in Q1 2013. This Hot Topic does not consider or discuss the new proposals.

Discussion
It is common in some industries for an entity to lease operating premises and then spend a period of time preparing the premises for their intended use. For example, a retailer might enter into a property lease and then spend some months adapting and fitting the property before opening a new store. During this 'pre-opening' period, various improvements are made and fixtures installed which may qualify to be capitalised as PP&E (if the criteria in IAS 16.7 etc are met). Issues then arise as to:

- whether or not operating lease expenses incurred during the pre-opening period are part of the cost of the PP&E
- whether or not operating lease expenses should be recognised during the pre-opening period in accordance with IAS 17.33 (given that deferring expense recognition until the start of operations might be argued to be 'more representative of the time pattern of the user's benefit than straight-line recognition).

It is sometimes argued that operating lease expenses incurred during the pre-opening period are part of the cost of the PP&E installed in the leased property (ie the improvements and fittings). IAS 16.16(b) requires that 'the cost of an item of PP&E comprises . . . any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.' However, in our view operating lease expenses are not 'directly attributable' to the installed PP&E. Rather, the lease expenses are attributable to the leased property (which, in an operating lease, is not regarded as an asset of the lessee).
Operating lease expenses incurred during the pre-opening period are more explicitly dealt with in IAS 16.19. IAS 16.19 does not permit capitalisation of costs of opening a new facility, costs of conducting a business in a new location or administrative and general overhead costs (and other similar items). In other words, start-up costs are neither assets in themselves, nor a component of the cost of other PP&E. Examples of costs that are directly attributable to the cost of an item of PP&E include:

- costs of employee benefits arising from the construction or acquisition of an item of PP&E
- costs of site preparation
- initial delivery and handling costs
- costs of testing whether the asset is functioning properly
- professional fees (IAS 16.17).

We also consider that the user (ie the lessee) derives benefits from leased property as soon as it has access to that property. The lessee's right to adapt and prepare the property for its own operations is a benefit. It is therefore inappropriate to defer or suspend recognition of lease expenses during the pre-opening period.

If property is held under a finance lease, the related finance charges may be eligible for capitalisation in accordance with IAS 23. IAS 23 requires capitalisation of eligible borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset. Eligible borrowing costs include finance charges in respect of finance leases (IAS 23.6(d)). IAS 23.8 states that "An entity shall capitalise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset." IAS 23.9 further states that "such borrowing costs are capitalised as part of the cost of the asset when it is probable that they will result in future economic benefits to the entity and the costs can be measured reliably."

The leased property might be a qualifying asset if it requires a substantial period of time to make it ready for its intended use. IAS 23.5 defines a qualifying asset as an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. However, IAS 23 requires capitalisation only whilst construction, development or other necessary activities are in progress (IAS 23.19). We therefore consider that a building held under a finance lease is a qualifying asset only whilst there is significant activity in relation to the building itself (eg structural work). A leased building that is complete, but requires minor modifications (such as decorating), is unlikely to be a qualifying asset (IAS 23.22).

The reason that finance lease interest costs might be eligible for capitalisation, whilst operating lease expenses are not, is that in finance lease accounting the leased property is recognised as an asset of the lessee. The 'qualifying asset' is the leased asset. By contrast, in an operating lease, the leased property is not an asset of the lessee and any improvements or fittings are therefore separate assets.
HT 2006-27 Classification of derivatives as current or non-current

Relevant IFRS
IAS 1 Presentation of Financial Statements
IAS 39 Financial Instruments: Recognition and Measurement

Project update
This Hot Topic reflects the requirements of IAS 39 Financial Instruments: Recognition and Measurement (IAS 39) and not those of IFRS 9 Financial Instruments (IFRS 9). IFRS 9 will eventually replace IAS 39 in its entirety. At this stage, IFRS 9 addresses the classification and measurement of financial assets and financial liabilities, along with derecognition. The requirements for financial liabilities and derecognition were carried forward unchanged (with the exception of some changes to the fair value option for financial liabilities to address the issue of own credit risk). On 28 November 2012, the Board issued an exposure draft proposing limited modifications to IFRS 9's financial asset classification model to address application issues. IFRS 9 is effective for annual periods beginning on or after 1 January 2015 (early adoption permitted). Work continues on Phases 2 and 3 of the project, which address impairment and hedge accounting, respectively.

Issue
Should assets and liabilities arising from derivative financial instruments (derivatives) be classified in the statement of financial position as current or non-current?

Guidance
Free-standing derivatives (ie derivatives other than embedded derivatives)
Free-standing derivatives (ie derivatives other than embedded derivatives) that are not formally designated as hedging instruments should be classified as current or non-current based on the normal IAS 1.66 and 69 criteria. In summary these criteria require current classification for:

- assets and liabilities that are held primarily for the purposes of being traded or
- assets that are (i) expected to be realised within 12 months of the reporting date; or (ii) expected to be realised, or are intended for sale/consumption, in the entity's normal operating cycle (if this is not 12 months and is clearly identifiable)
- liabilities that are (i) due to be settled within 12 months of the reporting date; or (ii) expected to be settled within the entity's normal operating cycle (if this is not 12 months and is clearly identifiable); or (iii) for which the entity does not have the unconditional right to defer settlement beyond 12 months.

Other free-standing derivatives should generally be classified as non-current
Derivatives that are formally designated as hedging instruments should normally be classified as current if the hedging relationship expires within 12 months of the reporting date and as non-current if the hedging relationship expires after more than 12 months.

Embedded derivatives
The classification of embedded derivatives and the associated host contract should be determined as a whole, based on the terms and conditions of the combined contract.

Discussion
IAS 39 addresses the measurement of derivatives, including embedded derivatives. It requires that derivatives are reported at fair value through profit or loss (or fair value through equity for the effective portion of derivatives designated as hedging instruments in a cash flow hedge). Derivatives therefore give rise to assets or liabilities.
IAS 1 addresses the presentation of financial statements. It generally requires the presentation of current and non-current assets and liabilities as separate classifications on the face of the statement of financial position (also known as a classified statement of financial position) (IAS 1.60), except when presentation based on liquidity provides information that is reliable and more relevant (in which case it shall present all assets and liabilities based on liquidity). Whichever method of presentation is adopted, an entity must disclose the amount expected to be recovered or settled after more than twelve months for each asset and liability line item where it combines amounts expected to be recovered or settled no more than twelve months after the reporting period and more than twelve months after the reporting period. In our view, derivative assets and liabilities therefore need to be classified as either current or non-current items when presenting a classified statement of financial position.

IAS 1 sets out various criteria to determine current versus non-current classification, primarily at IAS 1.66 and 69. The main criteria are summarised in the guidance section.

It was sometimes argued that all derivative financial instruments should be regarded as 'held primarily for the purpose of being traded' because IAS 39 includes derivatives in the 'held for trading' classification (IAS 39.9). Our view is that IAS 39’s requirements are concerned with measurement and that the inclusion of derivatives in a held for trading category is intended to ensure that the appropriate measurement requirements are applied. In the context of classification as current or non-current in accordance with the definitions in IAS 1.66 and 69, we consider that 'held primarily for the purpose of being traded' refers to management's reason for acquiring the asset or liability. However, it should not be presumed that all derivatives are held primarily for the purpose of being traded.

To clarify this point, the IASB made a minor amendment to the examples of current assets and current liabilities in IAS 1.68 and 71 as part of the Improvements to IFRS project in 2007. The Basis for Conclusions of IAS 1 (BC38A to BC38D) was also amended to reaffirm that current assets and current liabilities may include some (but not necessarily all) financial instruments classified as held for trading in accordance with IAS 39.

Many entities acquire derivatives for hedging purposes rather than for trading. Some derivatives might be formally designated in hedging relationships in accordance with IAS 39's hedge accounting requirements. Other derivatives might be regarded as 'economic hedges' i.e part of a hedging relationship that does not qualify for IAS 39 hedge accounting or for which management has decided not to adhere to IAS 39's strict documentation and effectiveness testing conditions.

When a formal hedge designation has been made, we consider that it is appropriate to look to the duration of the documented hedge relationship to determine the appropriate current or non-current classification. This will often correspond with the period to expiry or settlement/realisation of the derivative, but not always.

When no formal hedge designation is made, the entity should look to the contractual date of settlement (or realisation) of non-trading derivatives. This is straightforward in cases when the derivative is realised or settled at a fixed future date (for example: contracts to buy or sell foreign currency at a future date; 'European-style' options that are exercisable only on a single date). In other cases, the derivative might be settled or realised:

- through periodic payments or receipts (eg an interest swap in which the interest differential is paid or received monthly for the duration of the contract) or
- over a range of dates at the discretion of one of the parties (eg option contracts that can be exercised by the purchaser at any time between purchase and expiry, sometimes referred to as 'American-style' options).

In the first case, it may be necessary to split the fair value of the derivative into a current and non-current portion. In the second case, the purchaser of the option (ie the asset-holder) should look to its expected date of exercise. However, the issuer (writer, being the party with a liability) should classify its obligation as current since it can be required to settle the contract at any time before expiry.
Embedded derivatives

IAS 39.11 requires that embedded derivatives meeting certain specified criteria are separated from their host contract and accounted for as free-standing derivatives. In our view, this requirement is intended to ensure appropriate measurement of embedded derivatives and does not affect their classification as current or non-current. IAS 39.11 also explicitly states that “this Standard does not address whether an embedded derivative shall be presented separately on the face of the financial statements”.

Embedded derivatives cannot be settled or realised independently of the host contract. In other words, the combined contract is settled, realised or traded as a whole. We therefore believe that the classification of combined contracts should be considered as a whole.

Applying this approach to the following examples of combined contracts, the issuer would classify the contract as follows:

- A five year bond with a separated embedded put option that allows the holder to put the bond back to the issuer in six months’ time would be classified as a current liability. This is because the holder can require settlement within 12 months.
- A similar five year bond but with a call rather than a put (i.e., the issuer can call the bond in six months but the holder has no right to put it back to the issuer) would be classified as current if it expects to exercise the call, otherwise as non-current.
- A five year equity linked bond with no puts and calls but all of the payments are dependent on the performance of a specified equity index would be classified as non-current.
- A five year foreign exchange convertible (with no equity component) that can be converted quarterly at the option of the holder would be classified as current.

In some cases, the host contract might not be recognised in the statement of financial position at all. An example is a contract to buy or sell a non-financial item denominated in a foreign currency (see Hot Topic 2006-16). In this case the entity should look to the date on which the contract as a whole is settled. In this example, this would probably be the date on which the non-financial item is expected to be delivered.
Customer acquisition commissions paid to intermediaries

**Issue**
This Hot Topic discusses arrangements in which a service provider pays an intermediary to introduce new customers. It focuses on arrangements on which the commission payments are based on the revenues generated from the customers. The issues discussed are:

- determination of whether or not the commission arrangement is a financial instrument within the scope of IAS 39
- if applicable, classification of and accounting for changes in the carrying value of the financial instrument
- revenue recognition by the entity receiving commission
- expense or asset recognition by the entity paying commission.

Although this Hot Topic discusses customer acquisition commissions, the underlying principles also apply to some other types of commission and royalty contracts.

**Guidance**
Arrangements in which a service provider pays an intermediary to introduce new customers based on the future revenues generated from the customers give rise to complex accounting issues. The terms and conditions of such arrangements also differ extensively. This Hot Topic therefore provides general guidance on some of the key matters to consider. However, careful evaluation of all relevant facts and circumstances will be required to determine the appropriate IFRS treatment in each case.

**Is the arrangement a financial instrument within the scope of IAS 39?**
A contract is a financial instrument within the scope of IAS 39 if it creates a right of one party to receive cash and an obligation of the counterparty to pay cash. A contract to pay commission in exchange for new customer introductions is therefore outside the scope of IAS 39 before the introduction service has been provided. Once the service has been provided, the contract is a financial instrument unless the service provider has an unconditional right to avoid payment.
The fact that the amount of commission is wholly or partly contingent on the actions of a customer does not prevent the contract meeting the definition of a financial instrument (see IAS 32.AG8). This applies even if the contingency in question is ‘remote’ (see IAS 32.BC17). However, if the service provider is able to control the contingency (ie if it is not under any obligation to provide services and can thereby avoid paying commission); the contract is not a financial instrument.

Financial assets and liabilities within the scope of IAS 39 should be recorded at fair value on initial recognition, plus or minus any transaction costs if applicable (IAS 39.43). Fair value will usually need to be estimated based on the expected cash flows to be paid and received. A quoted price in an active market will not be available in most cases and therefore an appropriate valuation technique will need to be applied (see IFRS 13.61-69).

**Guidance note**
The IASB issued IFRS 13 *Fair Value Measurement* (IFRS 13) in May 2011, effective for annual periods on or after 1 January 2013 (early application permitted). IFRS 13 defines fair value, sets out in a single framework for measuring fair value and requires disclosures about fair value measurements. IFRS 13 does not determine when an asset, a liability or an entity’s own equity instrument is measured at fair value. Rather, the measurement and disclosure requirements of IFRS 13 apply when another IFRS requires or permits the item to be measured at fair value (with limited exceptions). This Hot Topic reflects the guidance in IFRS 13.

**Classification and accounting for changes in the carrying value of the financial instrument**
The financial asset recorded by the receiving entity should be classified in accordance with the definitions in IAS 39.9. This will often result in classification within ‘loans and receivables’, provided the payments are considered fixed or determinable and the other conditions in IAS 39.9 are met. After initial recognition, loans and receivables are measured at amortised cost using the effective interest method.

Changes in the amounts and timing of estimated cash flows give rise to gains and losses which should be recorded in the income statement (IAS 39.AG8). Our preferred approach is that these changes are reported as other income or expense, not as revenue (or negative revenue).

The financial liability recorded by the paying entity will also usually be measured at amortised cost after initial recognition. Subsequent changes in the carrying value of the financial liability should be recorded in the income statement.

**Revenue recognition for the entity receiving commission**
If the receiving entity has provided services and recognises a financial asset, it should determine the amount of revenue to be recorded in accordance with IAS 18. The fact that the entity has received a financial asset in exchange for services provided indicates that it may also be appropriate to record an equal amount of revenue (see IAS 18.9 and 21). However, the entity should also evaluate the extent to which it is probable that the economic benefits associated with the transaction will be received (see IAS 18.20(b) and 22). If some of those benefits are considered less than probable, a corresponding amount of revenue should be deferred. Deferred revenue should be recognised as actual revenue if and when receipt becomes probable.

If some or all of the deferred revenue is not received, the adjustment should be offset against the corresponding reduction in the carrying value of the financial asset.

**Project update**
The IASB and FASB (the Boards) have been working together on a joint project to clarify the principles for recognising revenue and to develop a converged revenue standard. A revised exposure draft was published in November 2011. Consistent with the prior proposal, the guidance in the revised exposure draft would replace the current multiple sources of guidance on revenue with a single model; however, the earlier proposals had been amended to reduce disruption to established practices (eg the revised exposure draft includes additional "practical expedients" intended to
simplify application in several areas). A final standard is now predicted in the first half of 2013. The areas that may be most affected include multiple-element arrangements, revenue subject to variable (eg performance-based) payments and contracts with significant financing and contract costs. The proposed revenue recognition guidance is not considered in this Hot Topic; the Hot Topic continues to reflect the guidance in IAS 18 Revenue.

Expense or asset recognition by the entity paying commission

If the paying entity recognises a financial liability at its fair value, it should recognise an equal amount as an expense unless it represents a payment for the acquisition of an asset which qualifies for recognition in accordance with IFRS.

In some cases, the entity paying commission acquires a customer contract. Customer contracts should be evaluated to determine if they meet the definition of an intangible asset in IAS 38.8 and the IAS 38 recognition criteria (for separately acquired intangible assets).

**Discussion**

**General**

In some industry sectors it is common for one entity to pay another for the introduction of new customers. Many such arrangements present no special difficulty. An example of a simple arrangement is an insurance broker that receives a single fee from an insurance provider for selling an insurance contract. Complications arise when the arrangement:

- involves future payments for services that have already been rendered; and
- when those payments are variable based on a factor that neither party controls.

Examples of this type of arrangement include:

- an investment manager engaging a financial advisor to sell units in managed funds, when the manager compensates the adviser on a 'trail commission' basis. A trail commission is an arrangement under which the adviser receives annually a stated percentage of the management fee that the investment manager earns from the investors in its funds as long as they stay invested in the fund
- a mobile phone retailer selling mobile phones to users. In conjunction with the phone sale, the customer enters into a contract with the network operator. In effect, the retailer 'signs up' a customer on behalf of the network operator. In return for the customer contract the network operator pays the retailer amounts based upon the usage made by the customer during the contract term.

The commercial intention of such arrangements is to provide an incentive to the intermediary to introduce high value customers to the service provider.

**Financial instruments and contracts for services**

This Hot Topic addresses the accounting treatment at the point the intermediary has performed its services (ie has introduced the customer). Before that point, the arrangement is for one party to provide services in exchange for cash, which fails the IAS 32.11 definition of a financial instrument. Such a contract is therefore also outside the scope of IAS 39 whilst it remains 'executory' (unless the non-financial item is readily convertible into cash and is not for own use - see IAS 39.5 and 6. This is unlikely to capture contracts for services). Once the services have been provided, the contract becomes a financial liability of one party (unless that party is able to avoid payment - see below) and a financial asset of the other.

It needs to be considered whether the party that pays the commission is able to control the contingency. This question can also be expressed as 'does that party have an unconditional right to avoid payment?' A contingent obligation to transfer cash (or another financial asset) is regarded as a financial liability unless the entity is able to control the outcome of the future events or circumstances that affect the future payments (see IAS 32.25 and IAS 32.AG8). Judgement is likely to be required to determine whether the contingency is controllable, particularly when the contingency relates to a customer of one of the parties.
In the context of the trail commission and mobile phone examples, we consider that an unconditional right to avoid making payments to the intermediary by cancelling the customer contract would amount to an ability to control the contingency (even if this is commercially unrealistic). However, this would only be the case if:

- the investment manager or network operator either has no contractual obligation to provide services to the customer or has an unconditional right to cancel that contract and
- the intermediary (mobile phone retailer or investment adviser) would not have rights of redress in this event.

We consider that an ability to 'escape' an obligation only by closing down a fund or network does not represent an unconditional right to avoid making payments.

**Consequences of financial instrument classification**

The main consequences of the arrangement meeting the definition of a financial instrument are set out in the guidance section. In summary, the main consequences will be that:

- the service provider and the intermediary will record a financial liability and a financial asset respectively
- on initial recognition, these amounts are recorded at fair value plus or minus transaction costs if applicable (IAS 39.43)
- the financial liability and financial asset need to be classified in accordance with the usual IAS 39 principles. These are not discussed in detail here. However, classification of the asset within loans and receivables has the effect that subsequent measurement is at amortised cost using the effective interest rate (IAS 39.9 and 46(a)). The financial liability will be measured on the same basis in most cases (IAS 39.47)
- fair values will usually need to be estimated based on expected cash flows, discounted at a market rate of interest
- if the measurement basis is amortised cost, interest income or expense is recognised as the discount unwinds (IAS 39.9). Changes in cash flow estimates will affect the carrying value and this is reflected in the income statement (IAS 39.AG8).

In some cases, the intermediary might 'sign up' a customer for a fixed period. However, the service provider might be committed to make further payments to the intermediary if the customer renews or extends the contract. This raises an issue as to whether the expected cash flows at inception should include expected cash flows from renewal or extension. This is an ambiguous area. However, in most cases the service provider is likely to have an absolute discretion not to renew or extend the contract with the customer. On this argument, we consider that it is acceptable for both the intermediary and the service provider to value the financial instrument based on the original contractual period. This is also likely to be a more practical approach.

**Revenue recognition**

As noted above, IAS 39 requires initial recognition at fair value of all financial instruments within its scope. Any uncertainty as to realisability will be reflected in the determination of fair value. The basic principle in IAS 18 is that revenue is measured at the fair value of the consideration received or receivable (IAS 18.9). On this basis, it seems appropriate to recognise revenue equal to the fair value of the financial asset received (ie on the same measurement basis as required in IAS 39).

However, IAS 18.20 gives further guidance on revenue recognition for the rendering of services. When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue should be recognised by reference to the stage of completion of the transaction at the reporting date. The outcome of the transaction can be estimated reliably when all the following conditions are satisfied:

- the amount of revenue can be measured reliably
- it is probable that the economic benefits associated with the transaction will flow to the entity
- the stage of completion of the transaction at the reporting date can be measured reliably
- the costs incurred for the transaction and the costs to complete the transactions can be measured reliably.
IAS 18 sets a different threshold for revenue recognition (compared to IAS 39's requirement to recognise all financial instruments at fair value). For this reason, we consider that the inclusion of a financial asset on the statement of financial position does not automatically entitle the intermediary to recognise the same amount of revenue. Revenue should be deferred to the extent that the ultimate collectability of the asset recorded is considered less than probable. The term 'probable' is not clarified further in IAS 18.

Changes in the carrying value of the financial asset
As noted above, changes in the carrying value of the financial asset resulting from changes in estimated cash flows will result in gains or losses in the income statement. Such changes will occur as customers generate greater or lower revenue than originally predicted. Our preferred treatment is that changes in the carrying value of the asset are presented as other income or expense, not as adjustments to revenue. This is because the intermediary is not providing any additional service (or reduction in service). The change in the carrying value of the asset results from the intermediary's exposure to customer behaviour rather than to any revenue-generating activity.

The counter-argument is that this arrangement requires revenue to be based on estimates and that changes in estimates are generally recorded in the same line item as the original transaction. There is support for this approach by analogy to IAS 11 Construction Contracts (IAS 11.12). We therefore consider that recording such changes within revenue is an acceptable alternative. However, IAS 18.34 is clear that credit losses (ie amounts due but uncollectible) should not be recognised as adjustments to revenue.

Expense or asset recognition by the entity paying commission
For contracts in which the service provider pays for the introduction of a customer, an evaluation should be made as to whether an intangible asset should be recorded. IAS 38 should be applied in making this determination. Because the service provider has paid an intermediary for the customer introduction, the requirements on separately acquired intangible assets (IAS 38.25 -32) should be applied.

In cases when the service provider acquires a customer contract, we consider that the conditions to record an intangible asset will often be met. This is because the contract provides a basis on which the entity can control future economic benefits (IAS 38.13). However, purchased customer information (eg a customer list) and customer relationships can also meet the recognition criteria.

The cost of an acquired intangible asset should be based on the fair value of the financial liability assumed, plus any other directly attributable costs (IAS 38.27).

If an intangible asset is recorded, it should be accounted at cost less amortisation. The IAS 38 revaluation model is also available if those assets are traded in an active market, which is expected to be rare (IAS 38.72 to 87). The cost model requires that a useful life is determined in accordance with IAS 38.88 to 96. If the intangible asset is a customer contract, the useful life should not exceed the contractual period (IAS 38.94). The intangible asset should be reviewed for impairment if indications of impairment exist (such as cancellation or lower than expected customer revenue).

Examples
Example 1 - mobile phone retailer and network operator
Mobile phone retailer A signs up three customers for network operator B on 1 Jan X11. Each customer's contract is a 12 month, non-cancellable agreement with a minimum spend of CU50/month (CU600/year). Retailer A does not provide any further services to B in relation to those customers. Operator B agrees to pay retailer A commissions of 5% of customer revenue, including any additional revenue if the customer extends the contract. However, operator B has no obligation to continue to provide services to the customers beyond the 12 month period.

Retailer A and operator B make the following estimates:
• the estimated customer revenue in each case over the 12 month contract period is CU1,200 such that estimated commissions are CU60
• the fair value of the expected commission payments from each contract is CU56 at inception (based on the discounted estimated commission of CU60)
• retailer A considers that only the minimum spend is 'probable'. Hence the 'probable' level of commission is CU30 (with a fair value of CU28).

Subsequently, over the 12 month period:

• Customer 1 spends exactly the amount predicted (CU1,200, resulting in commissions of CU60)
• Customer 2 spends only the contractual minimum (CU600, resulting in commissions of CU30)
• Customer 3 spends double the amount predicted (CU2,400, resulting in commissions of CU120).

**Analysis - Retailer A**

On 1 Jan X1 retailer A receives three financial assets from operator B. This is the case because the arrangement between A and B entitles A to receive cash. A is not required to perform any further services. Also, the customer contracts provided to operator B are non-cancellable, so B does not have an unconditional right to avoid payment. Retailer A should recognise the three financial assets at their fair value, which reflects expectations of future cash flows. At 1 Jan X1, A’s contractual entitlement relates only to the 12 month period. Although A will receive further payments if the customers extend their contracts, in this case, B is under no obligation to continue to provide service beyond the 12 month period.

Because A has determined that only the contractual minimum payments are probable, the amount of revenue recognised on 1 Jan X1 reflects only that portion of the fair value of the financial asset. (This is a somewhat artificial scenario for illustrative purposes. It is unlikely in practice that there would be such a large difference between the expected cash flows used to estimate fair value and the 'probable' cash flows used for revenue recognition purposes - especially as probable is interpreted as more likely than not).

The respective entries on 1 Jan X1 are as follows:

<table>
<thead>
<tr>
<th>Initial recognition</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial assets (56x3)</td>
<td>CU168</td>
<td></td>
</tr>
<tr>
<td>Revenue</td>
<td></td>
<td>CU84</td>
</tr>
<tr>
<td>Deferred revenue</td>
<td></td>
<td>CU84</td>
</tr>
</tbody>
</table>

As the revenue generated from customer 1 is as expected, the deferred revenue is 'released' to revenue over the course of the following 12 months and the financial asset is realised as the cash flows are received:

<table>
<thead>
<tr>
<th>Subsequent accounting - Customer 1</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>CU60</td>
<td></td>
</tr>
<tr>
<td>Financial asset</td>
<td></td>
<td>CU56</td>
</tr>
<tr>
<td>Revenue</td>
<td></td>
<td>CU28</td>
</tr>
<tr>
<td>Interest income</td>
<td></td>
<td>CU4</td>
</tr>
<tr>
<td>Deferred revenue</td>
<td></td>
<td>CU28</td>
</tr>
</tbody>
</table>
In customer 2's case, the financial asset becomes impaired. This loss is recorded in the income statement. Our preferred approach is that this is presented as an 'other expense', not a reduction in revenue. The deferred income also needs to be derecognised. This results in a gain which should also be presented outside revenue. In practice, we consider that it would be appropriate to offset the deferred revenue against the reduction in the carrying value of the asset due to impairment. (Although offsetting is not generally permitted in IFRS, in this case the derecognition of the deferred revenue does not meet the basic Conceptual Framework definition of income. The suggested approach avoids presenting 'income' in relation to the deferred revenue).

<table>
<thead>
<tr>
<th>Subsequent accounting - Customer 2</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>CU60</td>
<td></td>
</tr>
<tr>
<td>Financial asset</td>
<td></td>
<td>CU56</td>
</tr>
<tr>
<td>Interest income</td>
<td></td>
<td>CU2</td>
</tr>
<tr>
<td>Other income - derecognition of deferred revenue</td>
<td></td>
<td>CU28</td>
</tr>
<tr>
<td>Other expense - loss on financial asset*</td>
<td></td>
<td>CU28</td>
</tr>
<tr>
<td>Deferred revenue</td>
<td></td>
<td>CU28</td>
</tr>
</tbody>
</table>

* shown gross for illustrative purposes, but we suggest offsetting these amounts in the income statement

Customer 3's revenue exceeds the original estimate. Hence, a gain is recorded as a result of re-estimation of the cash flows from the financial asset. As above, we consider it preferable that this gain is recorded as 'other income', not as revenue. The entries are as follows:

<table>
<thead>
<tr>
<th>Subsequent accounting - Customer 3</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>CU120</td>
<td></td>
</tr>
<tr>
<td>Financial asset</td>
<td></td>
<td>CU56</td>
</tr>
<tr>
<td>Revenue</td>
<td></td>
<td>CU28</td>
</tr>
<tr>
<td>Interest income</td>
<td></td>
<td>CU4</td>
</tr>
<tr>
<td>Other income - gain on financial asset</td>
<td></td>
<td>CU60</td>
</tr>
<tr>
<td>Deferred revenue</td>
<td></td>
<td>CU28</td>
</tr>
</tbody>
</table>

Network operator B

Operator B has a financial liability to pay A in exchange for the three customer contracts. The contracts provide legally enforceable rights and meet all the conditions to be recognised as intangible assets. These assets should be amortised over the 12 month contract period.

The respective entries on 1 Jan X1 are as follows:

<table>
<thead>
<tr>
<th>Initial recognition</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intangible assets (56x3)</td>
<td>CU168</td>
<td></td>
</tr>
<tr>
<td>Financial liabilities</td>
<td></td>
<td>CU168</td>
</tr>
</tbody>
</table>

In the first case, the payments to retailer A are as expected. The financial liability is settled and is not re-estimated. The intangible customer contract asset is amortised over the 12 month period:
For customer 2, the cash flows from the customer are less than expected, which reduces the expected payments to retailer A. This results in a decrease in the liability to A and hence a gain in the income statement. The intangible asset might become impaired, although not necessarily. This is because even the minimum contractual cash flows from the customer appear to support a recoverable amount in excess of the carrying value of the intangible asset. As a result, a timing mismatch could occur between the recognition of a gain in relation to the financial liability and the amortisation of the intangible asset.

The entries over the 12 month period are:

<table>
<thead>
<tr>
<th>Subsequent accounting - Customer 2</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td></td>
<td>CU30</td>
</tr>
<tr>
<td>Financial asset</td>
<td>CU56</td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>CU2</td>
<td></td>
</tr>
<tr>
<td>Other income - reduction in financial liability</td>
<td>CU28</td>
<td></td>
</tr>
<tr>
<td>Other expense - amortisation of intangible asset</td>
<td>CU56</td>
<td></td>
</tr>
<tr>
<td>Intangible asset</td>
<td></td>
<td>CU56</td>
</tr>
</tbody>
</table>

For customer 3, the increase in expected cash flows from the customer increases the expected cash flows payable to retailer A. This results in an increase in the liability to A and corresponding expense. The intangible asset is also worth more. However, because intangible assets are measured at cost less amortisation, this value increase is not recorded in the income statement. The operator will of course recognise higher than expected customer revenues, but timing mismatches may arise.

The entries over the 12 month period are:

<table>
<thead>
<tr>
<th>Subsequent accounting - Customer 3</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td></td>
<td>CU30</td>
</tr>
<tr>
<td>Financial asset</td>
<td>CU56</td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td>CU4</td>
<td></td>
</tr>
<tr>
<td>Other expense - increase in financial liability</td>
<td>CU60</td>
<td></td>
</tr>
<tr>
<td>Amortisation of intangible asset - income statement</td>
<td>CU56</td>
<td></td>
</tr>
<tr>
<td>Intangible asset</td>
<td></td>
<td>CU56</td>
</tr>
</tbody>
</table>

**Example 2 - trail commission**

Investment manager C engages financial advisor D to sell units in funds to the general public that C manages. C compensates D on a trail commission basis. Under this arrangement, D receives annually 5% of the management fee that C earns from the investors in its funds that were introduced by D. This continues for as long as those investors remain invested in the fund. D does not provide any additional services to C or to the investor that it originally advised.
When one of the investors redeems its units and divests from the fund C will discontinue the payment of commission to D if that investor was one that D secured.

Units in C's funds are offered to the public in general. C does not have any unilateral right or ability to refuse to allow the customers to hold units in normal circumstances.

**Analysis**
The arrangement is mostly very similar in substance to the mobile phone example. The main difference is that this is an open-ended rather than a fixed-period arrangement. Investment manager C is not able to control how long its customers stay invested in the fund and hence has a financial liability to adviser D. D has an equivalent financial asset. Because the arrangement is open-ended, the duration (and useful life of any related intangible asset recorded by C) will need to be estimated. This should be based on the time period over which the investor will stay invested in the fund. This will be a critical estimate.

**Example 3 - royalty contract**
Manufacturer E makes and sells products that incorporate patented technology owned by company F. Manufacturer E agrees to pay F a fixed royalty for every product sold.

**Analysis**
Assuming that E has no obligation to make sales of the products concerned, this arrangement does not represent an obligation to transfer cash until products are actually sold. Hence the obligation and related expense is recognised by E as sales are made. Company F recognises revenue on the same basis.
HT 2006-30 Equity accounting, fair value adjustments and impairment

Relevant IFRS
IAS 28 Investments in Associates and Joint Ventures
IAS 36 Impairment of Assets
IFRS 3 Business Combinations

Issue
This Hot Topic discusses the adjustments required on the initial acquisition of an investment in an associate, and the effect of those adjustments on the investor's share of the associate's profit or loss (including impairment charges).

Project updates
In May 2011 the IASB issued three new standards (IFRS 10 Consolidated Financial Statements, IFRS 11 Joint Arrangements, and IFRS 12 Disclosures of Interests in Other Entities) and amended two (IAS 27 Separate Financial Statements and IAS 28 Investments in Associates and Joint Ventures) – sometimes referred to as the consolidation package. IFRS 10 redefines 'control' and provides extensive new guidance on applying the revised definition. The new model applies to both traditional entities and to special purpose entities (replacing IAS 27 and SIC-12 Consolidation – Special Purpose Entities). The guidance in IFRS 10 applies only to consolidated financial statements. The requirements for separate financial statements are unchanged and remain in IAS 27. The amended version of IAS 28, now renamed IAS 28 Investments in Associates and Joint Venturers, also remains substantively unchanged from the previous version. The new guidance is effective for annual periods beginning on or after 1 January 2013. Cross-references in this Hot Topic have been updated to reflect these changes.

Guidance
An investor initially records an interest in an associate at cost (IAS 28.10). On acquisition, the investor should also determine the fair value of its share of the associate's identifiable assets, liabilities and contingent liabilities (IAS 28.32). Consequently, the investor effectively restates the associate's statement of financial position in the same way as an acquiree's statement of financial position is restated in a business combination. The investor:

- revalues to fair value assets and liabilities included in the associate's statement of financial position
- recognises at fair value intangible assets (such as brands and customer relationships) that may not be included in the associate's statement of financial position
- recognises at fair value the associate's contingent liabilities
- records adjustments to give effect to uniform accounting policies (IAS 28.36).

It should be noted that this exercise also includes accounting for deferred taxes - IAS 12.19. The difference between the cost of the investment and the fair value of its share of the associate's identifiable assets, liabilities and contingent liabilities is goodwill. Because the investment is recorded as a single item, goodwill and the adjustments referred to above are included within the overall net investment. However, the acquisition-date adjustments affect the investor's share of the associate's profit or loss in future periods.

In reporting results from its investments in associates, the investor needs to track the values of the assets and liabilities imputed on acquisition, in order to determine the correct adjustments for depreciation, amortisation and impairment. In some cases an impairment charge may be necessary for an asset that the associate itself has not even recognised in the associate's own financial statements.

For example:

- depreciation charges are based on the fair values of depreciable assets at the acquisition date not on the amounts recorded in the associate's own financial statements (IAS 28.32)
• intangible assets not recognised by the associate give rise to amortisation charges (unless they have an indefinite useful life). The requirements of IAS 36 on impairment also need to be applied. Hence the investor may recognise (its share of) an impairment charge even though no charge is included in the associate’s financial statements
• if the associate has recognised goodwill in its financial statements, any related impairment charge is excluded from the investor's share of the associate's profit or loss for equity accounting purposes.

These adjustments are necessary in order to ensure that the investor records the correct share of the associate’s profit or loss in accordance with IAS 28.10. After applying the equity method, the investor should also consider whether there is objective evidence of impairment of its overall net investment (IAS 28.40). Any goodwill identified at acquisition is included in the overall net investment for this purpose. In evaluating the need for any additional impairment charge, the investor:
• applies the requirements of IAS 39.58-62 to determine whether or not there is objective evidence of impairment (IAS 28.40)
• if necessary, applies the requirements of IAS 36 to quantify any impairment loss (IAS 28.42).

**Discussion**

IAS 28 requires use of the equity accounting method of investments in associates (with some very limited exceptions). In summary, the equity method involves:
• recording the investment at cost on acquisition
• subsequently adjusting the carrying value for the investor's share of profits or losses, less any distributions received (IAS 28.10).

The share of profits or losses of the associate for this purpose will not usually be directly available from the associate's separate financial statements. This is because IAS 28 requires the investor to perform steps similar to an IFRS 3 'acquisition method' for the recognition and measurement of the associate’s assets and liabilities on acquisition of its investment. In effect, equity accounting is therefore similar to accounting for a business combination (even though the investment and the subsequent share of profit or loss are presented as single items in the statement of financial position and income statement).

The acquisition method will often result in fair value adjustments to the assets and liabilities recognised by the associate. Additional identifiable intangible assets might also be recognised, in particular, internally-generated intangibles such as brands. Intangibles are recognised if they are identifiable (if they meet either the separability criterion or the contractual-legal criterion) and their fair value can be measured reliably (IFRS 3.B31). Contingent liabilities of the associate are also included at fair value if these liabilities are present obligations that arise from past events (IFRS 3.23). These assets, liabilities and contingent liabilities are subsumed into the overall carrying value of the investment for presentation purposes, but need to be identified and tracked for measurement purposes.

As explained in the guidance section, the acquisition method adjustments affect the subsequent measurement of the investor's share of the associate's profit or loss. This should be derived from the associate's financial statements, as adjusted:
• to achieve uniform accounting policies
• to reflect the future effect of the acquisition method adjustments referred to above.

One practical consequence of these requirements is that the investor may need to carry out impairment tests on certain intangibles of the associate (because the associate has not recorded them). This will require information from the associate including forward-looking information.
Example
(The following example is intended to illustrate some of the points in the Hot Topic. It is not necessarily realistic or comprehensive. For the purpose of the example, tax effects are ignored).

On 1 Jan 20X1, investor A acquires a 40% interest in entity B, for CU300,000. Entity A determines that B meets the IAS 28 definition of an associate. Entity A reports in accordance with IFRS and applies accounting policies consistent with A's. At 1 Jan 20X1, Entity B's net assets total CU540,000. Entity A applies the requirements of IFRS 3 to recognise B's identifiable assets, liabilities and contingent liabilities. The book values and adjustments are summarised in the following table:

<table>
<thead>
<tr>
<th>CU000s</th>
<th>Book value at 1 Jan 20X1</th>
<th>Fair value and other adjustments</th>
<th>Notes</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property, plant &amp; equipment (PP&amp;E)</td>
<td>300</td>
<td>100</td>
<td>(a)</td>
<td>400</td>
</tr>
<tr>
<td>Goodwill</td>
<td>40</td>
<td>(40)</td>
<td>(b)</td>
<td>-</td>
</tr>
<tr>
<td>Other intangible assets</td>
<td>-</td>
<td>150</td>
<td>(c)</td>
<td>150</td>
</tr>
<tr>
<td>Other assets &amp; liabilities</td>
<td>200</td>
<td>-</td>
<td>(d)</td>
<td>200</td>
</tr>
<tr>
<td>Contingent liability - litigation</td>
<td>-</td>
<td>(150)</td>
<td></td>
<td>(150)</td>
</tr>
<tr>
<td>Total</td>
<td>540</td>
<td>60</td>
<td></td>
<td>600</td>
</tr>
<tr>
<td>Entity A's 40% interest</td>
<td></td>
<td></td>
<td></td>
<td>240</td>
</tr>
<tr>
<td>Cost of 40% interest</td>
<td></td>
<td></td>
<td></td>
<td>300</td>
</tr>
<tr>
<td>Notional goodwill</td>
<td></td>
<td></td>
<td></td>
<td>60</td>
</tr>
</tbody>
</table>

Notes
a) Adjustment to revalue PP&E to fair value of CU400,000. The remaining useful life is assessed as 10 years, with zero residual value
b) Goodwill recognised by entity B is not an identifiable asset so is excluded from the fair value statement of financial position
c) Adjustment to recognise two brands owned by entity B: Brand X is valued at CU130,000. Brand Y is valued at CU20,000. The estimated useful life of both brands is 10 years
d) Adjustment to record at fair value a contingent liability in relation to a lawsuit filed against Entity B.

The accounting entry recorded on 1 Jan 20X1 is as follows:

<table>
<thead>
<tr>
<th>1 Jan 20X1 (CU000s)</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in associate</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>300</td>
<td>300</td>
</tr>
</tbody>
</table>

During 20X1, Entity B records a net profit of CU200,000. This figure includes:

- an impairment charge of CU40,000 in relation to the goodwill recorded in Entity B's statement of financial position
- depreciation of CU30,000 in relation to PP&E
- a charge of CU200,000 reflecting a payment to settle the lawsuit referred to in (d) above.

Also, during 20X1 Entity B's management decides to discontinue Brand Y and focus on Brand X. Entity A determines that Brand Y is fully impaired. Entity B does not make any distributions in the year.
Based on these facts, Entity A makes the following adjustments to Entity B's net profit to determine the share profit for equity accounting purposes:

<table>
<thead>
<tr>
<th>Notes</th>
<th>CU000s</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net profit as reported by Entity B</td>
<td>200</td>
</tr>
<tr>
<td>Adjustments:</td>
<td></td>
</tr>
<tr>
<td>- additional depreciation</td>
<td>(a) (10)</td>
</tr>
<tr>
<td>- reversal of B’s goodwill impairment</td>
<td>(b) 40</td>
</tr>
<tr>
<td>- amortization of Brand X</td>
<td>(c) (13)</td>
</tr>
<tr>
<td>- impairment of Brand Y</td>
<td>(d) (20)</td>
</tr>
<tr>
<td>- litigation settlement</td>
<td>(e) 150</td>
</tr>
<tr>
<td><strong>Net profit for equity accounting purposes</strong></td>
<td>347</td>
</tr>
<tr>
<td><strong>Entity A’s 40% interest</strong></td>
<td>139</td>
</tr>
</tbody>
</table>

**Notes**

a) Adjustment to record additional depreciation based on the fair value of Entity B's PP&E

b) Goodwill recognised by Entity B is excluded from the fair value statement of financial position, so the impairment charge needs to be reversed for equity accounting purposes

c) Amortisation of Brand X - CU130,000/10 years

d) Impairment charge of CU20,000 to write-off Brand Y

Entity B has recorded an expense of CU200,00 for the litigation settlement but the contingent liability was recorded at an amount of CU150,000 in the fair value statement of financial position. This contingent liability is reversed for equity accounting purposes.

Entity A records the following entry to recognise its share of Entity B’s profits:

<table>
<thead>
<tr>
<th>31 Dec 20X1 (CU000s)</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in associate</td>
<td>139</td>
<td></td>
</tr>
<tr>
<td>Income statement (share of profit of associate)</td>
<td></td>
<td>139</td>
</tr>
</tbody>
</table>

Consequently, the carrying value of the investment at 31.12.20X1 becomes CU439,000. If there is any objective evidence of impairment of this net investment amount, an impairment review should be undertaken. The goodwill identified at acquisition (CU60,000) is included in the overall net investment for this purpose.
HT 2006-32 Cost of a new building constructed on the site of a previous building

**Issue**
If an entity constructs a new building on the site of a former building, is the carrying value of the old building part of the cost of the new building?

**Guidance**
The carrying value of the old building is **not** part of the cost of the new building. Accordingly, the carrying value of the old building should be written off to the income statement when no further economic benefits are expected from its use (IAS 16.67(b)). The costs of site clearance (including demolition) should however be included in the cost of the new building (IAS 16.17(b)).

If an entity acquires land and buildings (outside of a business combination), the total acquisition cost should be allocated between the land and the buildings based on their relative fair values at the date of acquisition (IFRS 3.2(b)). If the building is demolished to make way for a replacement building, the cost allocated to the building is recorded as an expense.

However, if the land and the new building are inventory (ie development property rather than property, plant and equipment or investment property), we consider that it is permissible to include the cost of the old building in the cost of the inventory/development property.

**Discussion**
Entities may own or acquire land with one or more existing buildings, with the intention of demolishing the old building in order to construct a new building on the site. This raises a question as to whether or not the carrying value of the old building is part of the cost of the new building.

IAS 16.16 sets out that the cost of an item of property, plant and equipment comprises:
- its purchase price
- other costs directly attributable to bringing the item to the location and condition necessary for its intended use (directly attributable costs)
- if applicable, initial estimates of the cost of fulfilling obligations for site restoration and similar costs.

IAS 16.17 goes on to identify examples of directly attributable costs. IAS 16.19 identifies examples of costs that are not directly attributable. The standard does not however include any explicit guidance on whether the carrying value of a previous building (or other item of property, plant and equipment) is part of the cost of a replacement building. In our view, the previous carrying value is not a cost directly attributable to the new building. This is because:
- the carrying value of the old building represents un-depreciated costs of the old building rather than costs incurred in the construction of the new building
- we regard demolition as similar to a disposal for zero proceeds. IAS 16.67 requires property, plant and equipment to be derecognised on disposal. IAS 16.71 requires a gain or loss to be recognised on de-recognition equal to the difference between net disposal proceeds, if any, and the carrying value of the item.
This approach applies equally to an existing building and to a building acquired with the specific intention to demolish and replace. IFRS 3.2(b) explains that on acquisition of a group of assets that does not represent a business, the total cost is allocated between the assets and liabilities acquired. This principle applies to the purchase of land and buildings. IAS 16.58 also states that land and buildings are separable assets and are accounted for separately.

The specific intention of the buyer to demolish rather than use a building does not affect its fair value (IFRS 3.262). However, in many circumstances the fair value of the existing building(s) might be much less than that of the land (although this should not be presumed). This is because a rational buyer intending to construct a new building is unlikely to acquire land with a highly valuable building. In some cases, the market for the old building might also be limited. For example, industrial buildings in an area in which industrial activity is in decline might have limited value. However, the land element might have substantial value for alternative use. These and other market-based factors will affect the relative fair values and therefore the cost allocation.

This discussion also applies if the new building is investment property (ie to be held primarily for capital appreciation and/or future rentals rather than for own use). This is because the cost model of IAS 16 can also be used to determine the valuation of self-constructed investment property (IAS 16.5).

Development property (ie property intended for sale in the ordinary course of business, or in the process of construction or development for sale) is within the scope of IAS 2 rather than IAS 16. IAS 2 sets out a different recognition principle for the determination of cost. In terms of IAS 2, the cost of inventories comprises 'all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition' (IAS 2.10). This is a somewhat lower threshold than IAS 16's. For example, costs for IAS 2 purposes need not be directly attributable. Accordingly, we consider that the amount paid by a developer for a building to be demolished and replaced, or redeveloped can be treated as part of the cost of the new development property.

Example
Entity A needs a site for a new warehouse and wishes to locate the warehouse close to its existing operations. The only available land in a suitable location has an existing factory. The entity agrees to acquire the land and factory for CU900,000. Entity A obtains an appraisal of the land and factory that indicates that:

- based on recent market transactions, the estimated fair value of the land is CU900,000. This reflects prices paid for land by a variety of purchasers including purchasers intending to use the land for a purpose other than its existing use
- the factory building has a fair value of CU100,000. This reflects the fact that there is a market for industrial buildings of this type and in this location, although potential purchasers are not generally prepared to pay as much for the land element as alternative use purchasers.

Entity A demolishes the factory building and realises CU40,000 in proceeds for certain scrap materials. It also incurs demolition and site clearance costs of CU50,000. It constructs a new warehouse on the site for further costs of CU500,000.

Analysis
In this example, the land has a fair value of CU900,000 and the building CU100,000. On a relative fair value basis, 90% of the acquisition cost of CU900,000 is therefore allocated to the land (CU810,000) and 10% to the building (CU90,000). (Note - it is not unrealistic that the fair value of the land and the building, when considered separately, add up to more than the combined fair value and the total amount paid. This is because the fair value of each element will reflect the highest price that could be obtained in the market for that element if sold separately. Thus, the reference market for the two elements might be different. In this example, the fair value of the land reflects the price that a non-industrial purchaser is willing to pay and the fair value of the building reflects the price that an industrial purchaser would pay.)
On demolition of the building, the carrying value (CU90,000) less scrap proceeds (CU40,000) is recorded as a loss on disposal.

The cost of the new warehouse is CU550,000, comprising demolition and site clearance costs of CU50,000 and other directly attributable costs of CU500,000.
IFRS Hot Topics 2007
HT 2007-01 Debt factoring and invoice discounting

Relevant IFRS
IAS 39 Financial Instruments: Recognition and Measurement

Issue
This Hot Topic discusses the main issues to be addressed in determining when debt factoring transactions result in:

- de-recognition of the underlying receivables or
- continuing recognition of the receivables or
- partial de-recognition of the receivables.

The Hot Topic also provides guidance on the appropriate accounting treatment in each case.

Guidance note
In this Hot Topic the term ‘debt factoring’ is used as a general term to describe arrangements involving a transfer of rights to cash flows from trade receivables. Other terms are sometimes used to describe this type of arrangement, such as ‘invoice discounting’. Also, terminology differs from one jurisdiction to another.

The IASB published Disclosures – Transfers of Financial Assets (Amendments to IFRS 7) in October 2010 to help users of financial statements better evaluate the risk exposures relating to transfers of financial assets and promote transparency in reporting of transfer activities. The amendments were effective for annual periods beginning on or after 1 July 2011.

Project update
This Hot Topic reflects the requirements of IAS 39 Financial Instruments: Recognition and Measurement (IAS 39) and not those of IFRS 9 Financial Instruments (IFRS 9). IFRS 9 will eventually replace IAS 39 in its entirety. At this stage, IFRS 9 addresses the classification and measurement of financial assets and financial liabilities, along with derecognition. The requirements for financial liabilities and derecognition were carried forward unchanged (with the exception of some changes to the fair value option for financial liabilities to address the issue of own credit risk). On 28 November 2012, the Board issued an exposure draft proposing limited modifications to IFRS 9’s financial asset classification model to address application issues. IFRS 9 is effective for annual periods beginning on or after 1 January 2015 (early adoption permitted). Work continues on Phases 2 and 3 of the project, which address impairment and hedge accounting, respectively.

Guidance
When an entity factors its trade receivables, an analysis should be carried out to determine whether or not the receivables should be 'de-recognised' (ie removed from the entity's statement of financial position). This analysis should be based on the entire arrangement, including any guarantees or other recourse arrangements.

An unconditional sale of receivables will result in de-recognition because all the risks and rewards are transferred (IAS 39.AG39(a)). However, most factoring arrangements do not involve an unconditional sale. IAS 39's more detailed requirements on de-recognition of financial assets then need to be applied.

These requirements are set out in IAS 39.15-37 and the associated Application Guidance. The requirements are also summarised in a flowchart in IAS 39.AG36.

Most debt factoring arrangements involve transferring rights associated with more than one receivable. In these cases, the first step in analysing an arrangement for de-recognition is to determine whether the de-recognition tests should be applied to each receivable individually or to the entire portfolio. The tests should be applied to the entire portfolio when the portfolio comprises 'a group of similar assets' (IAS 39.16). In our view, a group of trade receivables is normally a group of similar assets for this purpose.
In summary, a factoring arrangement will result in de-recognition when:

- it is a 'qualifying transfer' and
- it results in substantially all the risks and rewards being transferred to the transferee.

These two issues are considered further below.

**Is the arrangement a 'qualifying transfer'?**

A debt factoring arrangement can only result in de-recognition if it qualifies as a transfer in accordance with either IAS 39.18(a) or (b) (ie if it is a 'qualifying transfer'). A transfer is a qualifying transfer if:

- the contractual rights to the cash flows are transferred or
- the contractual rights to the cash flows are retained but the entity assumes an obligation to pay them on to the transferee in a manner that meets the so-called IAS 39.19 'pass-through tests' - see below.

The IASB has indicated that a transfer of the contractual rights to the cash flows need not necessarily involve transferring legal title to the underlying assets. This 'test' will also be met if the entity transfers rights to all the cash flows, whilst retaining legal title. However, the pass-through tests should be applied to arrangements that do not involve transferring all the contractual rights to the cash flows (see IASB Update September 2006).

The IAS 39.19 'pass-through' conditions are that:

- the entity has no obligation to pay any amounts to the transferee unless it receives the cash flows from the customers
- the entity cannot sell or pledge the receivables to a third party
- the entity has to remit the cash flows it collects without material delay.

The existence of guarantees, options that allow the transferee to transfer receivables back to the entity and other recourse arrangements are likely to conflict with the condition in the first bullet point above. Such arrangements will often therefore cause the pass-through tests to be 'failed'.

If the arrangement qualifies as a transfer, an analysis should be made of the extent to which it transfers the risks and rewards to the transferee.

**Have substantially all of the risks and rewards of ownership been transferred?**

A qualifying transfer will result in de-recognition when substantially all the risks and rewards are transferred (IAS 39.20(a)). If the entity **retains** substantially all the risks and rewards, it should continue to recognise the receivables (IAS 39.20(b)).

If the entity neither transfers nor retains substantially all the risks and rewards of ownership, the entity must evaluate whether it has retained control. If it has **not** retained control, it derecognises the assets and recognises any new assets/liabilities created. If the entity retains control, it continues to recognise the assets to the extent of its continuing involvement in them (IAS 39.20(c)(ii)).

In evaluating the extent to which risks and rewards are transferred or retained, risks and rewards that are reasonably expected to be significant in practice should be considered. In a portfolio of short term receivables, the most significant risk is usually **credit risk** (ie the risk that the customer will default). Hence the outcome of an evaluation of risks and rewards will often depend on which party assumes the risk of **reasonably possible credit losses**. An arrangement that involves the transferee having full recourse to the transferor for credit losses will 'fail' the risks and rewards tests. An arrangement in which the transferee has no recourse to the transferor for credit losses will generally 'pass' the risks and rewards tests.
With longer term receivables (including receivables from customers that are expected to be slow to pay) interest rate risk and slow payment risk might also become significant. An arrangement in which the entity continues to pay interest to the transferee until the underlying debtor settles involves the transferee retaining the risk of slow payment. The significance of this risk should be evaluated in the context of the overall arrangement.

We consider that dispute risk is not generally relevant to the analysis. This is because a dispute (eg a dispute over whether the contracted for goods or services have been delivered in accordance with the customer contract) concerns the existence of the asset rather than its risks and rewards.

Control
As noted above, the 'control test' is applied only when the risks and rewards test indicates that the entity neither transfers nor retains substantially all the risks and rewards of ownership. The key determinant of control is whether or not the transferee has the practical ability to sell the receivable (IAS 39.AG42).

When the transferee has this practical ability, control is considered to be transferred. If not, control is considered to be retained. This evaluation depends on the contractual arrangements in each case. However, the transferee will generally only be in a position to sell an asset if it has legal title to that asset (assuming the asset is not traded in an active market). In some jurisdictions and arrangements, legal title to the receivables usually remains with the entity (often because the underlying debt contracts cannot be transferred without the consent of the debtors). In these cases the transferor retains control. In other jurisdictions the transfer of legal title is more straightforward and is therefore more common.

Consequences of de-recognition
If the arrangement results in de-recognition of the receivables:

• the difference between the carrying amount and the consideration received is recognised in the income statement
• in the case of assets included in the 'available-for-sale' category any gain or loss previously recorded in equity is recycled to the income statement (this will not normally apply in a debt factoring arrangement as the underlying assets are usually included in the 'loans and receivables' category)
• if the entity retains servicing obligations in respect of the assets (which is not normally the case in a debt factoring arrangement), an asset or liability should be recognised - see below (IAS 39.25).

Consequences of failing de-recognition
If the arrangement does not result in de-recognition of the receivables:

• the entity continues to recognise the receivables in its statement of financial position until settled and applies the normal IAS 39 measurement rules (including impairment reviews if applicable) (IAS 39.29)
• the proceeds received are recorded as a liability, recognised at fair value less any transaction costs incurred. The liability is subsequently measured at amortised cost using the effective interest method (IAS 39.29)
• if the transferee services the receivables, a servicing expense should be recognised as incurred.

Consequences of partial de-recognition (continuing involvement)
The IAS 39 requirements on continuing involvement accounting are particularly complex. This guidance focuses on continuing involvement in the form of a guarantee issued by the entity to the transferee as part of the factoring arrangement. A guarantee may lead to continuing involvement accounting when its effect, combined with the other terms of the arrangement, is that the transferee has assumed some but not substantially all of the risk of reasonably possible credit losses. In this case:

• the entity partially de-recognises the receivables but continues to recognise an amount to the extent of its continuing involvement (ie an ongoing exposure to the assets concerned). When continuing involvement is in the form of a guarantee or similar, the amount of this new continuing involvement asset is the lower of (i) the amount of the receivables transferred and; (ii) the guarantee amount (IAS 39.30(a))
• an associated liability is recognised. The liability equals the sum of the guarantee amount and the fair value of the guarantee (IAS 39.AG48(a))
• the fair value element of the guarantee liability is subsequently recognised in the income statement on a time proportion basis or the amount that would be recognised in accordance with IAS 37 if applicable and if higher (IAS 39.47(c) and AG48(a))
• the continuing involvement asset and corresponding amount of the guarantee liability are reduced in unison as and when the amount that could become payable under the guarantee reduces to less than the guarantee amount.

Discussion
Debt factoring and invoice discounting are widely used to provide a source of finance, to offer protection against bad debt and/or for sales ledger administration. The terms of factoring transactions differ extensively. Common features include:

• the transferor entity receives cash up front in exchange for rights to cash collected from its receivables
• legal title to the receivables might or might not be transferred (more often not)
• the rights transferred are often subject to restrictions or guarantees
• the transferee may have recourse back to the transferor. These rights can be up to a set limit, or to the full extent of non-performance
• the transferee might administer the sales ledger, undertake credit control, send invoices and statements and undertake other servicing activities
• the debtors might pay the transferee directly, pay into a designated bank account over which the transferee has some control or pay the entity
• the arrangement is often 'rolling' (ie all new invoices raised are factored until the arrangement is discontinued)
• the transferee charges interest and fees.

Under a factoring arrangement control is passed to the factor who manages all aspects of the sales ledger. Invoices might be marked as assigned and payment made to the factor (which some businesses find unattractive). In an invoice discounting arrangement, the business continues to receive customers' payments, manage its own sales ledger and credit control activities. The invoice discounter might advance (say) 80% of invoice value and remit the balance, less interest and fees, when a customer pays.

These transactions need to be analysed to determine whether or not the underlying receivables should be derecognised in accordance with IAS 39. This is important because the accounting consequences can be significant. Broadly speaking, de-recognition accounting is similar to recording a sale of the receivables. Failing to meet the de-recognition tests results in accounting for the amount advanced by the factoring entity as a financial liability.

IAS 39’s requirements on de-recognition are complex and require interpretation in a number of areas. These requirements were introduced to address sophisticated financial transactions such as securitisations but also apply to more straightforward arrangements such as debt factoring. The requirements are intended in large part to ensure that financing arrangements are not kept 'off the statement of financial position' inappropriately.

Although this is a complex area, in most factoring arrangements it is relatively straightforward to determine whether or not de-recognition is appropriate. Factoring arrangements are often referred to as 'with recourse' or 'without recourse'. In a ‘with recourse’ arrangement, all or most of the credit risk remains with the entity. Such an arrangement will almost always fail the risks and rewards tests (and possibly others). It should therefore be accounted for as a loan.

By contrast, a 'without recourse' arrangement transfers all or most of the credit risk to the factor (transferee). Such an arrangement is likely to qualify for de-recognition (subject to an evaluation of other risks that might be relevant such as slow payment risk). In substance, such an arrangement could be economically similar to a sale of the receivables in which case it is accounted for accordingly.

The continuing involvement accounting requirements of IAS 39 will rarely apply in most factoring arrangements because most arrangements result in substantially all the risks and rewards being either transferred or retained. These requirements include special rules on recording and measuring continuing involvement assets and liabilities that deviate from the normal requirements of IAS 39.
Examples

Example 1 - Invoice discounting

Entity A agrees with factoring company B to enter into an invoice discounting arrangement. Under the terms of the arrangement, the factoring company B agrees to advance to entity A 85% of the face value of receivables from specified customers, with a face value of CU100,000. Entity A will continue to manage its own sales ledger. Customers are instructed to pay the amounts owed into a bank account controlled by the factoring company B. As customers pay, factoring company B deducts its charges for fees and interest and remits the remaining amount to A. If total receipts from customers are less than CU85,000, the factoring company has no recourse to company A.

Expected credit losses from the receivables included in the arrangement are 5% of face value and losses of up to 10% are considered reasonably possible.

Analysis

It is evident with only a limited analysis that this arrangement will not result in de-recognition of the receivables. Entity A retains all significant credit risks; factoring company B is exposed to losses only if they exceed 15%, which is more than the reasonably possible amount of losses.

In this example, the arrangement may not even represent a qualifying transfer of the receivables for the purpose of IAS 39.18. This is because (i) legal ownership is not transferred to B; and (ii) the rights transferred are not equivalent to legal ownership. The IAS 39.18(a) test is therefore failed. Further, the arrangement does not involve a transfer of the cash flows from the assets, since the factoring company remits back to Entity A the amount collected less a variable amount for fees and interest charges.

It might be argued that an analysis could be undertaken on the basis of a transfer of 85% of the cash flows, as IAS 39.16(b) requires application of the de-recognition tests to part of an asset when a pro-rata share of the cash flows is transferred. However, in this case the amount ultimately retained by the factor is not a pro rata share of the cash flows.

Entity A should therefore continue to recognise the receivables until settled. The amounts advanced will be recognised as a financial liability.

Example 2 - Debt factoring with recourse

Entity C agrees with factoring company D to enter into a debt factoring arrangement. Under the terms of the arrangement, the factoring company B agrees to pay CU91,500, less a servicing charge of CU1,500 (net proceeds of CU90,000), in exchange for 100% of the cash flows from specified local currency short-term receivables. The receivables have a face value of CU100,000. Factoring company D assumes the management of the sales ledger, and the customers will be instructed to pay the amounts owed into a bank account of the factoring company. Entity C also writes a guarantee to the factoring company under which it will reimburse any credit losses in excess of CU5,000. Expected credit losses from the receivables included in the arrangement are CU5,000 and losses of up to CU15,000 are considered reasonably possible. The guarantee is estimated to have a fair value of CU500.

Immediately before the transaction, the carrying value of the receivables was CU95,000. Entity C does not discount its trade receivables on the grounds that it regards the effect of discounting as immaterial (see IAS 39.AG79).

Analysis

This is a 'qualifying transfer' for the purposes of IAS 39.18(a), since the transferee has acquired rights to 100% of the cash flows. We consider that this arrangement therefore involves a transfer of rights equivalent to legal ownership.
The next step is to consider the extent to which the overall arrangement transfers substantially all the risks and rewards of ownership to factoring company D. In this example, the receivables are short-term and denominated in local currency. The most significant risk is therefore credit risk. Slow payment risk might also be significant but the effect of the fixed fee arrangement is that the entity transfers this risk to the factoring company. The effect of the guarantee is that transferor (Entity C) retains 100% of the risk that credit losses will exceed the expected amount. The main 'reward' is that credit losses will be less than the expected amount. It could therefore be argued that Entity C has neither transferred nor retained substantially all the risks and rewards of ownership. However, given that the downside risk is in this case more than the upside and that no downside risk is transferred, on balance our view is that the arrangement does not qualify for de-recognition.

As a result, Entity C should:

- continue to recognise the receivables
- record the consideration received as a liability. In this case, the gross consideration of CU91,500 is partly for the rights to the cash flows (the 'loan element'), partly for the guarantee. It should be allocated between the two elements
- the deduction for servicing can be dealt with in two different ways. One approach is to treat this as a prepayment and write it off over the period in which services are provided. The other is to treat the CU1,500 as a transaction cost, deduct it from the initial liability amount and (in effect) recognise the expense as part of the effective interest expense. The second approach is more straightforward and is adopted in this example
- account for the loan element at amortised cost using the EIR method. The loan repayments are not known or fixed - they are equal to the receipts from the debtors. Hence the initial carrying amount of the loan and subsequent amortised cost calculations are estimated based on the expected timing and amounts of the cash flows from the receivables
- account for the guarantee in accordance with IAS 39.47(c).

At the beginning of the arrangement, Entity C records the following entries:

<table>
<thead>
<tr>
<th>Initial accounting (CU)</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>90,000</td>
<td></td>
</tr>
<tr>
<td>Financial liability</td>
<td></td>
<td>89,500</td>
</tr>
<tr>
<td>Guarantee liability</td>
<td></td>
<td>500</td>
</tr>
</tbody>
</table>

Assuming the cash flows from the receivables are exactly as expected (ie CU95,000), the loan repayments will correspond to this amount. Interest expense of CU5,500 (CU95,000 less CU89,500) will be recognised over the life of the arrangement. The guarantee liability will be amortised to zero over the same period. The entries will be:

<table>
<thead>
<tr>
<th>Subsequent accounting (CU)</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade receivables</td>
<td></td>
<td>95,000</td>
</tr>
<tr>
<td>Financial liability</td>
<td></td>
<td>89,500</td>
</tr>
<tr>
<td>Interest expense - income statement</td>
<td>5,500</td>
<td></td>
</tr>
<tr>
<td>Guarantee liability</td>
<td>500</td>
<td></td>
</tr>
<tr>
<td>Amortisation of guarantee - income statement</td>
<td>500</td>
<td></td>
</tr>
</tbody>
</table>

**Example 3 - Debt factoring without recourse**

Facts as in Example 2 except that Entity C does **not** write a guarantee to debt factoring company D.

**Analysis**

In the absence of any recourse arrangement, the substance of this transaction is straightforward sale of the receivables. The entry recorded is:
Initial accounting (CU) | Debit | Credit |
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>90,000</td>
<td></td>
</tr>
<tr>
<td>Receivables</td>
<td>95,000</td>
<td></td>
</tr>
<tr>
<td>Loss on de-recognition</td>
<td>5,000</td>
<td></td>
</tr>
</tbody>
</table>

**Example 4 - Debt factoring with partial recourse**

Facts as in Example 2 except that the guarantee is for losses in excess of CU5,000 but payments under the guarantee are also capped at CU5,000. The guarantee is estimated to have a fair value of CU500.

**Analysis**

This arrangement leaves both parties exposed to reasonably possible credit losses, since the debt factoring company is exposed to losses in excess of CU10,000 and losses of up to CU15,000 are considered reasonably possible. Entity C therefore neither transfers nor retains substantially all the risks and rewards of ownership. Continuing involvement accounting is required.

Entity C therefore:

- partially de-recognises the receivables but recognises a continuing involvement asset. In the case of a guarantee this corresponds to the amount of the consideration it could be required to repay ie the guarantee amount (CU5,000) (IAS 39.30(a))
- recognises a liability corresponding to the guarantee amount plus the fair value of the guarantee (IAS 39.AG48(a))
- recognises a gain or loss on partial de-recognition.

Initial accounting (CU) | Debit | Credit |
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>90,000</td>
<td></td>
</tr>
<tr>
<td>Receivables</td>
<td>95,000</td>
<td></td>
</tr>
<tr>
<td>Continuing involvement asset</td>
<td>5,000</td>
<td></td>
</tr>
<tr>
<td>Continuing involvement liability</td>
<td>5,000</td>
<td></td>
</tr>
<tr>
<td>Guarantee liability</td>
<td>500</td>
<td></td>
</tr>
<tr>
<td>Loss on partial de-recognition - income statement</td>
<td>5,500</td>
<td></td>
</tr>
</tbody>
</table>

Subsequently, Entity C:

- retains the continuing involvement asset and liability until the amount which it could be required to repay is reduced to less than CU5,000 (as a result of payments from the debtors, exercise of the guarantee if applicable and eventual expiry of the arrangement)
- accounts for the guarantee in accordance with IAS 39.47(c).

Assuming the cash flows from the receivables are as expected (CU95,000), Entity C's continuing involvement will be reduced to zero. The guarantee liability will be amortised to zero over the repayment period, which will need to be estimated in many cases. The entries will be:

Subsequent accounting (CU) | Debit | Credit |
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Continuing involvement asset</td>
<td></td>
<td>CU5,000</td>
</tr>
<tr>
<td>Continuing involvement liability</td>
<td>CU5,000</td>
<td></td>
</tr>
<tr>
<td>Guarantee liability</td>
<td>CU500</td>
<td></td>
</tr>
<tr>
<td>Amortisation of guarantee - income statement</td>
<td>CU500</td>
<td></td>
</tr>
</tbody>
</table>
HT 2007-02 Non-controlling interest put and call options

Relevant IFRS
IAS 32 Financial Instruments: Presentation
IAS 39 Financial Instruments: Recognition and Measurement
IFRS 3 Business Combinations

Issue
Accounting for written put and purchased call options relating to shares in a subsidiary held by non-controlling interest shareholders.

Note
Hot Topic 2007-18 Derivatives and non-controlling interest participation rates provides guidance on both put and call options and other types of derivatives over shares in a subsidiary that have the effect of transferring the risks and rewards of ownership to the controlling interest. This Hot Topic focuses on those put and call options that do not transfer such risks and rewards.

This Hot Topic:
- addresses the accounting in the consolidated financial statements of the parent entity
- applies to options that can be settled only by exchanging shares for cash or other financial assets (gross physical settlement). Options that may or will be net cash-settled are accounted for as normal derivatives, at fair value through profit or loss (IAS 32.IE13 and IE18).

Project update
In May 2012, the IFRIC published a draft interpretation for public comment entitled Put Options Written on Non-controlling Interests. This draft IFRIC would apply to a put option written by a parent on the shares of its subsidiary held by a non-controlling interest shareholder that, if exercised, obliges the parent to purchase those shares. The draft IFRIC addresses a possible conflict between IAS 32 and IFRS 10 (previously IAS 27 - see related note below regarding the 'consolidation package'). IAS 32 requires that the financial liability is subsequently measured in accordance with IAS 39 (changes in the measurement of the financial liabilities are recognised in profit or loss) while IFRS 10 requires that changes in a parent's ownership interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions (meaning no gain or loss is recognised).

The draft IFRIC proposes that changes in the measurement of the financial liability would be required to be recognised in profit or loss in accordance with IAS 39 as changes in the measurement of the liability do not change the relative interests in the subsidiary held by the parent and the non-controlling interest shareholder; therefore, writing a put option to a non-controlling interest is not an equity transaction. This is consistent with the guidance in this Hot Topic.
Project update
This Hot Topic reflects the requirements of IAS 39 Financial Instruments: Recognition and Measurement (IAS 39) and not those of IFRS 9 Financial Instruments (IFRS 9). IFRS 9 will eventually replace IAS 39 in its entirety. At this stage, IFRS 9 addresses the classification and measurement of financial assets and financial liabilities, along with derecognition. The requirements for financial liabilities and derecognition were carried forward unchanged (with the exception of some changes to the fair value option for financial liabilities to address the issue of own credit risk). On 28 November 2012, the Board issued an exposure draft proposing limited modifications to IFRS 9’s financial asset classification model to address application issues. IFRS 9 is effective for annual periods beginning on or after 1 January 2015 (early adoption permitted). Work continues on Phases 2 and 3 of the project, which address impairment and hedge accounting, respectively.

Guidance
Written put and purchased call options over shares in a subsidiary held by non-controlling interest shareholders (‘non-controlling interest put options’ and ‘non-controlling interest call options’) should be accounted for as contracts over own equity. The implications of this are discussed below.

Non-controlling interest put options
Non-controlling interest put options are contracts that contain an obligation for the parent entity to acquire its own equity instruments. Accordingly, on initial recognition, a liability is recorded for the present value of the redemption amount (IAS 32.23). The redemption amount should be estimated if it is not contractually fixed. The corresponding debit entry is to equity. In some circumstances, it may be appropriate to record the debit to the non-controlling interest component of equity - see the discussion section below.

The liability is then generally accounted for in accordance with IAS 39. This usually involves measuring the liability at amortised cost using the effective interest method (IAS 39.47). Any changes to the estimated cash flows give rise to gains or losses in the income statement (IAS 39.AG8).

When the option is exercised or lapses unexercised, the carrying amount of the liability is reclassified to equity. If the option is exercised, the entity should also account for a purchase of non-controlling interest in accordance with IFRS 10.23 which states:

"Changes in a parent's ownership interest in a subsidiary that do not result in the parent losing control of the subsidiary are equity transactions (i.e., transactions with owners in their capacity as owners)."

Project update
In May 2010 the IASB issued three new standards (IFRS 10 Consolidated Financial Statements, IFRS 11 Joint Arrangements, and IFRS 12 Disclosures of Interests in Other Entities) and amended two (IAS 27 Separate Financial Statements and IAS 28 Investments in Associates and Joint Ventures) – sometimes referred to as the consolidation package. The new standards and amendments are effective for annual periods on or after 1 January 2013. This Hot Topic has been updated for the new standards and amendments issued by the IASB as part of the consolidation package. IFRS 10 redefines ‘control’ and provides extensive new guidance on applying the revised definition. The new model applies to both traditional entities and to special purpose entities (replacing IAS 27 and SIC-12 Consolidation – Special Purpose Entities).

In October 2012, the IASB issued Investment Entities (Amendments to IFRS 10, IFRS 12 and IAS 27). The amendments provide an exception to the consolidation requirements in IFRS 10 and require investment entities to measure particular subsidiaries at fair value through profit or loss, rather than consolidate them. The amendments are effective from 1 January 2014 with early adoption permitted.
Non-controlling interest put options are often issued as part of a business combination, when the non-controlling shareholders concerned are also retained in the management of the acquired business for a period. In such situations, an assessment should be made as to whether the overall terms of the option indicate that an element of post-acquisition management compensation is included. Appendix B of IFRS 3 (IFRS 3.B54 and B.55) provides guidance on this topic.

**Project update**
The draft IFRIC interpretation would not apply to NCI puts that were accounted for as contingent consideration in accordance with the 2004 version of IFRS 3. This is because IFRS 3 (2004) sets out different accounting requirements for contingent consideration. However, this is now of very limited relevance as IFRS 3 (2008) has replaced IFRS 3 (2004) and requires contingent consideration that satisfies the definition of a financial liability to be measured at fair value.

**Non-controlling interest call options**
Non-controlling interest call options are contracts that contain a right for the parent entity to acquire its own equity instruments. Such contracts are themselves equity instruments if they meet the conditions in IAS 32.

The cost of acquiring a non-controlling interest call option that meets the definition of an equity instrument is debited to equity (IAS 32.IE15). No further accounting entries are made for changes in the option's value or on its expiry.

If the option does not meet the definition of an equity instrument it is accounted for as a normal derivative, at fair value through profit or loss.

If the option is exercised, the entity should account for a purchase of non-controlling interest as an equity transaction (IFRS 10.23).

**Discussion**
It is common for a parent entity to hold a controlling interest in a subsidiary in which there are also non-controlling interest shareholders and to enter into arrangements that:

- grant the non-controlling interest shareholders an option to sell their shares to the parent entity (a 'non-controlling interest put option') and/or
- grant the parent an option to acquire the shares held by the non-controlling interest shareholders (a 'non-controlling interest call option').

The terms of such arrangements vary extensively. Options are often entered into when the parent acquires its controlling interest (ie as part of a business combination) but are also entered into at other times. It is also quite common that the exercise price of the option is variable. For example, the exercise price might be determined using a formula linked to the profitability of the subsidiary.

The most significant question to address in deciding on the applicable accounting requirements for these options is whether or not the underlying non-controlling interest shares are 'own equity' of the parent for the purposes of IAS 32. This is significant because IAS 32 includes certain special rules for derivatives over own equity that differ from the requirements for other derivatives. This question has been the subject of debate among commentators in the past. However, IFRIC discussions appear to confirm that the IAS 32 special rules apply in the same way to non-controlling interest shares as they do to shares of the parent entity. For example, IFRIC Update November 2006 states that:

"Paragraph 23 of IAS 32 states that a parent must recognise a financial liability when it has an obligation to pay cash to purchase the non-controlling interest shares, even if the payment is conditional on the option being exercised by the holder."

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The guidance in this Hot Topic is consistent with the IFRIC's view. Consequently, our guidance is that rights or obligations to purchase non-controlling interest shares are accounted for similarly to options over the parent entity’s own shares.

Written put options over own equity are accounted for differently to most other derivatives in that they are reported at gross liability amount with a corresponding debit to equity. This ‘gross’ approach contrasts with the usual method of accounting for derivatives at their (net) fair value. The different approach stems from the fact that IFRS does not regard own shares as an asset.

It is also important to note that a written put option is not itself an equity instrument. This is because it contains an obligation to transfer cash (see IAS 32.21 and 23). The draft IFRIC discussed above confirms this view.

A purchased call option over own equity contains no obligation for the parent entity to transfer cash. Hence such a contract is capable of meeting the definition of an equity instrument. However, in many cases the terms of the option might cause it to fail the equity definition. In particular, a non-controlling interest call option can meet the definition of an equity instrument only if its terms are 'fixed for fixed' ie it can be settled only by exchanging a fixed amount of cash for a fixed number of shares (IAS 32.16). Many such options have a variable exercise price, in which case the 'fixed-for-fixed' requirement is not met.

Some of the other issues in accounting for non-controlling interest puts and calls are discussed below.

**Where does the ‘debit’ go?**

This issue is relevant only for written put options. IAS 32 is clear that the debit entry on initial recognition is to equity. However, there is no guidance on which component of equity is debited. Some commentators take the view that the non-controlling interest associated with shares subject to a written put should be derecognised when the put is written. Assuming that the put is written subsequent to the business combination, the difference between the put liability and the carrying amount of the non-controlling interest is also adjusted to equity. In effect, this approach accounts for the option as though it has already been exercised.

We regard this as an appropriate approach when the overall terms of the arrangement indicate that, in substance, the risks and rewards of ownership of the non-controlling interest shares have transferred to the parent when the put is written. This assessment will require professional judgement based on individual facts and circumstances. (See Hot Topic 2007-18 for further details.)

In cases when the risks and rewards of ownership remain with the minority shareholders, this alternative approach does not in our view reflect the true economic position. The non-controlling interest continues to exist until the option is actually exercised and we prefer that the accounting reflect this. The alternative approach also creates difficulties if the option lapses unexercised (in which case the non-controlling interest would need to be reinstated and adjustments to goodwill might need to be reversed). Our preferred view is therefore that:

- the debit is made to a component of equity other than non-controlling interest eg other reserves (with disclosure of the ‘put option reserve’ component if material)
- the non-controlling interest component of equity continues to be recognised until the put option is exercised.

**Does the value of the put or call option form part of the consideration transferred in a business combination?**

For put or call agreements written at the time the parent obtains its controlling interest (at the time of the business combination), the terms and conditions of the transaction should be carefully considered to assess whether or not the put or call option is an integral part of the business combination or is a consequential but separate transaction. (As noted in IFRS 3.51 and 3.52, there are situations where parties enter into agreements that are separate from the business combination even though they may be entered into at the same time and as part of the sale/purchase contract.)
As part of this process, an assessment should be made to determine whether the put or call option results in the transfer of the risks and rewards of ownership of the underlying shares to the acquirer (see Hot Topic 2007-18). Significant judgement may be required in this determination.

If the acquirer determines that the risks and rewards of ownership are transferred on the acquisition date, the value of the put or call option is considered to form part of the consideration transferred in the business combination as a liability assumed. No non-controlling interest is recognised for the interest subject to the put or call option.

On the other hand, if the acquirer determines that the risks and rewards of ownership remain with the non-controlling interests, the put or call option is accounted for as a stand-alone financial instrument, separate from the business combination, as described above.

In either case, the put liability will be recorded at fair value.

**Subsequent measurement of put liability**

The guidance above on subsequent measurement reflects the requirements of IAS 32 and IAS 39. Therefore:

- for a written put, measurement of the liability is (usually) at amortised cost under the effective interest method. The unwinding of the discount is therefore an income statement expense. Changes to the estimated cash flows give rise to gains or losses in accordance with IAS 39.AG8
- for a purchased call, subsequent measurement depends on the initial classification as either an equity instrument or a derivative at fair value through profit or loss.

**Examples**

**Purchased call option**

On 1 Jan X1 parent entity P enters into a business combination arrangement in which it pays:

- CU800 for 80% of the share capital of subsidiary S
- CU50 for an option, exercisable on 31 Jan X2, to acquire the remaining 20% for an additional CU200.

At the date of the transaction, P determines that the call option does not transfer the risks of ownership of the remaining 20% and so considers the option to be a separate transaction from the business combination.

The fair value of S's identifiable assets, liabilities and contingent liabilities on 1 Jan X1 is CU600. In 20X1 and 20X2, S earns and retains total profits of CU100.

In accordance with IFRS 10.23, P treats purchases of non-controlling interest as purchases of own equity.

**Analysis**

The purchased call option is on fixed for fixed terms. It therefore meets the definition of an equity instrument. Accordingly, the amount paid of CU50 should be accounted for as a purchase of own equity. No further remeasurement of the amount recorded in equity is required.
At the date of the business combination, the entries to record the combination and the call option in P's consolidated financial statements are:

**1 Jan X1**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goodwill (800 + 120 - 600)†@</td>
<td>CU320</td>
</tr>
<tr>
<td>Identifiable net assets</td>
<td>CU600</td>
</tr>
<tr>
<td>Cash (800 + 50)</td>
<td>CU850</td>
</tr>
<tr>
<td>Equity - non-controlling interests (600*20%)</td>
<td>CU120</td>
</tr>
<tr>
<td>Equity - other</td>
<td>CU50</td>
</tr>
</tbody>
</table>

† Consideration transferred in exchange for the acquiree's identifiable assets and liabilities plus the non-controlling interest (measured at their share of the identifiable net assets of the acquiree) less the fair value of the identifiable net assets of the acquiree (IFRS 3.32).

@ This assumes that the put option is not considered as contingent consideration and is treated as a stand-alone financial instrument.

Should the option lapse unexercised, no further entries are made (for the option). If the option is exercised, P should also account for a purchase of non-controlling interest as an equity transaction. The entries would be:

**1 Jan X2**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>CU140</td>
</tr>
<tr>
<td>Equity - non-controlling interests*</td>
<td>CU200</td>
</tr>
<tr>
<td>Equity - other (balancing entry)</td>
<td>CU60</td>
</tr>
</tbody>
</table>

* The opening balance of CU120 plus the minority's 20% share of S's subsequent profits of CU100

**Written put option**

Parent P holds a 70% controlling interest in subsidiary S. The remaining 30% is held by entity Z. On 1 Jan X1, P writes an option to Z which grants Z the right to sell its shares to S on 31 Dec X2 for CU1,000 plus an adjustment for any profits earned by S in 20X1 and 20X2 in excess of a target. P receives a payment of CU100 for the option.

At the inception of the option, P determines that the put option does not transfer the risks of ownership of the non-controlling interest.

The applicable discount rate for the put liability is determined to be 6%.

On 1 Jan X1 P estimates that the expected amount payable under the put (assuming exercise) is CU1,000. However, in 20X1 profits improve and S re-estimates the exercise price to CU1,200. This estimate remains valid for the duration of the arrangement.

On 31 Dec X2 the non-controlling interest component of equity is CU900 and the book value of S's net assets is CU3,000.

In accordance with IFRS 10.23, P treats purchases of non-controlling interest as purchases of own equity.

**Analysis**

On 1 Jan X1 the present value of the (estimated) exercise price is CU890 (CU1,000 discounted over 2 years at 6%). The respective entries in P's consolidated financial statements on 1 Jan X1 are:
On 31 Dec X1, P adjusts the carrying amount of the put liability to reflect:

- one year’s effective interest at 6% (CU53 = 6%*890)
- the change in the estimated exercise price. The revised estimate is CU1,200. At 31 Dec X1 this estimated cash flow is discounted for 1 year using the original effective interest rate. The carrying amount is therefore CU1,132. The change of estimate gives rise to a loss of CU189 (calculated as the revised carrying value less what the carrying value would have been at 31 Dec X1 based on the previous estimate).

The respective entries in P’s consolidated financial statements on 31 Dec X1 are as follows:

<table>
<thead>
<tr>
<th>31 Dec X1</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>CU53</td>
<td></td>
</tr>
<tr>
<td>Other finance cost</td>
<td></td>
<td>CU189</td>
</tr>
<tr>
<td>Financial liability - put option</td>
<td></td>
<td>CU242</td>
</tr>
</tbody>
</table>

In 20X2 P recognises a further interest charge of CU68 based on the original effective interest rate and the revised carrying amount of the liability. This increases the liability to CU1,200. If the option expires unexercised, the liability is derecognised with a corresponding credit to equity.

The respective entries in P’s consolidated financial statements on 31 Dec X2 are as follows:

<table>
<thead>
<tr>
<th>31 Dec X2 lapse of option</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>CU68</td>
<td></td>
</tr>
<tr>
<td>Financial liability - put option</td>
<td></td>
<td>CU68</td>
</tr>
<tr>
<td>Financial liability - put option</td>
<td>CU1,200</td>
<td></td>
</tr>
<tr>
<td>Equity</td>
<td></td>
<td>CU1,200</td>
</tr>
</tbody>
</table>

If the option is exercised, entries are required in 20X2 to:

- recognise the interest expense (as above)
- reclassify the final put option carrying amount into equity (as above);
- record the cash payment of CU1,200
- the excess of the purchase price (CU1,200) over 30% of S’s net assets (CU900 = 30%*3,000) of CU300 should be adjusted to P’s equity account
- derecognise the non-controlling interest of CU900.
### 31 Dec X2 exercise of option

<table>
<thead>
<tr>
<th></th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>CU68</td>
<td></td>
</tr>
<tr>
<td>Financial liability - put option</td>
<td></td>
<td>CU68</td>
</tr>
<tr>
<td>Financial liability - put option</td>
<td>CU1,200</td>
<td></td>
</tr>
<tr>
<td>Equity (P)</td>
<td></td>
<td>CU1,200</td>
</tr>
<tr>
<td>Equity (P)</td>
<td>CU300</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td></td>
<td>CU1,200</td>
</tr>
<tr>
<td>Equity - non-controlling interest</td>
<td></td>
<td>CU900</td>
</tr>
</tbody>
</table>
HT 2007-03  Selected guidance on the application of IAS 12 Income Taxes

Relevant IFRS
IAS 12 Income Taxes

Background
Accounting for income taxes under IAS 12 Income Taxes gives rise to a number of interpretive and application issues. This is partly due to complexities and jurisdictional variations in the underlying tax legislation. Some of the complexity arises from the concepts in the Standard. Specific areas that give rise to application issues include the calculation, recognition and measurement of deferred taxes and whether deferred income taxes should be recognised in equity or in profit or loss.

This Hot Topic provides selected guidance on issues arising from the application of IAS 12. The following discussions focus on accounting for deferred income taxes. Some issues are, however, also relevant to accounting for current income taxes.

Guidance note
In November 2009, the GTI IFRS team issued the IAS 12 Guide: Deferred - a Chief Financial Officer’s guide to avoiding the pitfalls. The guide summarises the approach to calculating the deferred tax provision and also includes interpretational guidance in certain problematic areas of the deferred tax calculation. This Guide is available in the IFRS section of the GTInet website under ‘external publications’. Certain subject areas already included in the guide have been deleted from this Hot Topic.
Issues
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Scope and definition issues

It is important to determine if an amount payable to government or a tax-related grant given by government is within the scope of IAS 12. Other Standards that might apply to ‘governmental’ income and expenses include IAS 37 and IAS 20.

IAS 12.1-11 address scope and definitional issues. However, various interpretational questions and issues remain. The following sections explain:

- the definition of an income tax
- whether or not penalties and interest arising on current tax liabilities are within the scope of IAS 12
- where tax credits may overlap with the definition of government grants and fall outside the scope of IAS 12 (and IAS 20)
- how tax holidays affect accounting for income taxes under IAS 12.

Definition of an income tax

The scope of IAS 12 is limited to income taxes. These are defined in IAS 12.2 as follows:

“For the purposes of this Standard, income taxes include all domestic and foreign taxes which are based on taxable profits. Income taxes also include taxes, such as withholding taxes, which are payable by a subsidiary, associate or joint venture on distributions to the reporting entity.”

As a result, if taxes are not based on 'taxable profits', they are not within the scope of IAS 12. For example, sales or payroll taxes are not income taxes. These taxes are based on the sales an entity generates or on salaries and wages it pays to its employees.

However, with some other types of tax the question of whether the definition of an income tax is met is less clear. For example, when an entity is not taxed on the basis of its financial reporting accounting profit, the assessment basis of taxation may still be considered taxable profit. The IFRIC has acknowledged that whether a tax is within or outside the scope of IAS 12 is an area of interpretation and has pointed out in one of its agenda rejection decisions that "… the term 'taxable profit' implies a notion of a net rather than gross amount.” (IFRIC Update March 2006 and May 2009). Therefore, if a tax is based on a net income figure, (ie revenues less deductions) it will generally meet the definition of an income tax and needs to be considered in accounting for current and deferred tax under IAS 12. On the other hand, taxes levied on gross amounts (such as revenues or assets) are generally outside the scope of IAS 12.

Some taxes are assessed on different bases depending on the circumstances. For example, to secure a stable flow of tax payments to the tax authorities or for simplification, taxes may be based not only on taxable profits, but also on another amount such as sales or capital employed. In its May 2009 meeting, the IFRIC noted that IAS 12 is clear that income tax is a tax based on a measure of net profit and not on gross receipts. Where a tax may be imputed on an assessment basis that is a substitute for a net income figure, but is based on volume, revenue or some other basis that is not a net income amount, it is not within the scope of IAS 12.

Example 1

The 'Texas margin tax' in the USA is an example of a tax that depends on variable assessment bases. Broadly, this tax is imposed at 1% of a taxpayer's taxable margin, which is the lesser of:

- 70% of total revenue or
- the net margin, which is determined at total revenue less costs of goods sold.

The net margin is expected to be the lesser figure in almost all cases, with the total revenue basis used only rarely.

In our view, this tax should be accounted for under IAS 12 for the majority of entities, because most entities will be taxed on the net margin, which is a net figure. Only in exceptional cases, where an entity is continuously taxed on the percentage of revenues, would the Texas margin tax not effectively be based on a net income figure and therefore would not be accounted for under IAS 12.
Example 2
Another example of a tax that relies on variable assessment bases is the UK tonnage tax regime. In this regime the taxable amounts generated by a shipping company are determined by reference to the tonnage of qualifying ships. This assessment basis is an alternative to calculating net taxable income under the general corporation tax regime and is available to taxable entities for simplification. The UK tonnage tax and similar tax regimes, such as the Danish tonnage tax regime, are not within the scope of IAS 12 because they are based on gross tonnage and not on net profit.

Penalties and interest arising on income tax liabilities
Many tax authorities have powers to levy penalties and interest for late payment of income taxes and in the event of non-compliance with relevant tax laws etc. A question arises as to whether such tax-related penalties and interest are within the scope of IAS 12. There is no explicit reference to these charges in this Standard.

In our view, penalties and interest arising on income tax liabilities are outside the scope of IAS 12. This is because these duties are not imposed by a direct reference to an entity's taxable profit. They are a consequence of a taxable entity's failure to comply with its obligations to the tax authority and therefore should not affect the accounting for current or deferred income taxes. Penalties and interest arising on income tax liabilities should therefore be accounted for in accordance with IAS 37.

However, additional tax payments that become due after an uncertain tax position has been resolved with the relevant authority, should be accounted for in accordance with IAS 12. See Hot Topic 2006-13 Uncertain tax positions for further discussion on this issue.

Tax incentives
Some tax jurisdictions offer taxpayers special incentives in the form of credits against their taxable income or tax payable. These incentives might relate to capital expenditures, exports, or research and development expenditures (for example). There are many similarities between:

- government grants (covered by IAS 20)
- tax credits and similar tax benefits (covered by IAS 12)
- investment tax credits (excluded from the scope of IAS 12 and IAS 20).

Although IAS 12 deals with the accounting for temporary timing differences that may arise from government grants and investment tax credits, it does not deal with the methods of accounting for the receipt of such grants and credits (IAS 12.4). Consequently, a problem arises in determining how to account for certain tax incentives.

IAS 20 defines government grants as "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" (IAS 20.3). This term also encompasses assistance that is awarded by local, national or international government agencies and similar bodies that require an entity to operate in certain regions or industry sectors (SIC 10.3).

In some cases, the nature of the tax incentive falls within the definition of a government grant. However, any government assistance is outside of the scope of IAS 20 if it is provided by means of a tax deduction or by reducing income tax liabilities (IAS 20.2(b)).

A particular area of difficulty in dealing with tax incentives is the treatment of 'investment tax credits' because:

- such credits are scoped out of both IAS 12 and IAS 20 (IAS 12.4 and IAS 20.2(b))
- they are not defined in IFRS, so are difficult to identify.
In our view, the IAS 12 and IAS 20 scope exclusions for investment tax credits should be interpreted quite narrowly. The substance of the arrangement should be evaluated, rather than relying solely on the terminology used in the applicable tax legislation. For example, a tax credit or grant available under local tax legislation might be referred to as an 'investment tax credit'. However, in substance the credit might simply be part of the tax base of an acquired asset. In our view, 'normal' tax allowances available on the purchase of an asset are not investment tax credits for the purposes of IAS 12, even if they are accelerated. Such allowances should be treated as part of the tax base in accordance with IAS 12. Once the deduction is provided, it should be accounted for as an unused tax credit in accordance with IAS 12 until it has been utilised by the entity.

Some other grants or credits termed investment tax credits are (or may be) recoverable in cash from the government. In our view, the IAS 20 scope exclusion for investment tax credits applies only to credits that reduce taxable income or tax liabilities. The methodology of IAS 20 should be applied to grants or credits that are or may be recoverable in some other way (see Example 3 below).

The following examples demonstrate how tax incentives may be analysed to identify whether they have the characteristics of a government grant, an investment tax credit or a more general tax credit:

**Example 3**
An example of an income tax-related government benefit seen in practice that seems to have the characteristics of an investment tax credit is an incentive scheme used by the French government to encourage investment in R&D activities (crédit d’impôt recherché). The incentive is calculated as the sum of two components:

- 45% of the increase of the current year’s R&D expenditure over the average of the two preceding years
- 5% of the current year’s R&D expenditure.

The incentive can be used to offset taxable income. If it is not utilised within 5 years, it will be paid to the entity in cash.

This incentive scheme does not exclusively reduce income taxes (since it can be settled in cash if not utilised against taxable income). Also, it is an incentive to carry out R&D activities, not an incentive to invest in a particular asset or project. In our view it should therefore be considered as a government grant, not as an investment tax credit. The crédit d’impôt recherché scheme therefore should be accounted for in accordance with IAS 20 methodology.

**Example 4**
The Belgian tax authorities permit a tax allowance referred to as a 'tax deduction for risk capital' or a so-called 'notional interest deduction'.

For accounting years ending on or after 31 December 2006, the notional interest deduction is applicable equalling a percentage (3.442% for assessment year 2007, income 2006) of the 'adjusted' equity (including retained earnings) determined in accordance with Belgian accounting law.

The notional interest deduction is deducted from the company’s taxable income. If there is insufficient taxable profit available, the deduction can be carried forward to the following accounting years, up to a maximum of 7 years. There are no other obligations or commitments, i.e. there is no specific obligation to invest in a particular type of asset or project.

In our view, this is not an investment tax credit, but a conditional deduction allowed in determining accounting profits for tax purposes. As the deduction does not relate to a specific investment, but rather to the taxable entity and its equity distribution behaviour, it should be accounted for as a general tax credit in accordance with IAS 12.

Situations that may establish an investment tax credit outside the scope of IAS 12 arise if an entity:

- receives an incremental tax allowance for maintaining a certain level of operating activities in a certain industry sector, region or with a defined number of employees or
• receives an enhanced deduction for expenditure of a particular asset or project or activity, eg a tax authority may permit a deduction of 150% of an asset’s cost. The additional 50% may be considered an investment tax credit, depending on the substance of the arrangement, eg whether the enhanced deduction is attached to the calculation of the tax base of the asset or is available separately from the recoverability or settlement of the asset.

Even in these examples, however, our preferred view is that the incentive should be accounted for by analogy to either IAS 12 or IAS 20. We also consider that accounting for ‘genuine’ investment tax credits using the flow-through method may be an acceptable policy. Under the flow-through method, an investment tax credit is recognised only in the period(s) in which it reduces income tax expense.

Whichever method is used, appropriate disclosure of management’s judgements made in selecting the policy should be given in accordance with IAS 1 (IAS 1.122).

**Tax holidays**

The term 'tax holiday' refers to circumstances where entities are subject to reduced or zero income tax rates for a limited period of time, eg to attract new investors into a tax jurisdiction. Tax holidays are sometimes conditional, for example on reaching a specified investment volume in a region or country.

Tax holidays are generally for a limited period of time. Entities that benefit from tax holidays are therefore not exempt from applying IAS 12. Instead, they should incorporate the tax holiday period into the measurement of current and deferred taxes. For deferred taxes, this may require quite a detailed analysis of the fiscal periods in which temporary differences are expected to ‘reverse’ (ie affect taxable profits):

- temporary differences that are expected to reverse during the tax holiday period should be measured with the tax rate applicable as determined by the tax holiday rules. The same principle applies to unused tax losses and unused tax credits
- temporary differences, unused tax losses and unused tax credits that are expected to reverse after the tax holiday period should be measured with the tax rates applicable to those fiscal periods.

In any case, deferred taxes should only be measured with income tax rates that have been (substantively) enacted at the statement of financial position date by the relevant governmental body (IAS 12.47). In addition, if the availability of a tax holiday depends on whether or not an entity meets certain conditions, the likelihood that the conditions are met should also be considered in determining the appropriate tax rate.

**Example 5**

Company A has obtained approval from the tax authorities for a tax holiday period for four years from 20X6 to 20X9. During the tax holiday period, the entity will be subject to an income tax rate of nil percent. The tax holiday, however, can only be obtained if Company A purchases fixed assets exceeding $7 million by the end of 20X7.

In our view, the Company should assess on the 20X6 reporting date whether it is probable that it will meet the conditions determined by the tax authorities by the end of 20X7. If it is probable that the entity will meet the conditions, it should account for deferred tax on temporary differences in respect to particular assets and liabilities, but apply a tax rate of nil to the part expected to reverse during the tax holiday period. No deferred tax asset should be recognised for the tax holiday benefit itself. If it is not probable that those criteria will be met, the entity should use regular income tax rates based on the tax laws substantively enacted on the statement of financial position date. Information about the management’s judgement applied in determining the probability of meeting the conditions of the tax holiday should be disclosed in accordance with IAS 1.122.

**The initial recognition exemption**

IAS 12 requires recognition of deferred taxes for most deductible and taxable temporary differences. One important exception to this basic principle is the so-called 'initial recognition exemption'. Under this exemption, most (but not all) taxable and deductible initial recognition differences are excluded from accounting for deferred taxes if the provisions in IAS 12.15 and 24 are met.
The following paragraphs explain:

- how to identify initial recognition differences that are subject to IAS 12.15 and 24
- how to account for deferred taxes in circumstances where both initial and subsequent temporary differences exist.

In this Hot Topic, initial recognition differences that are exempted from deferred taxes in accordance with IAS 12.15 and 24 are referred to as 'qualifying initial recognition differences'.

**Qualifying initial recognition differences**

Initial recognition differences arise in circumstances where the carrying amount of an asset or a liability differs from its tax base at initial recognition. Such temporary differences are exempt from accounting for deferred taxes unless the underlying transaction:

- occurs in a business combination or
- affects either accounting profit or taxable profit of the entity (IAS 12.15(b) and 24).

If the initial recognition difference arises in a business combination, the resulting deferred tax item affects the calculation of goodwill (or any excess of the acquirer's net interest in the acquiree over the cost of the business combination).

The initial recognition of a compound financial instrument that requires the recognition of both an equity and a liability component in accordance with IAS 32, usually is not within the scope of the exemptions of IAS 12.15 or 24. If the total amount recognised for both the equity and the liability element equals the total tax base for the underlying financial instrument, any resulting initial recognition difference should be included in accounting for deferred taxes, with a corresponding gain or loss to be recognised in equity (IAS 12.23). This area is discussed in additional detail within the *IFRS 12 Guide: Deferred tax – a CFO’s guide to avoiding the pitfalls* (see GTInet.org > Assurance > IFRS > External publications). The following chart summarises the decision process to identify qualifying initial recognition differences:
However, there are some circumstances where it is not clear how the exemption should be applied. Examples of such areas include:

**Example 6**
A lessee records a finance-leased asset and a corresponding finance lease liability. On initial recognition, there is no effect on accounting profit. For tax purposes, deductions are available as the corresponding lease payments are made. Hence, future tax deductions can neither be allocated specifically to the liability nor to the leased asset. If an entity therefore determines that both the asset and the liability have a tax base of zero, this establishes initial recognition differences.

**Example 7**
If decommissioning costs of an asset that is within the scope of IAS 16 are recorded upon its initial measurement with a corresponding provision recognised in accordance with IAS 37; this also may give rise to a qualifying initial recognition difference. If future tax deductions may become available only if the cost for decommissioning of the asset is incurred in the future, this does not affect the tax base of the asset. This leads to an initial recognition difference. Any expenditure that relates to the settlement of the decommissioning liability, on the other hand, will give rise to future tax deductions, thus also resulting in an initial recognition difference (IAS 12.8).

Our preferred view is that the initial recognition exemption applies to both the assets and liabilities recorded in these examples. Hence, no deferred taxes should be recognised in respect of the above transactions. Other approaches to applying IAS 12 may also be acceptable. These may allow assessment of the existence of exempted initial recognition differences on a net basis or by allocation of possible future tax deductions to either the asset or the liability. However, in our view, entities should regard whatever the resulting initial recognition differences are as exempted in accordance with IAS 12.15(b) and 24.

The existence of qualifying initial recognition differences will lead to a reconciling item in the tax rate reconciliation as required by IAS 12.81(c). This is because the reversal of that difference will change the entity's effective tax rate in the period(s) in which the initial difference flows through into taxable profit or loss.

**Impact of tax credits relating to one-time events in interim financial statements**
A different approach to the estimated average effective annual income tax rate method described above is taken with tax benefits that relate to one-time events and to tax benefits that are more similar to a government grant. Such tax benefits are recognised in the interim period to which they relate (IAS 34.B19). Consequently, the estimated annual effective income tax rate excludes such items and is applied to the interim profit or loss excluding such one-off items.
HT 2007-07 Lease extensions and renewals

Relevant IFRS
IAS 17 Leases

Issue
How to account for lease extensions/renewals in the following situations:

- exercise of a renewal/extension option where extension period is included in the original lease term
- exercise of a renewal/extension option where extension period is not included in the original lease term
- negotiation of renewal/extension period not covered by a renewal/extension option in the original lease
- re-negotiation of a lease, including a renewal/extension period, that affects the terms and conditions during the original lease term.

Project update
The IASB and FASB (the Boards) have been working together to develop a new single approach to lease accounting that would ensure that all leases (other than short-term leases) would be recognised in the statement of financial position – i.e. no more operating or finance distinction. A revised exposure draft is expected in Q1 2013. This Hot Topic does not consider or discuss the new proposals.

Guidance
At inception of the lease, an entity considers the terms and conditions of the lease, including any renewal/extension options, to determine the appropriate classification of the lease (as an operating or finance lease) (IAS 17.4, 7-12). The lease term includes any period for which the lessee has the option to continue to lease the asset and, at inception of the lease, it is reasonably certain that it will exercise the option (IAS 17.4). The impact of exercising a renewal or extension option, or of negotiating a renewal/extension, depends on the circumstances. The requirements are summarised below:

<table>
<thead>
<tr>
<th>Summary</th>
<th>Reassess original lease classification?</th>
<th>Treatment of renewal/extension period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exercise of a renewal/extension option where extension period is included in the original lease term</td>
<td>No</td>
<td>No action needed</td>
</tr>
<tr>
<td>Exercise of a renewal/extension option where extension period is not included in the original lease term</td>
<td>No</td>
<td>See discussion below</td>
</tr>
<tr>
<td>Negotiation of renewal/extension period not covered by a renewal/extension option in the original lease</td>
<td>No</td>
<td>Treat extension period as a new lease</td>
</tr>
<tr>
<td>Re-negotiation of a lease, including a renewal/extension, that affects the terms and conditions during the original lease term</td>
<td>Yes</td>
<td>Reassess revised agreement as though revised terms were in place at inception of original lease</td>
</tr>
</tbody>
</table>

Leases are not reclassified for changes in estimates (for example, changes in the estimates of the residual life or the residual value of the leased property), or changes in circumstances (for example, default by the lessee) (IAS 17.13).

Exercise of a renewal/extension option where extension period is included in the original lease term
The exercise of a renewal/extension option that was included in the lease term at the inception of the lease does not trigger a reassessment of the lease classification. The existing accounting treatment of the lease continues without modification.
Exercise of a renewal/extension option where extension period is not included in the original lease term

The exercise of a renewal/extension option that was not included in the lease term at inception should not result in reclassification of the original lease. The accounting for the remaining part of the original lease term should continue without modification.

The renewal/extension period can be considered as a new lease agreement. Using this approach, the contractual provisions of this agreement should be evaluated to determine the appropriate classification using the criteria in IAS 17.7-12 with respect only to the renewal or extension period. This is consistent with the approach taken for reassessment of whether an arrangement contains a lease required by IFRIC 4.10(b) (see discussion below).

However, IAS 17 does not provide clear guidance on this issue. Another possible interpretation is set out in the discussion section. Whichever treatment is chosen, disclosure of the management judgements used to determine the policy should be given in accordance with IAS 1.122.

Negotiation of renewal/extension period not covered by a renewal/extension option in the original lease

The negotiation of a renewal/extension that does not include modification of any of the provisions of the original lease prior to the end of the original lease term should not result in reclassification of the original lease. The accounting for the remaining part of the original lease term should continue without modification.

The renewal/extension period is treated as a new lease agreement. The contractual provisions of this agreement should be evaluated to determine the appropriate classification using the criteria in IAS 17.7-12 with respect to the renewal or extension period.

Re-negotiation of a lease, including a renewal/extension that affects the terms and conditions during the original lease term

If the provisions of a lease are modified in a manner that affects the original lease term, then the modified agreement needs to be reassessed at the date of the modification to determine if a different classification of the lease applies. The test is whether the lease would have been classed differently if the changed terms had been in effect at the inception of the lease. If the lease is reclassified as a result of this reassessment, the revised agreement is regarded as a new agreement from the date of modification and accounted for as such, with cessation of the old agreement. No retrospective restatement should be made.

Discussion

Whether a lease is classified as a finance lease or as an operating lease depends on the substance of the transaction rather than the legal form of the contract. IAS 17.13 requires that lease classification is determined at the inception of the lease. The inception of the lease is the earlier of the date of the lease agreement and the date of commitment by the parties to the principal provisions of the lease. The lease term includes any period for which the lessee has the option to continue to lease the asset and, at inception of the lease, it is reasonably certain that it will exercise the option (IAS 17.4).

IAS 17.13 further states:

“If at any time the lessee and the lessor agree to change the provisions of the lease, other than by renewing the lease, in a manner that would have resulted in a different classification of the lease...if the changed terms had been in effect at the inception of the lease, the revised agreement is regarded as a new agreement over its term...” (Emphasis added)
Exercise of a renewal/extension option where extension period is included in the original lease term

If a renewal/extension option was included in the original provisions of the lease and at inception it was considered reasonably certain that the option would be exercised (for example if the option was at a bargain price), then the originally assessed lease term will include the extension period (IAS 17.4). Consequently, exercise of the option would not cause the classification of the lease to be reassessed. The original lease classification would continue to be applied even if the lessee subsequently determined that it no longer expects to exercise the option.

Exercise of a renewal/extension option where extension period is not included in the original lease term

If a lessee considers at inception of the lease that exercise of the option is less than reasonably certain (which is likely to be the case if the option is at fair value or at a rate that is not a bargain rate) then the lease term will exclude the renewal/extension period. If the lessee determines later that it will probably exercise the option, this would not change the classification of the initial lease. The change in intention is not a change in the provisions of the lease. Changes in estimates (for example, changes in the estimates of the residual life or the residual value of the leased property), or changes in circumstances (for example, default by the lessee), do not give rise to a new classification of a lease for accounting purposes (IAS 17.13).

Under US GAAP (ASU 840-10-35-4), the renewed or extended lease period is effectively treated as a separate agreement. Using this approach, the renewal/extension period is evaluated as a new lease under the classification criteria in IAS 17.7-12 only with respect to the renewal or extension period. This is consistent with the requirements of IFRIC 4.10, in particular IFRIC 4.10(b). The assessment of whether an arrangement contains a lease is done at the inception of the arrangement (IFRIC 4.10). A later reassessment is only done if certain conditions are met, e.g. when a renewal option is exercised, unless the term of the renewal had initially been included in the lease term in accordance with IAS 17.4. The evaluation of the renewal arrangement shall be evaluated only with respect to the renewal period (IFRIC 4.10(b)).

Unlike ASU 840-10-35-4, IAS 17.13 does not explicitly address the issue. Indeed, an alternative interpretation of IAS 17.13 is that it prohibits reassessment of lease classification except when the provisions of the lease are changed. When renewal or extension options are included in the original lease arrangement, their exercise does not amount to a change in the provisions of the lease. It is therefore possible to argue that IAS 17 requires the original lease classification to be preserved, including for the extension period. Ultimately, this is a point of interpretation. However, when clients adopt this approach we suggest that special care should be taken to ensure that the original lease classification includes a realistic assessment of the likelihood of any extension options being exercised. If an entity repeatedly asserts that it does not expect to exercise extension options in its leases and then does so, doubt will be cast on its approach to the original assessment.

Negotiation of renewal/extension period not covered by a renewal/extension option in the original lease

If there was no renewal/extension option in the original lease but the lessee negotiates a renewal/extension with the lessor, the renegotiated provisions of the lease need to be considered carefully to evaluate whether or not a reassessment of the lease classification is needed.

A renewal or extension of the arrangement that does not include modification of any of the provisions of the original lease should be evaluated only with respect to the renewal or extension period. There is no change to the provisions of the original lease and the renewal/extension agreement is treated as a separate agreement.
Re-negotiation of a lease, including a renewal/extension that affects the terms and conditions during the original lease term

Where the renegotiation involves modifying the terms of the initial lease for the remaining period prior to the renewal/extension period, then the initial lease classification needs to be reassessed in accordance with IAS 17.13. The assessment is made as if the changed terms had been in effect at the inception of the lease. The revised agreement is regarded as a new agreement over its remaining term, which includes both the remaining term of the original lease plus the renewal/extension period. Any reclassification is dealt with prospectively from the date of modification and no retrospective restatement should apply.

Examples

Example 1

Entity A has a non-cancellable lease of a machine for a 4-year period. At the inception of the lease, the lease was assessed as an operating lease. The economic life of the machine is 8 years. The lease did not contain an option to extend the term of the lease.

After 3 years, the entity applied to the leasing company to extend the lease for a further 4 years after the initial 4-year period is complete. The leasing company granted the extension on an arm’s length basis, to take effect immediately after the end of the existing lease period, without modification of the terms and conditions for the original 4-year lease period.

There is no modification of the provisions of the original lease so there is no need to re-assess the lease classification during the existing 4-year lease period. The accounting for the remaining term of the original lease term should continue without modification.

The four-year extension is assessed as a new lease agreement. Its classification is determined using the IAS 17 criteria, based on the asset at the start of the extension period and the terms of the lease as they apply to that period.

Example 2

Entity C leases a new building from Entity D. The original term of the lease was 25 years and the estimated economic life of the building is 45 years. The lease contained clauses requiring Entity C to carry out and pay for scheduled maintenance of the building. At inception the lease was classified as an operating lease. Now, after 20 years, Entity C renegotiates the lease. The maintenance clauses are removed, the rental amount lowered, and other clauses are modified, all with immediate effect. The new remaining lease term is 25 years, which is equal to the remaining estimated remaining economic life of the building.

In this case, the original terms of the initial lease are modified and so the lease classification needs to be reassessed in accordance with IAS 17.13. The reassessment is made as if the revised terms had been in effect at the inception of the original lease (ie as if the building had been leased for 45 years in the original agreement, scheduled maintenance was paid for by Entity C for the first 20 years and not thereafter, and the rental amount was at the higher amount for the first 20 years but the lower amount thereafter). The lease, as modified, would have been for 100% of the estimated economic life of the building, so the classification of the lease at inception would have been different. Therefore, the revised agreement is considered to be a new lease over its remaining term. If this new lease is determined to be a finance lease, this new classification is applied prospectively from the date of the modification; there is no prior year restatement. Entity C records the asset on its statement of financial position at the lower of its present fair value and the present value of the remaining minimum lease payments (calculated using the current interest rate, residual value, etc at the date of modification). It records a finance lease liability for the same amount.

Example 3

Entity E leases an asset from Entity F for 10 years. The lease includes an extension option under which Entity E may continue to lease the asset from Entity F for a further 5 years at a fair value rental. The asset has an economic life of 15 years. At inception, Entity E was not reasonably certain that it would exercise the option, (which is not a bargain rental option). Consequently, Entity E classifies the lease as an operating lease on the basis of a 10-year minimum lease period.
Near the end of the ninth year of the lease, Entity E serves notice to Entity F that it will exercise the option to extend the lease term for the further 5 years.

The exercise of the extension option does not change the provisions of the lease. A change in intention reflects a change in circumstances or estimates that do not trigger a reassessment of the lease classification during the original 10-year lease period. The accounting for the remaining term of the original lease term should continue without modification.

The 5-year extension can be assessed as a new lease agreement. Its classification is then determined using the normal IAS 17 criteria, based on the asset at the start of the extension period and the terms of the lease as they apply to that period.
HT 2007-08 Cash flow hedging and changes to a forecast transaction

Relevant IFRS
IAS 39 Financial Instruments: Recognition and Measurement

Issue
When an entity designates a cash flow hedge of a highly probable forecast transaction, what are the accounting consequences if:

- the timing of the transaction changes
- the transaction is no longer considered highly probable
- the transaction is no longer expected to occur
- the transaction is expected to occur only partially?

Project update
This Hot Topic reflects the requirements of IAS 39 Financial Instruments: Recognition and Measurement (IAS 39) and not those of IFRS 9 Financial Instruments (IFRS 9). IFRS 9 will eventually replace IAS 39 in its entirety. At this stage, IFRS 9 addresses the classification and measurement of financial assets and financial liabilities, along with derecognition. IFRS 9 is effective for annual periods beginning on or after 1 January 2015 (early adoption permitted). Work continues on Phases 2 and 3 of the project, which address impairment and hedge accounting, respectively.

The objective of phase 3 of the project (hedge accounting) is to improve the current hedge accounting requirements by removing certain 'bright-line' rules and making the accounting requirements more consistent with risk management practice. A Review Draft of the general hedge accounting section of IFRS 9 was published on 7 September 2012 and will remain on the IASB’s website for 90 days after which time the Board intends to finalise it. The expected effective date of the hedge accounting chapter of IFRS 9 is anticipated to be annual periods beginning on or after 1 January 2015, with early application permitted. The new requirements would, apart from a few exceptions, be applied on a prospective basis.

A revised general model should make welcomed improvements to hedge accounting, making it easier for many entities to achieve hedge accounting and reduce profit or loss volatility. Areas of major change include (but are not limited to):

- the increased eligibility of hedged items (including rules regarding hedging groups of items)
- the increased eligibility of hedging instruments
- the introduction of a 'rebalancing' mechanism to adjust the designated quantities of the hedged item or the hedged instrument of an existing hedging relationship for the purpose of maintaining a hedge ratio that complies with the hedge effectiveness requirements.

Guidance
Timing of the transaction changes
A highly probable forecast transaction continues to be eligible for cash flow hedge accounting even if the expected timing of the transaction changes. However, changes in the timing of forecast cash flows will affect the fair value of those cash flows. This is likely to reduce the effectiveness of the hedge.

Transaction is no longer considered highly probable
If the forecast transaction is no longer considered highly probable but is still expected to occur, it no longer meets the conditions for cash flow hedge accounting (IAS 39.88). From this point, future changes in the fair value of the hedging instrument are recorded directly in the income statement. However, amounts deferred in equity whilst the hedge was effective remain in equity until the forecast transaction occurs (IAS 39.101(b)).
**Transaction is no longer expected to occur**
If the forecast transaction is no longer expected to occur, amounts deferred in equity are immediately removed from equity and recognised in the income statement (IAS 39.101(c)).

**The transaction is expected to occur only partially**
A transaction might be expected to occur, or considered highly probable, only in part. For example, an entity might hedge its exposure to variability in cash flows related to a specified volume of foreign currency sales. The entity might then re-estimate its future sales and determine that only a proportion of the hedged amount is now expected and/or highly probable. In our view, if the full hedged amount is no longer considered highly probable:

- **all future changes** in the fair value of the hedging instrument should be recorded in the income statement
- **if the full hedged amount is still expected to occur**: amounts deferred in equity whilst the hedge was effective remain in equity until the forecast transaction occurs or
- **if the hedged amount is expected to occur only in part**: a proportionate amount of the gains or losses deferred in equity are removed from equity and recognised in the income statement. To the extent the transaction is still expected to occur, that proportion of the deferred gains or losses continues to be deferred in equity until the forecast transaction occurs.

**Discussion**

**General**
Cash flow hedge accounting is an accounting policy option that is available only if the strict conditions in IAS 39.71-88 (and the related Application Guidance) are met. Cash flow hedge accounting is available in respect of forecast transactions, subject to the normal designation and effectiveness requirements (see IAS 39.88(a) and (b)) and provided that the forecast transaction is:

- **highly probable**
- **presents an exposure to variations in cash flows that could ultimately affect profit or loss** (IAS 39.88(c)).

The designation of the hedge relationship is very important. In particular, the hedged transaction should be identified in sufficient detail that the occurrence (or non-occurrence) of the transaction can be objectively determined (see IAS 39.IG.F.3.10). The necessary level of detail will depend on the circumstances. For example, if an entity hedges an exposure to exchange rate movements for US Dollar (US$) sales it would be acceptable to identify the hedged transaction as 'the first US$10,000 of US$ sales in month X'. As sales are made in month X, it will be determinable whether or not they are part of the hedged transaction. It is not necessary to identify the exact items to be sold, the customers to whom the sales will be made or the exact date of the transaction. By contrast, a designation of simply 'sales of US$10,000' would be insufficiently specific. (See IAS 39.IG.F.3.10 for more guidance.) The designation should also clearly identify the hedged risk and how effectiveness will be assessed (see IAS 39.88(a) and (b)).

The mechanics of cash flow hedge accounting are set out in IAS 39.95-101. In summary, in a valid cash flow hedge:

- the portion of the fair value gain or loss on the hedging instrument that is an effective hedge is deferred in equity
- any ineffectiveness is recognised immediately in profit or loss
- when the forecast transaction occurs and results in the recognition of a **financial asset or liability**, the cumulative gain or loss shall be reclassified from equity to profit or loss as a reclassification adjustment in the same periods during which the hedged forecast cash flows affect profit or loss (IAS 39.97)
- when the forecast transaction occurs and results in the recognition of a **non-financial asset or liability**, the cumulative gain or loss is removed from equity and is either:
  - recognised in profit or loss as a reclassification adjustment when the asset or liability affects profit or loss (IAS 39.98(a)) or
  - applied as a 'basis adjustment' i.e. an increase or decrease in the initial carrying amount of the asset or liability (IAS 39.98(b)).
In a cash flow hedge, ineffectiveness arises only if the cumulative change in the fair value of the hedging instrument exceeds the change in fair value of the expected cash flows of the hedged item attributable to the hedged risk. In other words, 'under-hedging' (ie when the cumulative fair value change in the hedging instrument is less than the fair value change of the expected cash flows) does not give rise to ineffectiveness. This is an area where cash flow hedging differs from fair value hedging.

Changes to the forecast transaction
Because cash flow hedging is available for highly probable forecast transactions, the hedged transaction will not always occur as originally forecast. If an entity repeatedly designates such hedges and the transactions fail to occur, doubt will be cast on management's ability to forecast with sufficient accuracy to justify the designation.

Changes in the timing of transactions are commonplace. Such changes do not invalidate the hedging relationship but may give rise to ineffectiveness. If the ineffectiveness is so great that the hedge is no longer highly effective, hedge accounting must be discontinued (see IAS 39.88(b)).

Cash flow hedge accounting must also be discontinued if the forecast transaction is no longer considered 'highly probable'. IAS 39.101 specifies that the discontinuance is 'prospective' ie that prior period results are not restated. The detailed accounting requirements for the discontinuance then depend on whether or not the transaction is still expected to occur. Specifically:

- if the transaction is still expected to occur, IAS 39.101(b) requires that all future changes in the fair value of the hedging instrument are recorded in the income statement. Amounts deferred in equity whilst the hedge was effective remain in equity until the forecast transaction occurs.
- if the transaction is no longer expected to occur, IAS 39.101(c) requires that all future changes in the fair value of the hedging instrument are recorded in the income statement and also that amounts deferred in equity are reclassified from equity to profit or loss as a reclassification adjustment.

Assessing whether a forecast transaction is 'highly probable' and/or 'expected to occur' requires judgment based on individual facts and circumstances. Also, IAS 39 does not specify a quantitative threshold to define these terms. As a broad indicator, we suggest that 'highly probable' might be interpreted as a probability of 90% or more, and 'expected' as more likely than not (ie a probability of over 50%).

Partial occurrence of a transaction
Generally, forecast transactions should be identified in such a way that there is no ambiguity as to whether or not the transaction has occurred (see above). However, an area of difficulty arises when the hedged item is a group of similar transactions. In these cases, circumstances sometimes change such that some of the transactions in the group no longer meet the highly probable condition. If so, the hedge relationship no longer qualifies for hedge accounting. Future gains and losses on the hedging instrument must therefore be recognised in profit or loss. It is also clear that, as long as the forecast transaction is still expected to occur, the guidance in IAS 39.101(b) is applied. Accordingly, previous gains or losses deferred in equity remain there until the transaction occurs.

An issue of interpretation arises on how to treat previous gains or losses deferred in equity when the forecast transaction is expected to occur only in part. Possible approaches include:

- treating the entire transaction as no longer expected. This approach requires immediate recycling of 100% of the gains or losses deferred in equity or
- allocating the transaction into 'expected' and 'not expected' portions, with immediate recycling only to the extent of the not expected portion.

Arguably, the former approach is more rigorous. This is because the hedge designation treats the group of transactions as a single transaction. It is therefore consistent to argue that the transaction should not be allocated into portions but rather treated as a single transaction that will either occur or will not occur.
However, we consider this approach to be unnecessarily strict. We consider that the second approach is also an appropriate interpretation of IAS 39's requirements on discontinuance of a cash flow hedge. We prefer this interpretation as it is more consistent with the entity's risk management objective.

**Examples**

**Example 1 - discrete transaction no longer highly probable**

Company A, a Swiss company whose functional currency is Swiss Francs (SFR), sells specialist machinery to customers in the European Union. Sales are commonly denominated in euros (€). In January 20X0, Company A determines that it has a highly probable forecast sale of a machine for €5 million to a customer with whom negotiations are at an advanced stage (although there is no firm purchase order). The customer has indicated that it intends to place a firm order in May 20X0, for delivery in July 20X0 and payment in September 20X0. In January 20X0, Company A enters into a forward contract to sell €5 million for SFR8 million in September 20X0. It designates the forward contact as a cash flow hedge of the highly probable sale.

In May 20X0, the customer notifies Company A that, following a change in management, it is reconsidering its purchasing priorities. The customer indicates that it still expects to place an order but that a final decision will not be taken until July 20X0.

Company A’s management concludes that the transaction is no longer highly probable. However, management still expects the transaction to occur.

**Analysis**

Because the transaction is no longer highly probable, Company A discontinues hedge accounting prospectively from May 20X0. Accordingly, from May all future fair value movements in the forward contract are recognised immediately in profit or loss. Hedging gains and losses that were previously recognised in equity remain in equity until the hedged transaction occurs. If at any time the transaction is no longer expected to occur, the gains and losses deferred in equity are reclassified as a reclassification adjustment at that point and recognised in profit or loss.

**Example 2 - partial occurrence of hedged future sales**

In April 20X1, Company B (a euro functional entity that makes regular export sales denominated in US Dollars) enters into a foreign currency forward contract to sell US$10 million in exchange for euros. It decides to designate the forward contract as a hedging instrument in a cash flow hedge. The hedged item is the first US$10 million of US$ sales in September 20X1. The hedged risk is the change in fair value of the expected future cash flows due to exchange rate movements.

Sales are on average US$15 million per month. On this basis, Company B's management concludes that sales of at least US$10 million in September 20X1 are highly probable. In June 20X1, the order book indicates that September 20X1 sales are likely to be significantly less than originally expected. Management now expects sales of approximately US$8 million, of which only US$5 million is considered highly probable.

Between April and June 20X1, losses of €0.5 million were incurred on the forward contract. Up to that point, the hedge relationship was determined to be 100% effective. Accordingly, the entire €0.5 million loss was recorded in equity, in a cash flow hedging reserve.

**Analysis**

The hedge designation specifies highly probable forecasts sales of US$10 million in September 20X1. This level of sales is no longer considered highly probable. The entire hedge should therefore be discontinued prospectively. From June 20X1 all future gains and losses arising on changes in fair value of the foreign currency forward contract are recognised immediately in profit or loss.
Company B still expects sales of US$8 million in September 20X1 (80% of the sales specified in the hedge documentation). Of the €0.5 million loss recorded in equity to June 20X1, 80% or €0.4 million is therefore retained in equity. The other €0.1 million is removed from equity and recognised as an expense in the income statement. The €0.4 million is removed from equity and recognised as an expense when one of the following occurs (whichever is the sooner):

- the sales expectations reduce further or no longer expected to occur at all or
- the expected sales occur.

An alternative hedging strategy in these circumstances is to:

- at June 20X1 de-designate the original hedge relationship
- at the same time designate a new relationship. In the new hedge, the hedged item is the exchange risk associated with the first US$5 million of sales (the amount now considered highly probable). The hedging instrument is 50% of the original forward currency contract, for its remaining term to expiry.

If this strategy is used, the treatment of the loss deferred in equity under the original hedge is exactly the same ie it remains in equity to the extent the original transaction is still expected to occur, and recycled when the transaction does occur. Regarding the new hedge, IAS 39.75 permits a proportion of a derivative to be designated as a hedging instrument. It also permits a derivative to be designated as a hedging instrument at some time after its initial recognition. (It is not permitted to designate a derivative for only part of its remaining life). This strategy will enable a portion of the future gains or losses on the forward contract to be recognised in equity until the revised highly probable sales occur. It might therefore be a better solution for many entities.
HT 2007-09 Trade receivables and impairment

Relevant IFRS
IAS 39 Financial Instruments: Recognition and Measurement

Project update
This Hot Topic reflects the requirements of IAS 39 Financial Instruments: Recognition and Measurement (IAS 39) and not those of IFRS 9 Financial Instruments (IFRS 9). IFRS 9 will eventually replace IAS 39 in its entirety. At this stage, IFRS 9 addresses the classification and measurement of financial assets and financial liabilities, along with derecognition. The requirements for financial liabilities and derecognition were carried forward unchanged (with the exception of some changes to the fair value option for financial liabilities to address the issue of own credit risk). On 28 November 2012, the Board issued an exposure draft proposing limited modifications to IFRS 9’s financial asset classification model to address application issues. IFRS 9 is effective for annual periods beginning on or after 1 January 2015 (early adoption permitted). Work continues on Phases 2 and 3 of the project, which address impairment and hedge accounting, respectively. Amortised cost and impairment of financial assets is Phase 2 of the IAS 39 replacement project. The current ‘incurred loss’ model is anticipated to be replaced by an ‘expected loss’ approach. The proposals are not considered or reflected in this Hot Topic at this time.

Issue
Application of IAS 39’s impairment model to trade receivables. This Hot Topic applies only to short-term trade receivables that have no stated interest rate and that are measured at amortised cost subsequent to initial recognition. Users of this Hot Topic should also consider Hot Topic 2009-05 which discusses the effect of events after the reporting period on valuation, impairment and existence of financial assets.

Guidance note
The IASB issued IFRS 13 Fair Value Measurement (IFRS 13) in May 2011 which is effective for annual periods beginning on or after 1 January 2013 (early application permitted). IFRS 13 defines fair value, sets out in a single framework for measuring fair value and requires disclosures about fair value measurements. IFRS 13 does not determine when an asset, a liability or an entity’s own equity instrument is measured at fair value. Rather, the measurement and disclosure requirements of IFRS 13 apply when another IFRS requires or permits the item to be measured at fair value (with limited exceptions).

IFRS 13 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (ie an exit price). The definition of fair value emphasizes that fair value is a market-based measurement, not an entity-specific measurement. When measuring fair value, an entity uses the assumptions that market participants would use when pricing the asset or liability under current market conditions, including assumptions about risk.

Guidance
Initial recognition
Trade receivables should be initially recognised at fair value (IAS 39.43). The definition of fair value in IFRS 13 emphasizes that fair value is a market-based measurement, not an entity-specific measurement. When measuring fair value, an entity uses the assumptions that market participants would use when pricing the asset or liability under current market conditions, including assumptions about risk (eg the credit risk in the receivables) (IFRS 13.3). However, short-term receivables with no stated interest rate are permitted to be recognised at invoice amount if the effect of discounting is immaterial.
Project update
With the issuance of IFRS 13 *Fair Value Measurement*, the IASB deleted IAS 39.AG79 which stated in part, “…Short-term receivables and payables with no stated interest rate may be measured at the original invoice amount if the effect of discounting is immaterial.” At the time of updating this document, the IASB issued an ED *Annual Improvements to IFRSs 2010-2012* which includes proposed paragraph IFRS 13BC138A which acknowledges that the deletion of paragraph IAS 39.AG79 might be perceived as removing the ability to measure short-term receivables and payables with no stated interest rate at invoice amounts without discounting, when the effect of not discounting is immaterial. The proposed improvement clarifies that the Board did not intend to change practice in the measurement of short-term receivables and payables when it deleted paragraph IAS 39.AG79.

IAS 39 impairment model
At each reporting date, receivables should be reviewed for any objective evidence of impairment. Objective evidence of impairment might include:

- information indicating that the debtor is in significant financial difficulty (IAS 39.59(a))
- breach of contract eg a debtor not paying by the due date (IAS 39.59(b))
- information indicating that it is probable the debtor will become bankrupt or similar (IAS 39.59(c))
- downgrade in credit rating (in conjunction with other information) (IAS 39.60).

In practice, failure to pay by the due date will usually be the most common and easily identified indicator.

When evidence of impairment is identified, the amount of impairment is the difference between (i) the carrying value of the receivables; and (ii) the present value of the expected future cash flows discounted at the original effective interest rate (EIR) (IAS 39.63).
IAS 39.64 always requires **collective or portfolio** approach to impairment assessment. Further:

- an initial, **individual** review is required for items that are **individually significant** (IAS 39.64)
- in the collective assessment, items are grouped on the basis of **common credit risk characteristics** (IAS 39.AG87)
- items are removed from the collective assessment once information becomes available that specifically identifies losses on individual items (IAS 39.AG88)
- any individual items that are reviewed and found not to be impaired are then also included in the collective assessment (IAS 39.64).

The Discussion section, Example and Appendix provide additional guidance on how the IAS 39 impairment model might be applied in specific circumstances.

**Discussion**

**General**

Most businesses incur credit losses (bad debts) from time to time. The extent of credit losses varies widely depending (for example) on the credit standing of customers and entity-specific credit control practices.

IAS 39 deals with credit losses through its requirements on impairment. Its approach is often referred to as an 'incurred loss' model. Under this approach impairments are recognised only on the basis of one or more *loss events* that have occurred after initial recognition. Loss events are also referred to as **objective evidence of impairment**. An event is a loss event if there is a correlation between the event and deterioration in the expected cash flows (amount and/or timing) from the receivables.

Some entities reporting under relevant local generally accepted accounting practices have (before applying IFRS) adopted accounting policies that are not necessarily supported by objective evidence such as:

- establishing general bad debt reserves to 'cover' the risk of possible future bad debts
- alternatively, or in addition, determining bad debt reserves using a 'provision matrix' that specifies provision percentages based on the length of time receivables are overdue.

These practices are or may be inconsistent with IAS 39.

Although IAS 39's impairment model can appear complex, the degree of sophistication required in practice should reflect the significance of credit losses to an entity's business. For most commercial businesses, implementing procedures to comply with the impairment requirements should not prove unduly burdensome. However, some analysis might be required to compile and maintain the necessary data on credit loss experience.

**Bad debts and initial recognition**

The IAS 39 impairment model must be considered in conjunction with IAS 39's requirements **on initial recognition**. When an entity recognises receivables at fair value, the risk of credit losses is wholly or partly reflected in the initial carrying amount. This results from using a discount rate that reflects the credit quality of the instrument (IFRS 13.B13-14). If an entity's customers present a high level of credit risk the discount rate reflects this.

However, many entities do not discount short-term receivables (with no stated interest rate) if the effect of discounting is immaterial. Under this approach, expected credit losses are not reflected in the initial carrying value. The effect of discounting should however be assessed:

- based on the expected payment period (rather than the stated credit period)
- using a discount rate that reflects credit risk.

Although the IASB deleted the explicit language in IAS 39.AG79 upon issuing IFRS 13, the Board has since proposed an annual improvement to clarify that it did not intend to change practice in the measurement of short-term receivables and payables (see project update text box above for additional discussion).
IAS 39 does not permit an immediate impairment loss to be recorded on initial recognition. Also, the definition of the amortised cost/effective interest method states that future credit losses are not considered in estimating future cash flows (IAS 39.9). As a result of these requirements, it can appear that trade receivables are over-stated under IAS 39. This is because (i) on a portfolio basis, it may be probable that some credit losses will be incurred but (ii) in the absence of specific evidence of impairment, the receivables may be stated at invoice amounts. However this effect (if it exists at all) should not be significant. This is because:

- the effect of discounting on initial recognition is likely to be material for entities that incur very high levels of credit losses
- as soon as a receivable becomes past due, there is or may be evidence of impairment
- the collective impairment assessment of past due amounts reflects the expected cash flows from the portfolio (see below).

**Impairment assessment**
IAS 39 sets out a two-step approach to impairment. This involves:

- reviewing the receivables for any objective evidence of impairment. This review must be carried out at each reporting date (IAS 39.58)
- where such evidence exists, determining the amount of the impairment. For receivables reported at amortised cost, impairments are determined as the difference between (i) the carrying value of the receivables; and (ii) the present value of the estimated future cash flows discounted at the original effective interest rate (EIR) (IAS 39.63).

The most common type of evidence of impairment of trade receivables are set out in the Guidance section. Further possible indicators are included at IAS 39.59. Either a single or a combination of factors might cause impairment.

Consistent with the requirements on initial recognition, impaired short term receivables are not discounted if the effect is immaterial (IAS 39.AG84). In some cases, the effect of discounting might have been immaterial on initial recognition but become material because of a deterioration in the expected timing of the future cash flows. In these cases the EIR should be estimated based on a market rate for the original receivable at initial recognition.

**Individual assessment**
IAS 39 requires separate assessment of any items that are individually significant (IAS 39.64). An entity should also carry out a separate assessment of any items for which it has specific information (IAS 39.AG88). For example, an entity might receive notification that a customer has applied for protection from its creditors (‘Chapter 11’ or similar). This receivable should be assessed for impairment individually.

Eventually, specific information should become available for every impaired receivable. As a practical matter, entities might decide to treat very old balances that are no longer being pursued for payment as ‘de facto’ forgiven. These amounts are then de-recognised (ie written off).

When receivables are reviewed for impairment individually, the impairment loss (if any) is determined on a best estimate basis (IAS 39.AG86). In the context of a single item, the best estimate is usually the most likely outcome. In practice, the most likely outcome for an individual trade receivable is either that it will be paid in full or not at all.
Illustration 1
An entity has made a substantial sale to a large company and recorded a receivable of CU1m. The amount is due within 30 days. CU1m is individually significant to the entity. In accordance with IFRS 13, the receivable is recorded at the invoice amount (management estimates the market rate of interest for short-term, unsecured lending to this customer is 6%. The effect of discounting at 6% for 30 days is considered immaterial). At the year-end, the customer has not paid and the balance is 60 days past due. Management estimates that there is now a 95% probability that the amount due will be collected and a 5% risk of default. It further estimates that it will collect the outstanding amount (if paid) within 30 days.

The fact that the receivable is 60 days past due is an indicator of impairment. However, management still expects to receive 100% of the amount due based on the most likely outcome. Moreover, the effect of discounting remains immaterial. The receivable is not therefore considered impaired at the individual level, but is included in the collective assessment (see below).

Collective assessment
As noted in the Guidance section, IAS 39 usually requires a collective assessment of trade receivables in addition to any individual assessments. In carrying out the collective assessment:

- receivables should be grouped on the basis of common credit risk characteristics (IAS 39.AG87). The basis for the groupings will vary between entities. Possible bases include internal or external credit grading, geographical location and past due status
- items are removed from the collective assessment once information becomes available that specifically identifies losses on individual items (IAS 39.AG88)
- any items that have been reviewed individually and found not to be impaired are included in the collective assessment (IAS 39.64).

In a collective assessment, relevant indicators of impairment might include:

- adverse changes in payment status such as a significant deterioration in the 'ageing profile' of the portfolio (IAS 39.59(f)(i))
- economic factors such as an increase in unemployment rates, bankruptcies and/or industry conditions that correlate with default rates (IAS 39.59(f)(ii)).

The collective assessment differs from the individual assessment in that impairment losses are estimated on a portfolio basis (once there is evidence of impairment). As result an individual item that is assessed and found not to be impaired might nonetheless give rise to an impairment loss when included in the collective assessment. This requirement has proved controversial and is discussed at length in IAS 39's Basis for Conclusions (see IAS 39.BC111-117).

Formula-based or statistical methods may be used to determine impairment losses in a collective assessment (IAS 39.AG92). However, any formula should be consistent with the basic impairment model. Specifically the formula should:

- incorporate the time value of money (noting however that impaired short term receivables are not discounted if the effect is immaterial (IAS 39.AG84))
- consider the cash flows over the full remaining life of the asset(s)
- consider the age of the portfolio
- **not** create a loss on initial recognition.
For many entities the ageing profile of receivables is the most readily available evidence of potential impairment of a group of trade receivables. Entities that are able to correlate credit losses with past due status should be able to estimate future cash flows using this information. However, establishing this correlation might require quite extensive analysis. For example, an entity might wish to estimate the probability of default for receivables in a 61-120 days past due category. To achieve this it might be necessary to analyse a sample of previous ‘aged-debtors listings’ going back a number of years and determine the proportion of receivables in the 61-120 days past due category that ultimately paid or defaulted.

In some industries (such as credit card lenders and utilities supplying domestic customers) extensive historical loss credit loss experience and sophisticated credit monitoring systems are usually maintained. Such industries are also likely to experience substantial credit losses, increasing the need for comprehensive data to assess impairment. The extent of data and supporting analysis should reflect the extent of credit risk to which an entity is exposed. Assessing impairment involves judgements and estimates and it is not necessary to strive for an artificial degree of precision. Management should however review and if necessary refine its procedures and assumptions based on actual loss experience as it becomes available.

Illustration 2

An entity has a large number of customers. It performs credit checks of all new customers. Management assigns credit limits based on these checks and subsequent trading history. Stated credit terms are 30 days although the average collection time is 45 days. Credit losses are generally moderate at 1-2% of amounts invoiced. However, management has compiled historical data indicating that loss rates are: 10% once amounts become 0-30 days past due, 20% for 31-60 days, 40% for 61-120 days etc. For these past due amounts, management estimates that the payments are received on average within 30 days (taking into account only those amounts that are ultimately received). Management has also received specific information that a few customers have ceased trading or filed for creditor protection. Receivables are recorded at invoice amount on initial recognition. Management estimates that a market rate for short-term, unsecured lending to its customers is 10%.

Receivables from customers that have ceased trading or filed for creditor protection should be assessed separately. In the likely event that they are found to be impaired, these receivables are not included in the collective assessment. In the collective assessment, the inclusion of some of the receivables in the past due categories indicates impairment. Management is able to correlate credit losses with past due status. Accordingly the different past due categories can be used as the basis of grouping receivables into common credit risk characteristics. The historical loss data can also be used to estimate future cash flows and to quantify impairment losses.

The effect of discounting the impaired receivables portfolio continues to be immaterial hence no discounting is required.

Management’s loss assumptions should be monitored and refined when necessary as additional loss experience becomes available.

The flowchart in the Appendix summarises the relationship between the individual and collective impairment assessment.

Reversal of impairment losses

If the amount of an impairment loss decreases in a subsequent period, and the decrease relates to an event occurring after the impairment was recorded, the impairment loss is reversed through the income statement. The carrying amount of the receivable should not be increased above what the amortised cost would have been without the impairment loss (IAS 39.65).

In practice, this will not often be relevant for trade receivables. More commonly an impaired trade receivable will either be paid or will continue to be regarded as impaired.
Credit losses and dispute risk
For many entities, customers sometimes refuse to pay amounts invoiced due to disagreements over the goods or services supplied, invoicing errors and other types of dispute. Some entities set up credit note provisions or similar reserves to cover these situations. Non-payment due to a genuine commercial dispute is not an impairment for IAS 39 purposes. Instead, dispute risk relates to uncertainty that a valid financial asset exists in the first place (given that a financial asset arises from a contractual entitlement). Historical loss credit loss experience should therefore exclude reversals and write-offs resulting from genuine commercial disputes.

Dispute risk should, where significant, be considered in determining whether revenue and associated receivables should be recognised.

Example
Entity A is a distributor of car parts. It has a large number of customers. Customers range from large companies with strong credit standing to small businesses and individuals with limited credit history. For credit control purposes, Entity A groups its customers into three categories:

Group 1 - government and large companies
Entity A has historically experienced minimal credit losses for this group. On average, customers in this category settle their debts in approximately 45 days of invoice. However, some of these customers can be slow to pay. Management estimates that a market rate for short-term, unsecured lending to this category of customer is 4%. Because of the lack of a history of credit losses with this group, management is unable to identify any specific loss events that correlate with credit losses. Receivables from these customers are generally individually significant.

Group 2 - medium-size companies and established customers with reliable credit histories
Entity A has historically experienced credit losses of around 1-2% for this group. On average, customers in this category settle their debts in approximately 45 days of invoice. However, it is not uncommon for these customers to pay up to 60 days late. Historical experience indicates that the risk of default becomes around 5% once amounts are past due by 60 - 90 days and increases thereafter. Management estimates that a market rate for short-term, unsecured lending to this category of customer is 10%. None of the amounts are individually significant.

Group 3 receivables - small companies and individuals with limited credit histories
Entity A has historically experienced high credit losses for this group at around 5% of invoiced amounts. Margins are however sufficient to support doing business with these customers. On average, customers in this category settle their debts in approximately 90 days of invoice. Historical experience indicates that the risk of default increases to around 10% once amounts are past due. Loss rates increase further as the number of days past due increases. Management estimates that a market rate for short-term, unsecured lending to this category of customer is 25% and the effect of discounting is considered material. None of the amounts are individually significant.

Analysis
On the basis of these limited facts, the following table summarises how Entity A might design its processes for reviewing for and assessing impairment.
<table>
<thead>
<tr>
<th></th>
<th>Group 1</th>
<th>Group 2</th>
<th>Group 3</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Initial recognition</strong></td>
<td>Invoice amount (effect of discounting is immaterial)</td>
<td>Invoice amount (effect of discounting is immaterial)</td>
<td>Discounted amount, using a 25% discount rate over 90 days (discount of 5.7%, approximately equal to the expected level of credit loss at initial recognition)</td>
</tr>
<tr>
<td><strong>Items to be assessed individually</strong></td>
<td>All (since they are considered individually significant)</td>
<td>Items for which specific information is available and are found to be impaired</td>
<td>As Group 2</td>
</tr>
<tr>
<td><strong>Items to be assessed collectively</strong></td>
<td>All items assessed individually and found not to be impaired</td>
<td>Items for which no specific information is available and items for which specific information is available but found not to be impaired (unlikely in practice)</td>
<td>As Group 2</td>
</tr>
<tr>
<td><strong>Typical loss events (ie evidence of impairment)</strong></td>
<td><strong>Individual</strong> - evidence of significant financial difficulty (eg poor trading performance, media articles indicating problems), filing for creditor protection, downgrade in credit ratings</td>
<td><strong>Individual</strong> - evidence of financial difficulty, bankruptcy etc</td>
<td><strong>Individual</strong> - evidence of bankruptcy, unemployment, disappearance etc</td>
</tr>
<tr>
<td></td>
<td><strong>Collective</strong> - general and significant deterioration in past due status</td>
<td><strong>Collective</strong> - receivables become overdue by 60 days or more (note: this is an example of defining an 'impairment trigger'. The effect of excluding amounts overdue by less than 60 days will be that some impairments are not recognised. This is acceptable if the effect is immaterial).</td>
<td><strong>Collective</strong> - receivables becoming overdue (note: although a majority of customers pay beyond the due date, late payment is acceptable evidence of impairment if it correlates with historical loss experience).</td>
</tr>
<tr>
<td><strong>Assessment methodology</strong></td>
<td><strong>Individual</strong> - impairment recognised if the most likely outcome is that less than 100% will be received, based on specific facts.</td>
<td>Based on percentages of amounts in each overdue age category beyond 60 days. These percentages should be derived from historical loss rates and reviewed based on future loss experience as it emerges.</td>
<td>Based on set percentages of amounts in each overdue age category. These percentages should be derived from historical loss rates and reviewed based on future loss experience as it emerges.</td>
</tr>
<tr>
<td></td>
<td><strong>Collective</strong> - a largely judgmental assessment would be required in view of lack of history. The collective assessment may not need to be a detailed exercise given the low risk and individual review.</td>
<td>No discount is applied to the expected cash flows since the effect is considered immaterial.</td>
<td>A discount is applied based on the original EIR and the revised estimated of period to receipt.</td>
</tr>
</tbody>
</table>
Appendix

Flowchart for impairment review of portfolio of trade receivables

1. Separate individual items for which specific information has been identified
   - Specific items
   - Remaining items

2. Identify and separate any individually significant items
   - Significant items
   - Remaining items

3. Group remaining items into classes on the basis of common credit risk characteristics
   - No

4. Review each class of items for any objective evidence of impairment
   - Objective evidence of impairment?
     - Yes
     - No

5. Assess individual items for objective evidence of impairment and determine if impaired at individual level
   - Specific items impaired?
     - Yes
     - No

6. Quantify impairment (based on re-estimated cash flows for item or class of items discounted at original EIR)

7. Record impairment charge in P&L, as a separate allowance account or a deduction from receivables

8. STOP
HT 2007-11 Loans with early repayment options

Relevant IFRS
IAS 39 Financial Instruments: Recognition and Measurement

Issue
This Hot Topic provides guidance on accounting for debt instruments that include options allowing the borrower to repay the debt before the end of its full contractual term. It is written from the perspective of the borrower, although much of the guidance is equally applicable to the lender.

Project update
This Hot Topic reflects the requirements of IAS 39 Financial Instruments: Recognition and Measurement (IAS 39) and not those of IFRS 9 Financial Instruments (IFRS 9). IFRS 9 will eventually replace IAS 39 in its entirety. At this stage, IFRS 9 addresses the classification and measurement of financial assets and financial liabilities, along with derecognition. The requirements for financial liabilities and derecognition were carried forward unchanged (with the exception of some changes to the fair value option for financial liabilities to address the issue of own credit risk). As the guidance stands today, IFRS 9 removes the requirement to separate embedded derivatives from financial asset hosts. It requires a hybrid contract to be classified in its entirety at either amortized cost or fair value. On 28 November 2012, the Board issued an exposure draft proposing limited modifications to IFRS 9’s financial asset classification model to address application issues. IFRS 9 is effective for annual periods beginning on or after 1 January 2015 (early adoption permitted). Work continues on Phases 2 and 3 of the project, which address impairment and hedge accounting, respectively.

Guidance
An option allowing the borrower to repay a debt instrument before the end of its full contractual term (a prepayment option) is an embedded derivative. This embedded derivative should be accounted for separately from the underlying 'host debt' unless it is closely related (to the host debt instrument). The prepayment option is closely related if:

a) its exercise price is approximately equal to the amortised cost of the host debt at each date on which the option can be exercised; or

b) the exercise price of a prepayment option reimburses the lender for an amount up to the approximate present value of lost interest for the remaining term of the host contract (IAS 39.AG30(g)(i) and (ii)). For this purpose:

- we consider that the exercise price usually includes all the payments due as a result of exercising the option. This also includes payments that are described as 'penalty interest' or 'early repayment fee'
- the amortised cost of the host debt instrument should be determined on the basis of the expected cash flows and term excluding potential effects of the prepayment option (ie on the basis of an otherwise identical instrument that does not include the prepayment option)
- an understanding of the specific provisions of the debt instrument related to the calculation of the exercise price is necessary to assess whether the exercise price is intended to reimburse the lender for the value of the lost interest.

An alternative approach permitted in some circumstances is to designate the entire instrument at fair value through profit or loss. The 'fair value option' is available for debt with prepayment options if (i) the option could significantly modify the cash flows and (ii) it is not readily evident that the option is closely related (IAS 39.11A). Although the fair value designation removes the need to separate the embedded derivative, determining the fair value of the combined debt contract may not be straightforward (except for debt instruments traded in an active market). For example, the fair value of the instrument would need to take account of changes in the borrower's credit standing.
Prepayment option is determined to be closely related
If the prepayment option is closely related, the combined debt instrument is accounted for as a single instrument. Accordingly, and assuming the debt is measured at amortised cost using the effective interest method:

- the combined debt instrument is initially recorded at fair value (plus or minus any directly attributable transaction costs) (IAS 39.43)
- in determining the effective interest rate (EIR), the expected cash flows and expected life of the instrument are estimated taking account of the prepayment option (see IAS 39.9). Accordingly:
  - if (at inception) the option is expected to be exercised, the expected cash flows would include payments of interest and principal to the exercise date along with the exercise price of the option or
  - if the option is not expected to be exercised, the expected cash flows would include payments of interest and principal over the full contractual term
- subsequently the assessment of the likelihood of the option being exercised may change. This will affect the expected cash flows and expected life of the instrument. The change in expected cash flows and life is accounted for by discounting the revised cash flows at the original EIR. The effect on the carrying value is reported in profit or loss (IAS 39.AG8).

Prepayment option is determined not to be closely related
If the prepayment option is not closely related, the debt instrument should be split into a host contract and an embedded derivative. Each component is then accounted for separately. Assuming again that the host debt is measured at amortised cost using the effective interest method:

- the terms of the host debt instrument and prepayment option are determined consistently with the IAS 39.AG30(g) 'test' described above
- on initial recognition, the fair value of the combined instrument is split into:
  - the fair value of the host debt
  - the fair value of the prepayment option
- any directly attributable transaction costs are allocated to the host debt
- the EIR of the host debt is determined based on the expected cash flows excluding any effects of the prepayment option. Subsequently, amortised cost is measured on the same basis and using this EIR
- the carrying value of the host debt is not affected by changes in the probability of exercising the prepayment option
- the prepayment option is measured at fair value through profit and loss.

Discussion
General
Entities and individuals sometimes issue debt instruments (ie borrow money) for a fixed term but also include an option (or options) to repay early. Such prepayment options are common in mortgage products and in many commercial loans. In IAS 39 terms, these options (sometimes referred to as prepayment options) are usually embedded derivatives because if exercised they will or may modify the cash flows of the debt instrument.

Applying the concept of embedded derivatives in practice can be challenging. It is necessary to:

- determine whether or not the contract includes an embedded derivative
- determine whether or not the economic characteristics of the embedded derivative are closely related to those of the host contract
- if they are not closely related, separate the contract. This involves identifying the terms and conditions of the host component and the embedded derivative. This in turn can require judgement, since the terms of the two components are not normally stated expressly.
IAS 39.10 defines embedded derivatives as: “...a component of a hybrid (combined) instrument that also includes a non-derivative host contract - with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to a specified interest rate, financial instrument price...”

It may not seem immediately apparent that an option to repay a (say) fixed rate loan early meets this definition because: (i) the option affects cash flows only if exercised; and (ii) the cash flows of fixed rate debt do not vary with interest rates. However, in this context a variation in cash flows should be interpreted as a possible change in the fair value of expected cash flows. A fixed price option to prepay a fixed rate loan will increase in value as interest rates decline (and vice versa). Accordingly, the option’s expected cash flows vary according to interest rates in a similar way as a separate option to purchase a fixed rate debt asset at a fixed price. The application guidance to IAS 39 also makes clear that put, call or prepayment options in debt contracts are embedded derivatives (IAS 39.AG30(g)).

The 'closely related' test

IAS 39 does not contain any general principle for assessing whether or not embedded derivatives are closely related. However, IAS 39.AG30(g) includes specific 'tests' for put, call or prepayment options in debt contracts. The embedded option is closely related only if a) the exercise price is approximately equal to the amortised cost of the host debt on each exercise date or b) the exercise price of a prepayment option reimburses the lender for an amount up to the approximate present value of lost interest for the remaining term of the host contract.

The outcome of the closely related test is dependent on how the combined contract is analysed into the host and embedded derivative. Although this may seem obvious in many cases, this can be problematic. Two areas of difficulty are that:

- the fair value of the host debt at inception is not equal to the fair value of the combined contract (i.e. the loan proceeds, assuming the transaction is 'at market'). This is because the option itself has value. The Example section illustrates this point. However, for straightforward loans prepayable at the principal amount we consider that it is acceptable to analyse the host contract on the basis of the stated terms of the combined contract (see under 'straightforward situations' below)
- the treatment of some fees payable on early repayment - see discussion below under 'Valuing the Prepayment Option'.

'Approximately equal'

IAS 39 does not interpret the term 'approximately equal' as used in IAS 39.AG.30(i) to determine whether the exercise price of the prepayment option is sufficiently close to the amortised cost of the host debt or the present value of the lost interest resulting from early repayment. As a very general indication we suggest that 'within 5%' should be the upper limit for interpretation of this term. However, it is for management to make this judgement based on the specific facts and circumstances in each case. If the effect of the judgement is significant, disclosure should be provided in accordance with IAS 1.122.

'Exercise price reimburses the lender for lost interest'

Alternatively, the prepayment option is considered closely related if the exercise price reimburses the lender for an amount up to the approximate present value of lost interest for the remaining term of the host contract. This test is performed by reviewing the specific provisions of the debt instrument in relation to the formula to be used for the calculation of the exercise price. For this purpose, the lost interest is determined as the product of the principal amount prepaid multiplied by the interest rate differential. The interest rate differential is the excess of the effective interest rate of the host contract over the effective interest rate the entity would receive at the prepayment date if it reinvested the principal amount prepaid in a similar contract for the remaining term of the host contract (IAS 39.AG30(g)(ii)). As above, we suggest that 'within 5%' should be the upper limit for interpretation of the term 'approximate present value'.

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Prepayment versus extension options
Another area of interpretation is distinguishing between an option to:

- repay a loan early
- extend the term of a loan (a term extending feature).

For example, a 10 year loan with an option to repay at par after 5 years is the same economically as a 5 year loan with an option to extend for 5 years on the same terms. However, IAS 39 includes a different test of whether an embedded term extending feature is closely related to the host contract. Broadly, a term extending feature is regarded as closely related only if the interest rate is reset to approximate market rates at extension (IAS 39.AG30(c)).

Because of this different approach, a judgement needs to be made as to the substance of the embedded option. Indicators that the option is a term extending feature might include that:

- at inception, the expected outcome is that the loan will be repaid before its full term (ie it is probable that a prepayment option will be exercised or an extension option will not be exercised)
- the terms of the loan are amended in the secondary period.

In the absence of substantive indicators one way or the other, the legal form of the contract should be followed.

Straightforward situations
The closely related test should be straightforward for many types of prepayable loan. Examples of debt instruments for which it should be readily evident that the prepayment option is closely related include the following (in both cases assuming transaction costs are insignificant):

- fixed interest loan prepayable at the principal amount (plus accrued interest) - the amortised cost of the debt will always approximate the principal amount (plus accrued interest) which in turn equals the exercise price of the option
- floating rate loans prepayable at the principal amount (plus accrued interest) - although expected cash flows vary with interest rates, the effect of altering the EIR in accordance with IAS 39.AG7 is usually that the amortised cost approximates the principal amount (plus accrued interest).

With on-demand debt (such as a bank overdraft), the borrower is usually able to repay the loan before the lender demands payment. However, there is no embedded prepayment option (because the borrower has no ability to continue the loan if the lender demands immediate repayment). Similarly, there is no substantive prepayment option in a short-term trade payable.

Valuing the prepayment option
The fair value of the embedded prepayment option reacts to various contractual and economic factors. Depending on the specific facts and circumstances, the involvement of a valuation specialist should be considered to ensure a robust valuation of the option as market prices for prepayment options or similar instruments are usually not readily obtainable. However, in assessing whether separate accounting for a prepayment option may exceed materiality levels, its key value drivers should be considered. Typical factors include, but are not limited to

- the exercise price
- the interest rate of the host debt instrument
- the risk free-rate of interest, the entity's specific credit spread and their volatilities
- the contractual terms of the prepayment option, which limit its exercise
- the expected term of the option.
One of the key inputs to any valuation model used to determine the option's fair value is its exercise price, sometimes referred to as 'penalty interest' or 'early repayment fee'. Prepayment options correlate positively to any spread between the interest rate of the host debt instrument and the exercise price. Longer contractual and expected terms of the option also increase the fair value of the option, as it becomes more likely to be exercised by the entity. The probability of the prepayment option to be exercised is also sensitive to the spread between the interest rate of the host debt instrument and current market interest rates. In addition to any changes in risk-free interest rates, the entity-specific interest rate may also react to the entity's credit rating.

These features are reflected in IAS 39.AG30(g)(ii), which was inserted as part of the 2009 Annual Improvements to IFRSs. This notes that the prepayment option is closely related to the host contract if the exercise price reimburses the lender for an amount up to the approximate present value of lost interest for the remaining term of the host contract. IAS 39.AG30(g)(ii) further states that:

- Lost interest is the product of the principal amount prepaid multiplied by the interest rate differential
- Interest rate differential is the excess of the effective interest rate of the host contract over the effective interest rate the entity would receive at the prepayment date if it reinvested the principal amount prepaid in a similar contract for the remaining term of the host contract.

As the determination of whether the prepayment option is closely related to the host debt is made at inception of the contract, an entity will have to use judgement in identifying the appropriate interest rates to be used in the above calculation.

**Example**

An entity borrows CU1,000,000 from a bank on 1 January X1. Interest is charged at 10% payable annually in arrears. The loan is repayable in 5 years (on 31 December X5). The loan includes an option to prepay on 1 January each year for CU1,050,000.

The bank indicates that, without the prepayment option, it would lend at 9%. Transaction costs are insignificant.

**Step 1: determine terms of host and embedded derivative**

The combined contract can be analysed into:

- a debt host comprising the annual interest payments of CU0.1m and the repayment of principal of CU1m
- an embedded derivative comprising an option to exchange the future amounts payable under the loan for CU1.05m.

**Step 2: determine amortised cost of host debt at each exercise date**

In substance, the borrower is borrowing at 9% (not 10%). The additional interest of 1% is in substance a payment for the prepayment option. The EIR for the host debt contract is therefore 9%. The contractual payments under the loan agreement discounted at 9% have a fair value of CU1,038,897. This amount is the initial carrying value of the host debt. By implication, the embedded derivative has a fair value of CU38,897 (asset) (such that the combined fair value of the host and embedded derivative equal the fair value of the combined contract, ie CU1,000,000).

Alternatively, if the fair value of the prepayment option were known to be CU38,897, the fair value of the debt host could be determined as the sum of this and the fair value of the host. The EIR is then derived as the interest rate that discounts the future cash flows to the fair value of the debt host.
Step 3: compare the exercise price of the option with the amortised cost of the debt

This comparison is shown below.

<table>
<thead>
<tr>
<th></th>
<th>Opening amortised cost</th>
<th>Interest at 9%</th>
<th>Payments</th>
<th>Closing amortised cost</th>
<th>Exercise price of option</th>
<th>Difference %</th>
</tr>
</thead>
<tbody>
<tr>
<td>20X1</td>
<td>1,038,897</td>
<td>93,501</td>
<td>(100,000)</td>
<td>1,032,397</td>
<td>1,050,000</td>
<td>1.7%</td>
</tr>
<tr>
<td>20X2</td>
<td>1,032,397</td>
<td>92,916</td>
<td>(100,000)</td>
<td>1,025,313</td>
<td>1,050,000</td>
<td>2.4%</td>
</tr>
<tr>
<td>20X3</td>
<td>1,025,313</td>
<td>92,278</td>
<td>(100,000)</td>
<td>1,017,591</td>
<td>1,050,000</td>
<td>3.2%</td>
</tr>
<tr>
<td>20X4</td>
<td>1,017,591</td>
<td>91,583</td>
<td>(100,000)</td>
<td>1,009,174</td>
<td>1,050,000</td>
<td>4.0%</td>
</tr>
<tr>
<td>20X5</td>
<td>1,009,174</td>
<td>90,826</td>
<td>(1,100,000)</td>
<td>0</td>
<td>N/A</td>
<td></td>
</tr>
</tbody>
</table>

In this case, it is debatable whether the exercise price is 'approximately equal' to the amortised cost of the debt host at each date. The assessment should be made by management based on the entity's specific facts and circumstances (including the significance of the transaction to the entity). The accounting implications of both separating and not separating the prepayment option are discussed below.

Step 4A: account separately for the debt host and embedded option

In this case, the debt host is reported as set out above. The respective entries on initial recognition are as follows:

<table>
<thead>
<tr>
<th>1 Jan X1</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>CU1,000,000</td>
<td></td>
</tr>
<tr>
<td>Derivative asset - prepayment option</td>
<td>CU38,897</td>
<td></td>
</tr>
<tr>
<td>Loan payable</td>
<td>CU1,038,897</td>
<td></td>
</tr>
</tbody>
</table>

Subsequently, the prepayment option derivative is reported at fair value through profit or loss.

Step 4B: account for the combined contract with no separation

In this case, there is a further step to determine the expected cash flows. If management does not expect to exercise the option, the loan is reported initially at CU1,000,000 and subsequently measured at amortised cost using an EIR of 10%.

If management expects to exercise the option, the expected cash flows and life of the loan are determined on this basis. For illustrative purposes, if the option is expected to be exercised in four years, the expected cash flows, EIR and amortised cost would be as follows:

<table>
<thead>
<tr>
<th></th>
<th>Cash flows</th>
<th>Interest at 11.06%</th>
<th>Amortised cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Jan X1</td>
<td>1,000,000</td>
<td>N/A</td>
<td>1,000,000</td>
</tr>
<tr>
<td>31 Dec X1</td>
<td>(100,000)</td>
<td>110,607</td>
<td>1,010,607</td>
</tr>
<tr>
<td>31 Dec X2</td>
<td>(100,000)</td>
<td>111,780</td>
<td>1,022,387</td>
</tr>
<tr>
<td>31 Dec X3</td>
<td>(100,000)</td>
<td>113,083</td>
<td>1,035,470</td>
</tr>
<tr>
<td>31 Dec X4</td>
<td>(1,150,000)</td>
<td>114,530</td>
<td>1,050,000</td>
</tr>
<tr>
<td>EIR</td>
<td></td>
<td>11.06%</td>
<td></td>
</tr>
</tbody>
</table>

If management expectations change subsequent to initial recognition, the revised estimated cash flows are discounted at the EIR determined at inception. The effect is reported as a gain or loss in the income statement.
Note: The example above only illustrates the first test under (IAS 39.AG30(g)(i) and (ii)). As noted in the discussion section, the alternative second test is not expected to require a similar detailed calculation but rather require a review of the specific provisions of the debt instrument to determine whether the embedded derivative is closely related to the host contract. The accounting implication for the embedded derivative whether it is closely related or not will be the same as those illustrated in Steps 4A and 4B.
HT 2007-12 Acquisition by a listed 'empty' shell company

Relevant IFRS
IFRS 3 Business Combinations
IAS 27 Separate Financial Statements
IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors

Issue
Accounting for a transaction in which a substantial operating entity arranges to be acquired by a listed shell company with nominal net assets.

Project update
The IFRIC has two related topics on its current agenda:

- It is presently conducting outreach on practical difficulties encountered when applying the definition of a business and related application guidance in IFRS 3. This issue will be discussed at a future IFRIC meeting and may lead to additional or amended guidance in due course.
- Further, the IFRIC received a request to provide guidance on accounting for transactions similar to those addressed in this Hot Topic.

The latter issue was discussed at the November 2012 IFRIC meeting. The IFRIC tentatively observed that IFRS 3’s guidance on identifying the accounting acquirer and on reverse acquisitions would be applied by analogy based on the IAS 8 hierarchy. The IFRIC also tentatively decided that a reverse acquisition transaction in which the accounting acquiree is listed but not a business is a share-based payment transaction within the scope of IFRS 2 Share-based Payment. Accordingly, any excess of the fair value of shares deemed to be issued by the accounting acquirer over the fair value of the accounting acquiree’s recognisable net assets is expensed as a share-based payment for a listing.

The IFRIC tentatively decided that it was not necessary to add this issue to its agenda in light of existing IFRS requirements. This Hot Topic has not yet been updated to reflect the tentative views as the IFRIC’s process is not yet finalised. The accounting guidance in this Hot Topic is consistent with the tentative views, but without specific reference to IFRS 2. If the IFRIC’s agenda decision is finalised as proposed, entities would also need to consider relevant IFRS 2 disclosure requirements.

Guidance
A transaction in which a substantial operating entity arranges to be acquired by a listed shell company with nominal net assets should be assessed to determine:

- which entity is the acquirer for the purposes of IFRS 3
- whether or not the acquired entity (as identified for IFRS 3 purposes) is a business.

Typically in such a transaction the operating entity obtains effective operating control of the combined entities, with shareholders of the former public shell continuing only as passive investors. If so, the operating entity is the acquirer.
Further, in our view, an entity whose activities are limited to managing cash balances and filing obligations does not constitute a business. When the listed entity also holds other assets and liabilities and undertakes other activities, judgement may be required to determine whether it is a business.

A transaction in which an operating entity obtains control over another entity that is not a business is not a business combination (IFRS 3.2(b)). It is therefore outside the scope of IFRS 3, but still creates a parent-subsidiary relationship that must be accounted for under IFRS 10. We consider that such a transaction should be accounted for similarly to a reverse acquisition, but without recognising goodwill. Specifically:

- the consolidated financial statements of the legal parent (listed shell entity) are presented as a continuation of the financial statements of the private operating entity (the legal subsidiary, which is considered the accounting acquirer)
- the deemed acquisition cost (see Example section) should be allocated to the identifiable assets and liabilities of the listed shell company on the basis of their fair values at the date of purchase (see Example section)
- any excess of the deemed acquisition cost over the fair value of the assets and liabilities of the listed shell entity should be treated as a cost of obtaining a listing and recorded as an expense. In some rare situations, the total fair value of identified assets and liabilities may exceed the deemed cost. In such cases, the recognised values of the assets and liabilities would be reduced on a prorata basis to total the deemed cost (IFRS 3.2(b))
- any other transaction costs incurred should be allocated between the costs of a new issue of equity shares and the cost of the listing
- no goodwill is recognised.

When the listed entity is identified as the accounting acquiree and is also considered to be a business for IFRS 3 purposes, the normal IFRS 3 reverse acquisition principles are applied (IFRS 3.19-B27). Goodwill would then be recognised to the extent the deemed acquisition cost exceeds the fair value of the listed entity's identifiable assets and liabilities. Under this scenario, although part of the acquisition cost might (in substance) relate to the cost of obtaining a listing, this cost would be subsumed within goodwill.

**Discussion**

Private operating entities seeking a 'fast track' stock exchange listing often arrange to be acquired by a smaller listed entity. This is usually affected by the listed entity issuing shares to the private entity shareholders in exchange for their shares in the private entity. The listed entity becomes the 'legal parent' of the larger operating entity, which in turn becomes the 'legal subsidiary'. The operating entity is usually more valuable than the listed entity, and hence former shareholders of the legal subsidiary obtain more than 50% of the post-transaction shares in the legal parent.

**Identifying the acquirer**

The guidance in IFRS 10 should be used to identify the acquirer-the entity that obtains control of the acquiree (IFRS 3.7 and B13). If the guidance in IFRS 10 does not clearly indicate which of the combining entities is the acquirer, the factors in paragraphs B14-B18 are considered (IFRS 3.7 and B13).

The principles in IFRS 3.B14-18 will often indicate that the legal subsidiary is the acquirer for IFRS 3 purposes. Indicators that the legal subsidiary is the accounting acquirer include:

- the former owners of the legal subsidiary as a group retain or receive the largest portion of the voting rights in the combined entity (IFRS 3.B15(a))
- the relative size (measured, for example, assets, revenues or profit) of the legal subsidiary is significantly greater than that of the other combining entity or entities (IFRS 3.B16)
- the (former) owners or managers of the legal subsidiary dominate the composition of the governing body or senior management of the combined entity (IFRS 3.B15(c)-(d)).

**Is the acquisition a business combination?**

Having determined that the legal subsidiary is the accounting acquirer/parent, it is necessary to determine whether or not it has obtained control of (i) a business; or (ii) an entity that is not a business.
IFRS 3 Appendix A defines a business as 'an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants.'

Further, IFRS 3.B7 provides guidance in applying the definition of business, as follows:

' A business consists of inputs and processes applied to those inputs that have the ability to create 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:

a) Input: Any economic resource that creates, or has the ability to create, 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 or has the ability to create outputs. Examples include strategic management processes, operational processes and resource management processes. These processes typically are documented, but 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.'

In our view, a listed company that has divested all of its operations and whose activities are limited to managing its cash balances and filing obligations does not constitute a business since it does not have any processes or outputs. For this reason, we consider that many transactions in which a substantial operating entity arranges to be acquired by a non-operating listed shell company with nominal net assets are not business combinations. Accordingly, these transactions are outside the scope of IFRS 3 (IFRS 3.2(b)).

However, this is a matter of judgement. In other situations, a listed entity may be assessed to be a business because it holds other assets and liabilities and undertakes other activities. In such circumstances, the 'normal' reverse acquisition requirements of IFRS 3 apply and goodwill may be recognised (IFRS 3.B19-27 and IFRS 3.IE1-IE15). The remainder of this Hot Topic deals with the case where the listed shell entity is not considered to be a business.

**Developing an accounting policy when a business acquires an entity that is not a business**

Because this transaction is outside the scope of IFRS 3, it is necessary to develop an accounting policy in accordance with the principles and 'hierarchy' in IAS 8.7-12.

Although the listed entity has (in substance) been acquired, it continues to have filing obligations and is also the legal parent entity of the operating entity. IFRS 10 therefore applies to its financial statements and requires that they are prepared on a consolidated basis.

Because the transaction is outside the scope of IFRS 3, it can be argued that IFRS 3’s principles on identifying an acquirer and applying reverse acquisition accounting do not apply.

A case could then be made for taking a purely 'legal' view of the transaction under which the legal parent consolidates the legal subsidiary from the date of the combination. With such an approach, questions remain as to:
• how the identifiable assets and liabilities of the legal subsidiary should be brought into the consolidation (eg at previous carrying amount or fair value)
• whether or not any goodwill should be recognised.

However, we consider that such an approach is not likely to provide the most relevant and reliable information. We also consider that it is not appropriate to recognise goodwill outside a business combination. Further, it is questionable that an IFRS 3-type fair value purchase price allocation should be performed for the identifiable assets and liabilities for the legally-acquired entity when, in substance, no change of control has occurred. Finally, such an approach is not supported by the IFRIC’s agenda decision.

Instead, we are of the view that the substance of the transaction is that the legal subsidiary (operating entity) has paid (usually through the issue of equity and/or cash) to acquire a listing and the cash and other net assets (if any) held by the listed shell. An accounting policy that results in 'losing' the financial history of the operating entity would in our view fail to reflect this substance. We therefore consider that some aspects of IFRS 3 should be applied by analogy. Specifically, we consider that IFRS 3’s principles should be applied on:

• identifying the accounting acquirer
• presenting the consolidated financial statements of the legal parent as a continuation of the accounting acquirer’s financial statements.

This approach allows the legal parent to satisfy its filing obligations to prepare consolidated financial statements whilst still reflecting the commercial substance of the transaction, which is that the legal subsidiary is the accounting acquirer.

**Treatment of excess of acquisition cost over net assets acquired**

The approach described above treats the excess of the deemed acquisition cost over the cash balances and other net assets acquired as a cost of obtaining a listing. We consider that such listing costs should be recorded as an expense. However, as noted above these costs will be subsumed within goodwill if it is concluded that the listed entity is a business (with the effect that the transaction is a business combination).

We do not believe such costs give rise to an intangible asset (or other type of asset). This is because listing is a status attaching to the entity's shares rather than being an asset controlled by the entity itself.

**Separate financial statements**

If the legal parent is required or chooses to prepare separate financial statements in addition to consolidated financial statements, reverse acquisition methodology does not apply. The legal parent applies the normal IAS 27 approach in its separate financial statements. Accordingly, it records its investment in the legal subsidiary initially at cost, ie the fair value of the shares it issued to purchase the legal subsidiary (IFRS 3.B20 and IAS 27.10).

**Example**

X plc (a listed company) currently has divested all of its operations, and its current activities are limited to managing its cash balances and filing obligations.

Z Limited is a substantial operating entity that wishes to obtain a fast track listing. The summarised statements of financial position of X and Z immediately prior to the transaction are:
Entity X acquires 100% of the issued share capital of Entity Z by issuing 990 shares for each share in Z (9.9m new shares issued in total). Post-combination, the ownership ratios are therefore:

- X's former shareholders: 1%
- Z's former shareholders: 99%

Entity X's share price immediately before the announcement of the transaction was CU5 per share. Hence the total fair value of X is CU500,000. Prior to the transaction, Entity Z's management obtains a valuation of its shares which values each share at CU5,000. Entity Z incurs transaction costs of CU50,000.

**Deemed consideration transferred in exchange for accounting acquiree**

The consideration transferred in exchange for accounting acquiree (Entity X) should be determined from the perspective of Entity Z, (the accounting acquirer). However, Entity Z has issued no consideration. Accordingly, the acquisition-date fair value of the ‘deemed’ consideration transferred by Entity Z is based on the number of equity interests that Entity Z would have had to issue to give the owners of the legal parent (Entity X) the same percentage equity interest in the combined entity that results from the reverse acquisition. The fair value of the number of equity interests calculated in that way can be used as the fair value of consideration transferred in exchange for the acquiree (IFRS 3.B20). The fair value may be determined either by using the fair value of the legal acquirer or the legal acquiree, whichever is the more reliable (IFRS 3.33 and IE5).

In this example, Entity Z would have had to issue an additional 101 shares in order for the former shareholders of Entity Z to hold 99% of the shares in the combined group (10,000/0.99 - 10,000). In accordance with the normal hierarchy in IFRS for fair value measurement, the quoted market price of Entity X's shares is considered to provide a more reliable basis for measuring the deemed consideration than the estimated fair value of Entity Z's shares determined using a valuation technique. Therefore, the consideration transferred is deemed to be CU500,000 (100,000 of Entity X's shares with a fair value per share of CU5).

This cost (CU500,000) is characterised as:
- CU250,000 in exchange for the cash balances of X
- the balance (also CU250,000) as the cost of the listing.

In the case above, the only asset of Entity X is cash. The balance of cash of CU250,000 represents its fair value. However, in situations where the acquiree has other assets or liabilities, these should be recognised at their fair values. The excess between the deemed cost and the total fair value of identified assets and liabilities is considered to be the cost of the listing.
Transaction costs
Given that the transaction is characterised as an issuance of shares by Z in exchange for cash and a listing, associated transaction costs should also be analysed between the two elements of the transaction. In the absence of more specific details on these costs, it seems appropriate to allocate 50% of the costs to the listing, and 50% to the equity issuance for cash. Costs allocated to the listing are expensed. Costs allocated to the deemed equity issuance are deducted from equity.

A straightforward approach to accounting for the transaction is for X's financial statements to be presented as the amounts in Z's financial statements, with the following entries to give effect to the transaction:

<table>
<thead>
<tr>
<th>Date of combination (CU000s)</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash - balance acquired from X</td>
<td>250</td>
<td></td>
</tr>
<tr>
<td>Costs of listing (income statement)</td>
<td>250</td>
<td></td>
</tr>
<tr>
<td>Equity</td>
<td></td>
<td>500</td>
</tr>
<tr>
<td>Cash - transaction costs</td>
<td></td>
<td>50</td>
</tr>
<tr>
<td>Equity</td>
<td>25</td>
<td></td>
</tr>
<tr>
<td>Costs of listing (income statement)</td>
<td>25</td>
<td></td>
</tr>
</tbody>
</table>
The income statement presented in X's consolidated financial statements is that of Z, including Z's pre-transaction results and comparative information, with the entries above to give effect to the transaction. The (separate) entity-only and consolidated statements of financial position of Entity X, including the entries to give effect to both the legal acquisition of Z and the adjustments and eliminations, is prepared as follows:

<table>
<thead>
<tr>
<th></th>
<th>Entity X pre-transaction</th>
<th>Cost of Z</th>
<th>Entity X entity-only</th>
<th>Entity Z</th>
<th>Combination transactions/adjustments</th>
<th>Entity X consol</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>CU000</td>
<td>CU000</td>
<td>CU000</td>
<td>CU000</td>
<td>CU000</td>
<td>CU000</td>
</tr>
<tr>
<td>Investment in Z</td>
<td>-</td>
<td>49,950 (1)</td>
<td>49,950</td>
<td>-</td>
<td>(49,950) (3)</td>
<td>-</td>
</tr>
<tr>
<td>Cash</td>
<td>250</td>
<td>250</td>
<td>5,000</td>
<td>(50) (2)</td>
<td>5,200</td>
<td></td>
</tr>
<tr>
<td>Other net assets</td>
<td>-</td>
<td>-</td>
<td>45,000</td>
<td>45,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>250</td>
<td>50,200</td>
<td>50,000</td>
<td>50,200</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Issued share capital, 100,000 shares / 10 million shares*</td>
<td>1,000</td>
<td>49,950 (1)</td>
<td>50,950</td>
<td>-</td>
<td>(49,950) (3)</td>
<td>(1,000) (4)</td>
</tr>
<tr>
<td>Issued share capital, 10,000 shares / 10 million shares*</td>
<td>-</td>
<td>-</td>
<td>10,000</td>
<td>(25) (2)</td>
<td>500 (4)</td>
<td>10,475*</td>
</tr>
<tr>
<td>Retained earnings(losses)</td>
<td>(750)</td>
<td>(750)</td>
<td>40,000</td>
<td>(25) (2)</td>
<td>(250) (4)</td>
<td>39,725</td>
</tr>
<tr>
<td></td>
<td>250</td>
<td>50,200</td>
<td>50,000</td>
<td>750 (4)</td>
<td>39,725</td>
<td>50,200</td>
</tr>
</tbody>
</table>

Adjustments:

1. to record the issue of shares by X and cost of investment in Z. The cost of investment should be based on the fair value of the 9.9m shares issued by X. In this example this is estimated by references to the fair value of the investment obtained in Z (CU50m less the costs of CU50,000 incurred by Z)
2. to record the transaction costs of CU50,000 and allocate 50% of those against equity and 50% as an expense
3. to reverse out the acquisition of Z by X in order to present X as the legal acquirer
4. to eliminate X's equity and pre-combination retained losses, and record the notional equity issuance by Z.

* although the equity amount is determined from the legal subsidiary's (Entity Z's) equity balance, adjusted for the deemed cost of the acquisition, the equity structure (ie the number and type of equity instruments) is Entity X's legal equity structure (ie 10m shares). The amount reported as equity is the share capital of the legal subsidiary (CU10m) plus the deemed consideration transferred (CU500,000) less transaction costs charged to equity (CU25,000).
Disclosure of key management personnel compensation

**Relevant IFRS**
- IAS 24 Related Party Transactions

**Issue**
The Hot Topic provides guidance on the following aspects of the IAS 24.17 requirement to disclose key management personnel (KMP) compensation:

- disclosure in the financial statements of a subsidiary for which the KMP are paid by the parent
- application of the disclosure requirement when management services are provided by another entity.

**Guidance**

- Disclosure in the financial statements of a subsidiary for which the KMP are paid by the parent
  IAS 24.17’s requirements should be applied on the basis of the compensation provided to the KMP for their services to the subsidiary, even if the compensation is paid by the parent or another entity. When the same individual provides key management services to more than one subsidiary (but is paid by one entity), the compensation disclosed should be determined based on a reasonable allocation of the total compensation. We recommend that the basis of the allocation should be disclosed.

  If a reasonable allocation of the total compensation is impractical, we consider that the total compensation payable to the KMP should be disclosed along with an explanation of the arrangement.

- Application of the requirements when management services are provided by another entity
  When an entity is managed by another entity (eg an investment fund that is managed by a corporate fund manager), we consider that the management entity should be treated as a related party if it carries out the functions normally associated with key management. Hence management fees payable should be disclosed along with information concerning the nature of the arrangement (IAS 24.13, 18).

  Some arrangements have the legal form of a contract between the reporting entity and a management entity but in substance relate to the services of an individual. Such arrangements should be evaluated in accordance with their substance. Accordingly, if the services of an individual who acts as a member of the KMP are procured through a contract with an entity, amounts payable should be disclosed as KMP compensation under IAS 24.17. By contrast, when the substance is for the provision of the services of the management entity, we do not consider it necessary to 'look through' that entity to identify the KMP of the reporting entity.

**Project update**
The *Annual Improvements to IFRSs 2010-2012 Cycle* includes a proposed amendment to IAS 24 to address the disclosure of related party transactions that arise when a management entity provides key management personnel services to a reporting entity. To address the diversity in disclosures that has arisen from IAS 24 being unclear on this topic, the Board proposes the following changes to IAS 24 in its proposed improvements:

- amend the definition of a ‘related party’ to include entities, or members of its group that provide key management personnel services to the reporting entity
- extend the disclosure requirements to require the separate disclosure of transactions for the provisions of key management personnel services and
- exclude key management personnel compensation provided by a management entity to its own employees from the disclosure requirements of paragraph 17 to prevent duplication.

This Hot Topic has not been modified to consider the proposed improvement as the project has not yet been finalised. Target completion of the 2010-2012 Annual Improvements Cycle is Q2 2013.

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Discussion

General

IAS 24.9 defines KMP as:

“those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.”

KMP are specified to be related parties (IAS 24.9). IAS 24.17 requires that:

“An entity shall disclose key management personnel compensation in total and for each of the following categories:

a) short-term employee benefits;
b) post-employment benefits;
c) other long-term benefits;
d) termination benefits; and
e) share-based payment.”

Disclosure in the financial statements of a subsidiary for which the KMP are paid by the parent

It is common in groups of companies that:

• the same individual (or individuals) is a director (or otherwise a member of the KMP) of more than one group entity
• these individuals are paid by one group entity.

At a group level, this situation does not present any difficulties. Normally, the KMP of the parent entity are regarded as the group KMP and the compensation disclosed is their total compensation for services to the group. However, an issue arises in the financial statements of individual entities when the KMP are paid by another group entity. IAS 24 does not address the issue of how much compensation should be disclosed in the individual financial statements.

The definition of compensation at IAS 24.9 makes it clear that the relevant amount is the benefits payable to the KMP in exchange for the services to the entity in question. Compensation is therefore disclosable even if another entity pays the KMP. This applies whether or not the parent or other paying entity recharges the cost by way of a management fee or similar.

When the same individuals are KMP of several group entities but are paid by the parent (or another entity), the IAS 24.9 approach requires an allocation of their total compensation on the basis of the services provided to each entity. Such an allocation could be made based on the estimated time spent on each entity's affairs or another reasonable basis. When there is no reasonable basis for an allocation we recommend that each entity should disclose:

• the total compensation for each member of its KMP
• an explanation that this total amount is for services to more than one entity
• a description of any recharge arrangements.

An alternative approach is to disclose the fact that key management is compensated by the parent with no disclosure of the amount. This is not our preferred approach and is acceptable only if there is no reasonable basis to make an apportionment.

Management services provided by another entity

Some entities that prepare IFRS financial statements are managed by another entity (usually for a fee). For example, certain types of investment funds do not have executive directors (or equivalent) but are instead managed by an investment management entity. This gives rise to a number of issues including:

• whether the investment management entity should be regarded as a member of the KMP of the fund; and
• whether the KMP of the management entity are also KMP of the fund.
We consider that KMP are individuals rather than entities. Moreover, a management fee is not normally an employee benefit and does not therefore meet the definition of compensation in IAS 24.9. Nonetheless, if an entity carries out the functions of key management we believe it should be regarded as a related party.

Some management contracts are, in substance, arrangements to provide the services of specific individuals to a managed entity. If so, the individuals concerned would be KMP of the entity if they perform a key management role.

When the contract is a genuine 'entity to entity' arrangement, we would not regard the KMP of the management entity as KMP of the fund (managed entity). There is therefore no need to 'look through' the management entity to identify the KMP of the fund.

**Examples**

**Example 1 - parent pays compensation to KMP of subsidiary**

An executive director of a subsidiary is compensated directly by the parent on behalf of the subsidiary. The director works 100% for the subsidiary and does not receive any compensation from the subsidiary. The subsidiary pays a management fee to the parent, which contains an element for the key management personnel’s compensation, among other things. The management fee is disclosed as related party transactions in the subsidiary’s financial statements.

How should the key management compensation be disclosed in the subsidiary’s separate financial statements?

**Analysis**

IAS 24.17 requires the disclosure of key management compensation. IAS 24.9 is also clear that consideration paid to the director on behalf of the subsidiary should be disclosed. Accordingly, the director’s remuneration should be disclosed in the subsidiary’s separate financial statements. We recommend a statement is also included that the compensation is paid at the parent’s level, and it is recharged as part of the management fee. In any case, the management fee is a related party transaction and is disclosable under IAS 24.18.

**Example 2 - parent pays compensation to KMP of several subsidiaries**

An individual is an executive director of a parent entity and each of its 10 subsidiaries. The director is paid CU250,000 by the parent for services to the group as a whole. The time spent by the director on each subsidiary’s affairs is not tracked and varies from one day to the next.

How should the key management compensation be disclosed in each subsidiary’s separate financial statements?

**Analysis**

In principle the CU250,000 should be allocated amongst the subsidiaries. In this case it appears that no reasonable basis of allocation could be derived and justified. The total compensation should therefore be disclosed by each entity, together with a statement that this is paid by the parent.

**Example 3 - managed fund**

An investment fund prepares IFRS financial statements. The fund is overseen by trustees who are responsible for appointing a fund management entity. The fund has no executive management or employees and the management entity undertakes all day to day decision making, including investment decisions. Fees are levied by the management entity as a fixed percentage of the fair value of the fund’s investment portfolio. The investment management contract is not dependent on specified individuals. However, in practice particular employees of the management entity are assigned responsibility for key management decisions.

In this case, the management entity is not considered to control or have significant influence over the fund. (The basis for this conclusion is outside the scope of this Hot Topic, but such a conclusion might depend on factors such as the Trustees’ power to remove the fund manager).

Who are the KMP of the managed fund? What disclosures are required of the management fee payable?
Analysis

KMP of the managed fund are the trustees.

The fund manager is an entity and not a member of the KMP. Also, the arrangement with the fund manager appears to be an entity-to-entity arrangement rather than a mechanism to provide the services of specified individuals. We do not therefore consider that any individual directors or employees of the management entity should be treated as KMP of the fund.

In this case, the fund is not an associate or subsidiary of the management entity. If it were, the management entity and the fund would clearly be related parties under IAS 24 and fees payable would be disclosable (along with the nature of the relationship and some other information - see IAS 24.13-24). Nonetheless, we consider that the fund management entity is a related party because it carries out the functions associated with key management. Accordingly the nature of the relationship and fees payable should be disclosed.
HT 2007-15 Employee loans at low interest rates

Relevant IFRS
IAS 19 Employee Benefits
IAS 39 Financial Instruments: Recognition and Measurement
IFRS 2 Share-based Payment

Project update
This Hot Topic reflects the requirements of IAS 39 Financial Instruments: Recognition and Measurement (IAS 39) and not those of IFRS 9 Financial Instruments (IFRS 9). IFRS 9 will eventually replace IAS 39 in its entirety. At this stage, IFRS 9 addresses the classification and measurement of financial assets and financial liabilities, along with derecognition. The requirements for financial liabilities and derecognition were carried forward unchanged (with the exception of some changes to the fair value option for financial liabilities to address the issue of own credit risk). On 28 November 2012, the Board issued an exposure draft proposing limited modifications to IFRS 9’s financial asset classification model to address application issues. IFRS 9 is effective for annual periods beginning on or after 1 January 2015 (early adoption permitted). Work continues on Phases 2 and 3 of the project, which address impairment and hedge accounting, respectively.

Issue
Accounting for low interest rate loans to employees.

Guidance
Loans to employees are financial assets and should be recorded at fair value on initial recognition (IAS 39.43, IAS 39.43A). Fair value can be estimated as the present value of the future cash flows, discounted at a market rate for a similar loan (IAS 39.AG64). The loan asset is subsequently accounted for in accordance with IAS 39. After initial recognition, loans are normally accounted for at amortised cost with interest income determined using the effective interest method.

If the interest rate on the loan is below the market interest rate, fair value will be less than the amount of the loan. This initial difference is an employee benefit. It should therefore be accounted for in accordance with IAS 19. In our view:

- if the benefit (ie the favourable terms of the loan) is not dependent on future service by the employee, it should be recorded as an employee benefit expense when the loan is advanced (IAS 19.156)
- if benefit is clearly linked to future employee service, the initial difference should be recognised as an expense over the service period. This amount recorded as an expense can be estimated as the difference between:
  - the interest income for the period based on the fair value of the loan asset and the amortised cost using the effective interest method
  - the interest actually charged to the employee.
Discussion
Many entities make loans to their employees on favourable terms. IFRS does not include specific requirements on employee loans. The general requirements of the relevant standards are therefore applied.

Employee loans are financial instruments and are therefore within the scope of IAS 39. IAS 39.43 and IAS 39.43A require that financial instruments are initially recognised at fair value. For loans made on market terms, fair value at inception will usually equal the loan amount. Where the loan is on favourable terms, the fair value of the entity's loan asset will be less than the loan amount.

Employee loans are usually included in IAS 39's loans and receivables category. Accordingly, after initial recognition they are recorded at amortised cost using the effective interest rate (EIR). The loan asset is also subject to IAS 39's impairment requirements.

The difference between the loan amount and its fair value is, in substance, an employee benefit. The principles of IAS 19 therefore apply. However, IAS 19 does not provide any direct guidance on accounting for this form of benefit. In the absence of specific guidance, the general principles of IAS 19 should be applied to determine:

- whether the benefit should be recognised immediately or amortised over a longer period; and
- if amortised, the basis of allocating the expense into reporting periods.

Immediate expense recognition or allocation?
If the loan is available on favourable terms irrespective of any future employment requirement or other service obligation, there is no basis on which to allocate any of the interest benefit to future periods.

Sometimes the terms of a loan establish a clear link between the benefit and future service. Examples of this include employee loans that:

- are repayable if the employee leaves or
- revert to a market interest rate if the employee leaves.

In these examples, although the employee receives the loan proceeds up front, the interest benefit is available only while the employee provides service to the entity. In accordance with objective (b) of IAS 19, an expense should be recognised when the employee provides services.

Basis of allocation
The allocation of the employee benefit expense depends (amongst other things) on whether the benefit is considered long-term or short-term in accordance with IAS 19. A benefit is long-term if some or all of it is expected to be settled more than 12 months after the employee provides service (IAS 19.8). This definition is difficult to interpret for a benefit provided in the form of a long-term loan. In our view, most low interest loan arrangements involve the payment of benefits in each period in which service is rendered and are therefore short-term. Other subsidised goods and services are also typically considered to be short-term benefits (IAS 19.9(d)). However, some arrangements might have conditions or features that make them long-term in nature.

Under short-term benefit accounting, the entity should recognise (in each period) the undiscounted expense payable in exchange for employee services in the period (IAS 19.11). The cost to the entity in each period can be estimated as the difference between:

- the interest income for the period based on the fair value of the loan asset and IAS 39's amortised cost using the effective interest rate method
- the interest payable by the employee.

Other methods of allocation might also be acceptable. A straight-line amortisation of the initial difference over the applicable service period is often a reasonable approximation of the amount attributable to each period (at least for loans with a fixed principal amount).
Short-term advances
Some entities might advance small amounts to employees on a short-term basis. The benefit component of such loans might be immaterial. In our view it is acceptable to record such advances at face value if there is no stated interest rate and the effect of discounting is immaterial.

Project update
With the issuance of IFRS 13 Fair Value Measurement, the IASB deleted IAS 39.AG79 which stated in part, "...Short-term receivables and payables with no stated interest rate may be measured at the original invoice amount if the effect of discounting is immaterial." At the time of updating this document, the IASB issued an ED Annual Improvements to IFRSs 2010-2012 which includes proposed paragraph IFRS 13.BC138A which acknowledges that the deletion of paragraph IAS 39.AG79 might be perceived as removing the ability to measure short-term receivables and payables with no stated interest rate at invoice amounts without discounting, when the effect of not discounting is immaterial. The proposed improvement clarifies that the Board did not intend to change practice in the measurement of short-term receivables and payables when it deleted paragraph IAS 39.AG79.

Loans linked to the entity's shares
Loans linked to the entity's shares in some way need careful analysis. This type of arrangement may (wholly or partly) be within the scope of IFRS 2. For example, a loan made to an employee to purchase shares of the entity, and is secured only over those shares, may in substance represent the grant of a share option. In an option-type arrangement, the loan proceeds are returned to the company in exchange for the shares at the inception of the scheme. The employee receives shares but is obliged either to make the loan repayments or to return the shares. At the maturity of the loan, the employee can choose to:

- surrender the shares, which is equivalent to allowing the notional share option to lapse or
- repay the loan, which is equivalent to paying the exercise price of the notional share option.

This arrangement gives rise to share-based payment expense determined in accordance with IFRS 2. The expense is recorded based on grant date fair value of the overall scheme. If the shares are surrendered, there are no further accounting entries. If the loan repayments are made, the company records an equivalent credit in equity in the same way as it would on receipt of the proceeds of exercise of a normal employee share option.

Employees are also sometimes issued shares and provided with a 'full recourse' loan to fund the share purchase. The full recourse loan is secured not only over the shares but also over other assets. A proportion of the loan may be forgiven if specified performance targets are reached (eg a specified increase in share price or earnings per share over a defined period). In such cases, it is necessary to assess the overall substance of the arrangement. For example:

- if in practice the loan is forgiven even if the targets are not achieved, or when an employee leaves, the substance of the arrangement may be an award of shares (rather than share options) to be accounted for under IFRS 2
- if in practice the employees are allowed to 'settle' the loan by giving back the shares if the targets are not achieved, the arrangement operates in a similar way to a loan with recourse only over the shares (see above)
- if the employees are required to settle the loan in cash if the targets are not achieved, or upon leaving, the arrangement may comprise both a contingently forgivable loan (see below) and an award of shares.

Finally, a loan that is not used to fund a share purchase, but is forgiven if the share price increases, satisfies the IFRS 2 definition of a cash-settled share-based payment.

Forgivable loans
An employee loan might be forgivable (for example after a certain period of service or if performance targets are achieved). The terms and conditions of this type of arrangement should be evaluated to determine if it gives rise to any financial asset. The substance of such an arrangement might be that it is a prepaid employee benefit in its entirety. A loan that is forgiven after a certain period of service exceeding 12 months would be a long-term employee benefit.
Example 1
An entity makes a 5 year, interest free loan of CU10,000 to an employee. The loan remains available whether or not the employee remains in service. The market rate for a similar loan is 10%.

Analysis
The loan is at a favourable rate of interest for the employee, and the CU10,000 exceeds the fair of the employer’s financial asset. The fair value of the loan is estimated based on the future cash flow (CU10,000 in five years’ time) and the market interest rate (10%). This results in an initial carrying amount of CU6,209. The loan is likely to be classified as a loan or receivable for IAS 39 purposes. If so, it is measured at amortised cost under the effective interest rate. In this case, the effective interest rate is 10%.

As the loan continues to be available if the employee leaves within the 5 year loan term, there is no clear link between the interest benefit and any future service. The interest benefit of CU3,791 is therefore recognised as an expense at the date of the loan.

The journal entries on making the loan are as follows:

<table>
<thead>
<tr>
<th>Initial recognition of loan with no future service component (CU)</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td></td>
<td>10,000</td>
</tr>
<tr>
<td>Loans and receivables</td>
<td>6,209</td>
<td></td>
</tr>
<tr>
<td>Employee benefit expense</td>
<td>3,791</td>
<td></td>
</tr>
</tbody>
</table>

Example 2
A bank makes mortgage loans to its customers at a market rate, which is currently 5%. It also provides loans to its employees of up to CU500,000 at a discounted rate of 2%. The loans are for a 10 year period. The principal is repayable in equal annual instalments, along with interest due for the year. The loans remain available if an employee leaves, but the interest rate reverts to the current market rate. The entity estimates that employees on average remain in employment for 5 years from the date of advancing a loan.

The loans can be repaid early at their amortised cost. The early repayment option is considered to be a closely related embedded derivative in accordance with IAS 39.AG30(g) and is therefore not separated from the host debt contract.

Analysis
In this example, the terms of the arrangement provide a clear link between the interest benefit and future service. In determining the fair value of the loan the expected cash flows will take account of expected employee turnover. The expected cash flows for a loan of CU500,000 are therefore:

- 10 repayments of principal at CU50,000 per annum
- 5 interest payments of the discounted rate of 2%
- 5 interest payments at the market rate of 5%.

These cash flows are discounted at 5% to estimate the loan’s fair value. This is CU447,413, which is CU52,587 less than the loan amount. The loan is initially recognised at this fair value amount. Subsequently, interest income is recorded at the effective interest rate of 5%. The difference between the interest paid by the employee and the IAS 39 effective interest income is recognised in each of the first 5 years as an employee benefit expense. On initial recognition, the CU52,587 interest benefit is recorded as a prepayment in accordance with IAS 19.11(a).

The relevant amounts and their calculation for a loan of CU500,000 advanced on 1 Jan 20X1 are shown in the following table:
If expectations regarding an employee's future length of service change, this will affect the expected cash flows under the loan. The revised estimated cash flows are discounted at the original EIR (IAS 39.AG8). The remeasurement can be regarded as an adjustment to finance income or expense, or as an adjustment to employee benefit expenses.
HT 2007-16 Share-based payment and change of valuation technique

Relevant IFRS
IFRS 2 Share-based Payment
IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors

Issue
If an entity makes equity-settled share-based payments to its employees and measures the fair value of the equity instruments at the grant date, is the entity permitted (or required) to re-estimate the grant date fair value in a future period? This could be an issue, for example, if an entity wished to change the valuation technique used to value share options.

Project update:
The IASB issued IFRS 13 Fair Value Measurement (IFRS 13) in May 2011, effective for annual periods beginning on or after 1 January 2013 (early application permitted). IFRS 13 defines fair value, sets out in a single IFRS a framework for measuring fair value and requires disclosures about fair value measurements. The measurement and disclosure requirements of IFRS 13 do not apply to share-based payment transactions within the scope of IFRS 2 Share-based Payment (IFRS 13.6(a)).

Guidance
In the absence of a prior period error as defined in IAS 8.5, it is not appropriate to restate the grant date fair value of equity instruments issued in an equity-settled share-based payment arrangement.

Discussion
IFRS 2.11 requires that the fair value of equity instruments granted in an equity-settled share-based payment arrangement is measured at the grant date. In the absence of a market price, fair value is estimated using a valuation technique (IFRS 2.17). The grant date fair value then becomes the basis for determining the expense recognised for the services provided by the employees.

As the grant date fair value is usually estimated using a valuation technique, the question arises as to whether that estimate should or may be revised in future periods. For example, the entity might have better information concerning the inputs to its valuation model. Alternatively, the entity might wish to change its assumptions or to use a different valuation technique. IFRS 2 does not address this situation directly.

In our view, re-estimation is not consistent with the requirement to measure fair value at the grant date for the following reasons:

1. A fair value estimate made in accordance with IFRS 2 should be consistent with generally accepted valuation methodologies. It should incorporate all factors and assumptions that knowledgeable, willing market participants would consider in setting the price (IFRS 2.17). Because all relevant factors and assumptions have been incorporated in the original valuation, it is difficult to argue that there is any basis to revise the valuation in the future (even if it would have been possible to arrive at different valuations at the grant date).

2. A revised fair value estimate made at a later date is likely to be tainted by incorporating information that was not available at the grant date (such as newer information on expected volatility or expected life). Only information available to market participants at the grant date should be included. 'Hindsight' should not be incorporated into a fair value measurement.
3. If the new valuation technique gives a materially different estimate, this might indicate that:

- one or the other technique is inappropriate in the circumstances (ie the technique cannot be considered 'a generally accepted valuation methodology' for the type of instrument to be measured). This would represent a prior period error if the original technique is inappropriate or
- the assumptions being used in the newer estimate are inconsistent with previous assumptions. This could result from the inappropriate use of hindsight (see above), the use of unreasonable assumptions, or assumptions that are reasonable but fall elsewhere in an acceptable range. If it is concluded that the original assumptions were unreasonable (in other words it is clear that market participants would not have made these assumptions at the grant date), this is also indicative of an error.

**Valuation techniques, changes of accounting policy, accounting estimates and errors**

Some commentators argue that a valuation technique is an accounting policy. Under this view, the entity might change its valuation technique and account for this retrospectively. Accounting policies are: "the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements” (IAS 8.5). A change in the measurement basis (eg from fair value to intrinsic value) would therefore be a change in accounting policy (IAS 8.35). However, in our view the estimation technique used in measuring fair value for IFRS 2 purposes is not an accounting policy. Rather, it is the tool that is used to apply the chosen accounting policy. IAS 8.35 also clarifies that in cases where it is difficult to distinguish between a change in accounting policy and a change in estimate, the change is treated as a change in estimate.

Changes in estimates are common in financial reporting and are recorded in the current period. Changes in accounting estimates result from new information and developments and reflect the **present status** of assets and liabilities, and **expected future benefits and obligations** (IAS 8.5). Accounting estimates are therefore made in relation to assets and liabilities for which a **current measure** is required. The requirement of IFRS 2 is to measure grant date fair value. This fixes the measurement at a specified point in time and is not therefore a current measure. (By contrast, IFRS 2 requires a current estimate of the number of equity instruments expected to vest as a result of any non-market vesting conditions (IFRS 2.20). The standard also requires current measurement of the fair value of obligations under cash-settled share-based payments (IFRS 2.30)).

In rare circumstances, a grant date fair value might need to be amended because the original measurement contained a material prior period error. An error might relate to:

- clerical mistakes in the model used
- inappropriate inputs and assumptions to the model (ie inputs and assumptions that are inconsistent with those that market participants could be reasonably expected to make in pricing the instruments)
- use of a valuation method which is not generally accepted given the features of the equity instruments being measured. For example, IFRS 2.B5 points out that the Black-Scholes-Merton model does not allow for the possibility of early exercise. That model might therefore be unsuitable for long-lived options with the possibility of early exercise, unless an adjustment is made for expected life (IFRS 2.B17)
- a failure to take account of relevant information that was available and could reasonably be expected to have been obtained in making the original estimate (IAS 8.5).

If an entity does make a revised estimate of grant date fair value which differs materially from the original estimate, the causes of the difference should be investigated. If an error has been made in the original estimate, this should be corrected retrospectively in accordance with IAS 8.42. More commonly, it will be concluded that the original estimate was reasonable and in compliance with the requirements of IFRS 2. The two estimates might nonetheless be very different. This reflects a high degree of estimation uncertainty resulting from the sensitivity of valuation techniques to certain assumptions (such as share price volatility). If it is concluded that the original assumptions and resulting grant date fair value estimate were within an acceptable range at that time, the original estimate continues to be applied.
IFRS 2 attempts to deal with the estimation uncertainty in part through extensive disclosures. The required disclosures include detailed information on how fair value was measured (IFRS 2.47).

**Alternative view**

Some commentators point out that IFRS 2 does not contain an explicit prohibition on re-estimating grant date fair value. These commentators note that revising prior period estimates is a normal part of accounting. On that basis, it is argued that re-estimation is implicitly permitted (or even required). Under this view, an entity might use (say) the Black-Scholes-Merton formula to estimate grant date fair value then, in a later period, use a more sophisticated binomial model to derive a 'better' estimate. The effect of the revised estimate on the cumulative IFRS 2 expense is considered a change in an accounting estimate and is recorded in profit and loss in the current period.

This approach is problematic for all of the reasons explained above. There is also a risk that the entity might attempt to 'cherry-pick' its valuation technique in situations when a revised technique results in a lower expense. This approach also gives rise to questions as to when re-estimation is appropriate and whether it is a requirement or permission. The entity will also need to justify why it used the Black-Scholes-Merton model at the grant date if a binomial model is considered superior.

An entity arguing for this approach will therefore need to demonstrate that:

- the original estimate did not contain an error (ie that it complied with IFRS 2)
- the revised estimate does not incorporate 'new' information that would not have been available to market participants at the grant date.

**Example**

An entity granted share options to its employees on 31 December X1. The options vest after three years for employees who remain with the entity. Post-vesting on 31 December X4, the options are exercisable at any time up to 31 December X9. There are no other vesting conditions. The entity uses the Black-Scholes-Merton (BSM) model to estimate grant date fair value. It adjusts the expected option life to take account of the possibility of early exercise. The cumulative IFRS 2 expense is recognised over the three year vesting period, adjusted for the estimated number of options ultimately expected to vest.

On 31 December X3 (two years after grant), the same entity enters into a new scheme again involving a grant of share options. This is in addition to the first scheme (ie it is not a replacement award). For the second scheme, the entity uses a binomial model to estimate grant date fair value and intends to use a binomial model for all future schemes. In order to be consistent, the entity decides to re-estimate the grant date fair value of the first scheme. It arrives at a significantly lower fair value.

What are the accounting consequences of this?

**Analysis**

In the situation described, the entity should analyse the reasons why the newer valuation is significantly lower. The reason could be that the binomial valuation uses assumptions and inputs that are inconsistent with the BSM valuation. In turn, this might be because some of the inputs reflect hindsight (ie information that was not available at the grant date). Alternatively, one or other of the models might contain a clerical or other error.

If the entity concludes that the original BSM-based estimate complied with IFRS 2's objectives, it should continue to account for the first scheme using that estimate. In the rare situation that an error is identified in the original estimate, the error should be corrected retrospectively.
Note: For a simple scheme such as this one, the BSM model is widely accepted. However, the BSM model is regarded by some as overly simplistic. For example it allows only for a single measure of expected volatility of the underlying share price, which is an important assumption. By contrast, a binomial model includes the ability to model changes in expected volatility over the life of the option and other factors such as the possible inter-relationships between expected life and intrinsic value. The binomial model is therefore more sophisticated and is often regarded as coping better with complex features such as market vesting conditions. Nonetheless, in a simple scheme such as this one, the two approaches can be expected to yield similar estimates if the underlying assumptions are compatible. (Note - the assumptions will not be identical because the binomial model requires a wider range of inputs).
HT 2007-17 Lease prepayments and impairment

Relevant IFRS
IAS 17 Leases
IAS 36 Impairment of Assets
IAS 37 Provisions, Contingent Liabilities and Contingent Assets

Issue
If an entity has entered into an operating lease and has prepaid some of the rentals (a lease prepayment), how should the lease prepayment be assessed for impairment?

Project update
The IASB and FASB (the Boards) have been working together to develop a new single approach to lease accounting that would ensure that all leases (other than short-term leases) would be recognised in the statement of financial position – i.e. no more operating or finance distinction. A revised exposure draft is expected in Q1 2013. This Hot Topic does not consider or discuss the new proposals.

Guidance
The operating lease prepayment asset should be considered for impairment in accordance with IAS 36. Accordingly:

- the entity should assess at each reporting date whether there is any indication that the lease prepayment is impaired (IAS 36.8)
- if there is an indication of impairment, the entity determines the recoverable amount of the asset and records an impairment loss if the recoverable amount is less than carrying value (IAS 36.59).

A lease prepayment does not usually generate cash flows independently of other assets. Accordingly, its recoverable amount will generally need to be assigned to a cash-generating unit (CGU) for the purpose of applying IAS 36. If there is an indication of impairment, the recoverable amount is determined for the respective CGU (IAS 36.66 and 67(b)). The impairment loss is applied first to any goodwill allocated to the CGU and then pro rata to the carrying amount of each asset in the group (including the lease prepayment) (IAS 36.104).

Discussion
A lessee often makes an upfront payment to the lessor on entering into a lease. The upfront payment is sometimes referred to as a lease premium (particularly for leases of land and buildings). If the lease is classified as an operating lease in accordance with IAS 17, the lease payments are recognised as an expense on a straight-line basis over the lease term (or another systematic basis if more representative of the time pattern of the user's benefit) (IAS 17.33). Consequently the upfront lease payment is recorded on the statement of financial position as a prepayment asset. It should be noted that the land and buildings elements of a property lease are considered separately for lease classification purposes (IAS 17.15A). This sometimes results in a property lease being classified as an operating lease of land and a finance lease of a building.

An upfront payment relating to a finance lease would reduce or eliminate the finance lease liability. There is therefore no need to consider whether the prepayment is impaired. Under finance lease accounting, the leased asset is recorded on the statement of financial position of the lessee. The leased asset is then within the scope of IAS 36 for impairment purposes (IAS 17.30).

In accordance with the normal straight-line expense pattern of IAS 17, an operating lease prepayment is generally amortised to the income statement evenly over the term of the lease. Operating lease prepayments are within the scope of IAS 36, which applies to all assets except those scoped out by IAS 36.2-5. The prepayment is therefore written down to its recoverable amount if it becomes impaired.
A consequence of recording an impairment loss is that this deviates from the 'straight-lining' requirement of IAS 17. Although this might seem to create a conflict, we consider that it is appropriate to deviate from straight-lining if the lessee does not expect to be able to recover the carrying amount of the prepayment. This is because:

- when IAS 36 applies, its requirements must be applied in addition to the basic measurement principles of other standards that apply to the asset in question
- the straight-lining approach is also overridden when an operating lease becomes onerous (IAS 37.5(c) and Example 8).

**Determining the recoverable amount of a lease prepayment**

The recoverable amount is defined as the higher of fair value less costs of disposal and value in use (IAS 36.6). When applying these concepts to a lease prepayment, it is important to note that the asset being assessed is the prepayment, not the underlying leased asset. Accordingly:

- the fair value of the prepayment reflects the amount the lessee could obtain by selling or transferring its leasehold interest. In situations when the lease is part-prepaid but also requires future lease payments, fair value would be reduced by this requirement
- the value in use reflects the present value of the future cash flows the lessee could obtain from its right to use the underlying asset over the remaining term of the lease. The future cash flows included in this estimate are reduced by any future lease payments to be made to the lessor.

In some circumstances, it might be possible to determine recoverable amount for the lease prepayment separately. In determining recoverable amount, a separate estimate must be made when it is possible to do so (IAS 36.66). This would be the case when (for example):

- the lessee intends to transfer its rights under the lease to a third party in the near future (such that value in use is insignificant) or
- when the lessee has sub-let the asset to another party (such that the leasehold interest generates cash flows largely independently of other assets, and those cash flows are determinable).

More commonly, the lessee will generate cash flows from its rights under the lease in combination with other assets. Accordingly, the lease prepayment is assessed for impairment as part of the CGU to which it belongs (IAS 36.66). When a lease of land and buildings is classified as a finance lease of a building and an operating lease of land, any prepayment relating to the land element is likely to be included in the same CGU as the building.

**Example**

An entity (the lessee) enters into a 20 year lease of land on 1 January X1. The lessee pays an upfront amount of CU40,000 to the lessor. No further lease payments are due. The lease is classified as an operating lease and the CU40,000 is therefore recorded as a prepayment. It is amortised to the income statement on a straight-line basis (resulting in an expense of CU2,000 each year). The lessee constructs a factory building and purchases plant and equipment at a total cost of CU60,000. Construction is completed on 31 December X5. The factory assets' estimated useful life is 15 years. Estimated residual value is zero. Depreciation is therefore charged on a straight-line basis at CU4,000 each year.

The leasehold interest in the land and the factory building and other assets are considered to be a single CGU for the purposes of IAS 36. No goodwill is allocated to this CGU.

During 20X10 changes are made to applicable environmental regulations that are expected to significantly increase the ongoing operating costs of the factory. The entity considers this to be an indication of possible impairment.
Analysis
The entity has determined that the CGU might be impaired. It therefore determines the recoverable amount of the CGU. The total carrying value of the assets in the CGU at 31 December X10 is CU60,000 as follows:

- leasehold prepayment: CU20,000 (after deducting 10 years of amortisation of CU2,000 each year);
- factory assets: CU40,000 (after deducting 5 years of depreciation of CU4,000 each year).

If we assume that the recoverable amount is CU48,000, an impairment loss of CU12,000 is recorded in the income statement. This would be allocated pro-rata to the pre-impairment carrying amounts (CU4,000 to the leasehold prepayment and CU8,000 to the factory assets). Assuming there are no further impairments, the reduced carrying amounts (CU16,000 and 32,000 respectively) would form the basis for the future amortisation and depreciation charges.
HT 2007-18 Derivatives and non-controlling interest participation rates

Relevant IFRS
IAS 27 Separate Financial Statements
IAS 39 Financial Instruments: Recognition and Measurement
IFRS 10 Consolidated Financial Statements

Issue
The effect of put options, call options and forward contracts over shares in a subsidiary on the allocation of profits between the parent and non-controlling interests.

Scope
Hot Topic 2007-02 addresses accounting for written put and purchased call options relating to shares in a subsidiary held by non-controlling interest shareholders. That Hot Topic explains that a written put option over shares held by non-controlling shareholders sometimes has the effect of transferring the returns associated with ownership to the parent. In those cases, the non-controlling interest is derecognised. This Hot Topic provides guidance on when both written put options and other types of derivatives over shares in a subsidiary have the effect of transferring the returns associated with ownership. Consistent with Hot Topic 2007-02, this Hot Topic:

- addresses accounting in the consolidated financial statements of the parent
- applies only to derivatives that can be settled only by exchanging shares for cash or other financial assets (gross physical settlement).

Project update
In May 2011 the IASB issued three new standards (IFRS 10 Consolidated Financial Statements, IFRS 11 Joint Arrangements, and IFRS 12 Disclosures of Interests in Other Entities) and amended two (IAS 27 Separate Financial Statements and IAS 28 Investments in Associates and Joint Ventures) – sometimes referred to as the consolidation package. IFRS 10 redefines ‘control’ and provides extensive new guidance on applying the revised definition. The new model applies to both traditional entities and to special purpose entities (replacing IAS 27 and SIC-12 Consolidation – Special Purpose Entities). The guidance in IFRS 10 applies only to consolidated financial statements. The requirements for separate financial statements are unchanged and remain in IAS 27. The new guidance is effective for annual periods beginning on or after 1 January 2013. Cross-references to IAS 27 in this Hot Topic have been updated to reflect these changes.

Guidance
Normally, the allocation of profits and losses between the parent and non-controlling interests is based on present ownership interests (ie ignoring shares that will or may be transferred on exercise of derivatives such as forwards and options (IFRS 10.B89)).

However, as an exception to this general rule, an instrument that ‘currently gives the entity access to the returns associated with an ownership interest’ is regarded as an ownership interest in substance. In this case, the allocation takes into account the eventual exercise of the potential voting rights (IFRS 10.B90).

Derivatives that may transfer the risks and reward include:

- a fixed price forward (ie non-option) contract between the parent and non-controlling interest to buy or sell shares in the subsidiary at a future date
- combined put and call options with a fixed exercise price
- a fixed price put or call option that is deeply in the money at inception such that exercise is virtually certain
- a total return swap.

In our view, dividend rights must be considered in determining whether the parent or non-controlling interest has the rights to returns associated with the underlying shares.
In our view, the assessment of whether a derivative contract transfers the economic benefits should be made at inception (ie when the contract is entered into).

**Discussion**

**General**

IFRS 10 requires non-controlling interests (NCI) in the profit or loss and net assets of consolidated subsidiaries to be presented within equity, separately from the equity of the owners of the parent (IFRS 10.22). This involves determining the proportionate interest in the results and net assets of the subsidiary attributable to the NCI (sometimes referred to as the participation rate). This is normally straightforward. The number and classes of shares owned by the parties other than the parent determines the NCI’s entitlement to profits and share of net assets on a winding up.

The existence of contracts to buy shares from the NCI (eg a purchased call, written put or forward) or sell shares to them (eg a written call, purchased put or forward) complicates the analysis. These contracts are relevant in assessing whether the investor has control or significant influence if they are substantive (IFRS 10.B47). However, the participation rate is usually determined based on present ownership interests (IFRS 10.B89). This approach recognises that:

- derivatives do not normally convey a right to share in profits etc until settled or exercised
- in the case of options, exercise is uncertain.

However, the Application Guidance to IFRS 10 clarifies that the present ownership interest for the purpose of IFRS 10.B90 takes account of the substance of the arrangement.

**Types of derivative contract**

An agreement that involves a predetermined future transfer of the underlying shares at a fixed price (ie a forward contract) has the effect that the selling party will receive a fixed amount of cash and no longer has any interest in changes in value of the underlying shares. This contract might therefore transfer the economic benefits of the underlying shares to the ‘buyer’ at inception. However, the proportionate rights to dividends and their significance should also be considered - see below.

A similar analysis applies to fixed price option contracts that are almost certain to be exercised. A call option contract (ie a right to buy shares) is almost certain to be exercised if its exercise price is substantially less than the fair value of the underlying share (often referred to as ‘deep-in-the-money’). Conversely, a put option (ie a right to sell shares) is almost certain to be exercised if its exercise price is substantially more than the fair value.

With option-type arrangements, other factors might also influence the assessment of the transfer of economic benefits. For example, an option might be 'in the money' for the option holder but that party might face financial or regulatory constraints that could result in the option being allowed to lapse.

Sometimes the forward or exercise price is not fixed. For example, the exercise price of a put or call option might be specified as the fair value of the underlying shares at the date of exercise. Alternatively, the price might be based on a formula (eg a multiple of EBITDA per share). A derivative that may or will result in a future transfer of shares at their future value does not transfer the economic benefits of the underlying shares to the buyer at inception.

Sometimes the parent and NCI shareholders might negotiate both a put and a call option. The combined option might be structured as a single instrument. In that case, it should be assessed as a single instrument. However, sometimes the combined option may be structured as two separate instruments. Financial instruments that are legally separate are normally assessed and accounted for separately. However, separate instruments are sometimes a single instrument in substance. If so, they should then be treated as a single instrument. The Implementation Guidance to IAS 39 Financial Instruments: Recognition and Measurement includes a useful list of indicators as to when separate financial instruments are accounted for on an aggregated basis. The indicators are as follows:

- the contracts were entered into at the same time and in contemplation of one another
- have the same counterparty
• relate to the same risk
• there is no apparent economic need or substantive business purpose for structuring the transactions separately that could not have been accomplished in a single transaction (IAS 39.IG.B6).

At the date of exercise, a fixed price combined put/call contract will be favourable to one party or the other and is therefore highly likely to be exercised.

**Dividend rights**

A further complication in assessing the economic effect of derivatives over shares in a subsidiary is that derivatives do not normally transfer any proportionate rights to dividends (until exercise or settlement). For example, a forward contract to buy or sell shares at a fixed price in two years’ time transfers to the buyer the risks and rewards of changes in value of the underlying shares in the next two years. However, the proportionate rights to any dividends declared during that period normally remain with the current legal owner of the shares subject to the forward.

In our view, proportionate dividend rights must be considered in determining whether the parent or non-controlling interest has present access to the economic benefits associated with the underlying shares. If the proportionate dividend rights are a significant component of the economic benefits, the derivative in question may not transfer substantially all the risks and rewards of ownership. However, the effect of dividends may not be significant. This could be because:

• the terms of the arrangement prevents the payment of dividends or restricts the amounts to a lender's return
• the forward or exercise price is adjusted to compensate the party that would otherwise be disadvantaged if a dividend is paid
• in specific circumstances the payment of dividends prior to settlement of the derivative(s) is highly unlikely (for example due to the subsidiary's lack of profits or cash flows or because the parent can control the dividend policy).

**Examples**

**Example 1: purchased call option**

Parent P owns 80% of the ordinary shares of subsidiary S. Minority shareholder M owns the remaining 20%. P purchases an option to acquire the 20% holding owned by M for a fixed price in 12 months' time. The exercise price is based on the estimated fair value of the 20% holding at inception. Dividend rights are unaffected by the call option. Dividends are material and are paid regularly.

**Analysis**

The purchased call option does not transfer the economic risks and rewards associated with ownership of the underlying shares to P. All else being equal, P will probably exercise its option if the value of shares in S has increased from inception to the exercise date, and allow the option to lapse if the value decreases. The option gives parent P the ability to share in an increase in value but it is not exposed to declines in value. Also, P does not receive dividends on the underlying shares prior to exercise of the call. P therefore continues to allocate 20% of the results and net assets of S to M in its consolidated financial statements. If the call option meets the definition of an equity instrument in accordance with IAS 32, its purchase price is debited to equity (see Hot Topic 2007-02). If not, it is measured at fair value in accordance with IAS 39.

**Example 2: combination of put and call options**

Facts as in Example 1 except that Parent P and minority shareholder M negotiate both a call option for P to acquire M's shares, and a put option for M to sell its shares to P. The price in the put and call options is the same and fixed at inception. Dividend rights are unaffected by the put and call options but dividends have not been paid in recent years.
Analysis

The combined put and call option appear, in substance, to constitute a single financial instrument. Accordingly, a combined assessment is made as to whether the returns associated with ownership of the underlying shares are transferred to P. All else being equal, P should exercise its option if the value of shares in S increases and M should exercise its option if the value declines. In either case P will pay a fixed amount of cash and will therefore obtain the benefit of a value increase and bear the risk of a decrease.

The options do not transfer the proportionate interest in any dividends declared by S. However, P is likely to be in a position to control S’s dividend declarations. If so, it may be irrational for P to decide that S should pay a dividend prior to acquiring M’s shares (as that cash would leave the group). Accordingly, dividend rights may not be significant in this case.

If dividend rights are not considered significant, P should account for this arrangement as though the shares of M have been acquired at the date of entering into the put and call options. Accordingly, the non-controlling interest is derecognised and 100% of the results and net assets of S are allocated to P from that date. A liability is recognised for the present value of the exercise price in accordance with IAS 32.

The purchase of M’s shares is accounted for in accordance with IFRS 10.23, as an equity transaction.
HT 2007-19 Career average and annual salary pension plans

Issue
Does IAS 19 require an entity to attribute benefit on a straight-line basis for annual salary and career average salary post-employment benefit plans under IAS 19.70 (and therefore to take account of future salary increases)?

Guidance
Yes. With both annual salary and career average salary schemes, higher levels of benefit are generally accrued in future periods because of the effect of future salary increases. IAS 19.70 therefore requires attribution of benefits to periods of service on a straight-line basis (rather than in accordance with the plan’s benefit formula). IAS 19 sets out detailed requirements for the recognition and measurement of defined benefit plans that require future salary growth to be reflected in allocating the benefit cost to current and prior period service costs.

Discussion
The classification of employee benefit plans is based on the employer’s obligation to make further contributions, rather than on the basis of the benefit to which the employees are entitled. A career average or annual salary post-employment plan is normally classified as a defined benefit plan. This is because such plans promise the employee benefits based on a formula linked to salary and period of service. The entity has an obligation to make whatever contributions are needed to satisfy this benefit promise. (See Hot Topic 2007-20 for further discussion of defined contribution (DC) and defined benefit (DB) classification of current and career average salary plans.)

An entity attributes benefit for a defined benefit plan to periods in which the obligation to provide post-employment benefits arises as a result of employees rendering services (IAS 19.71). Employee service gives rise to an obligation under a defined benefit plan even if the benefits are conditional on future employment (in other words they are not vested). IAS 19.70 requires attribution of benefits to periods on a straight-line basis if “an employee’s service in later years will lead to a materially higher level of benefit than in earlier years”. With a final salary type scheme, it is clear that service in later years (when employees’ salaries tend to be higher) result in a higher level of benefit than in earlier years. However, the same is also true of annual salary and career average salary plans. This is because in the majority of cases where salaries tend to be higher after a longer period of employment. The effect is that:

- in an annual salary plan, the benefit earned each year relates only to that year’s salary. However, the employer has also made a longer term promise when the employee joins such a plan, which is that salary increases in future will result in a proportionately higher accrual of pension benefit for the service period
- in a career average salary plan, the future years’ service at a higher salary increases the career average salary. This in turn leads to higher benefits being earned in later years.

In addition, IAS 19.87 requires post-employment benefit obligations to be measured on a basis that reflects, among other things, estimated future salary increases that affect the benefits payable.

Example
Example 1a
An entity operates a career average salary post-employment benefit plan. The plan provides an annual pension of 3% of career average salary for each year of service up to the normal retirement age of 65, from when the pension is payable.
Analysis
The benefit attributed to each year of service is equal to the present value at the expected retirement date of an annual pension of 3% of the estimated career average salary payable from the expected retirement date until the expected date of death. The present value of the defined benefit obligation is the present value of annual pension payments of 3% of career average salary, multiplied by the number of years of service up to the statement of financial position date.

The career average salary is calculated to reflect expectations about length of service and future salary increases. Future salary increases take account of inflation, seniority, promotion and other relevant factors, such as supply and demand in the employment market (IAS 19.90).

Example 1b
The facts are the same as in example 1a, except that the plan's benefit formula is based on annual salary, not career average salary.

Analysis
Benefit equal to the present value, at the expected retirement date, of an annual pension of 3% of the estimated career annual salary payable from the expected retirement date until the expected date of death is attributed to each year of service. This will be the same as the calculation under the career average plan in example 1a. The benefit the employee will ultimately receive will be the same as under the career average plan.

Example 2a
An entity operates a career average salary post-employment benefit plan for employees. The plan provides an annual pension of 3% of career average salary for each year of service up to age 60. The career average salary is determined taking into account all salary changes up to retirement (including any changes beyond the age of 60). The pension is payable from the age of 65.

Analysis
The benefit to be recognised is the present value, at the expected retirement date, of an annual pension of 3% of the estimated career average salary (up to age 65 where applicable) payable from the expected retirement date until the expected date of death. This is attributed to each year of service up to age 60. This is the date when further service by the employee will lead to no material amount of further benefits under the plan. No benefit is attributed to service after that date. The present value of the defined benefit obligation is the present value of annual pension payments of 3% of career average salary, multiplied by the number of years of benefit-eligible service up to the statement of financial position date.

The career average salary is calculated to reflect expectations about length of service up to age 60 and future salary increases up to age 65 (or remaining working life of shorter).

Example 2b
The facts are the same as in example 2a, except that the plan's benefit formula is based on annual salary up to the age of 60, not career average salary.

Analysis
The result in this example will not be the same as the calculation under the career average plan in example 2a, as salary increases between ages 61-65 will not be taken into account in calculating the benefit payable and no additional pension entitlement is earned in those years. Consequently, the value of the benefit is lower under the current salary plan but the period over which the benefit is attributed is then same, ie the period of service up to age 60.
Benefit equal to the present value, at the expected retirement date, of an annual pension of 3% of the average of the estimated annual salary up to age 60 payable from the expected retirement date until the expected date of death is attributed to each year of service up to age 60. This is the date when further service by the employee will lead to no material amount of further benefits under the plan. No benefit is attributed to service after that date. The present value of the defined benefit obligation is the present value of annual pension payments of 3% of eligible average salary, multiplied by the number of years of benefit-eligible service up to the statement of financial position date.

The eligible average salary is calculated to reflect expectations about length of service and future salary increases up to age 60.
HT 2007-20 Insured post employment benefit plans

Relevant IFRS
IAS 19 Employee Benefits

Issue
Is a 'fully insured' post-employment benefit plan a defined benefit or a defined contribution plan?

Guidance
Where an entity pays insurance premiums to fund its obligations under a post-employment benefit plan that includes a defined benefit-type pension promise, the plan is a defined contribution plan only if:

- all the actuarial and investment risks of the plan have passed to the insurance company for the whole of the plan life
- the entity has no obligation to pay the employee benefits directly or to pay further amounts if the insurer does not pay all future employee benefits relating to employee service in current and prior periods (IAS 19.46(b)).

Otherwise the plan is a defined benefit plan. In that case the insurance policy is accounted for as a plan asset or as reimbursement rights, depending on the terms and conditions of the policy (IAS 19.48).

Discussion
A defined contribution plan is a post-employment benefit plan under which an entity pays fixed contributions into a separate fund and has no legal or constructive obligation to pay further contributions if the fund does not have sufficient assets to pay all employee benefits relating to employee service in the current and prior periods (IAS 19.8). The classification of employee benefit plans is therefore based on the nature of employer's obligation to make contributions, rather than on the basis of the 'benefit promise' to which the employees are entitled. However, if the benefit promise is of a defined benefit type (eg expressed as percentage of future salary) the obligation to pay for those benefits is not fixed.

Under a defined contribution plan, the entity's obligation is limited to the amount that it agrees to contribute to the fund. The actuarial risk (that benefits will be less than expected) and investment risk (that assets invested will be insufficient to meet expected benefits) fall on the employee (IAS 19.28).

Many post-employment benefit plans promise benefits based on salary and period of service. The salary figure used to determine benefits is usually specified in the terms of the plan and may be based on annual, career average or final salary levels. Such plans are normally classified as a defined benefit plans because the employer entity has an obligation to make whatever contributions are needed to satisfy this benefit promise. Consequently, the actuarial and investment risk fall, in substance, on the employer (IAS 19.30).

An entity may enter into an insurance contract with the objective of transferring actuarial and investment risks to the insurer, and to fund vested benefits, under a post-employment benefit plan. IAS 19.46 provides guidance on the link between the payment of insurance premiums and classification of the scheme. An 'insured plan' is treated as a defined contribution plan in the limited circumstances that the entity has no legal or constructive obligation regarding benefits related to employee service in the current or prior periods (IAS 19.46-49).

In some jurisdictions, insurance companies offer contracts relating to annual salary plans that claim to 'fully insure' the benefits payable relating to employee service in the current and prior periods. The insurer receives a fixed payment (or payment fixed in terms of a percentage of salary) in exchange for assuming responsibility to pay benefits accruing over a specified period (the cover period). This raises a question as to whether the insurance contract results in defined contribution classification for the scheme.
In our view, the substance of the insurance contract needs to be reviewed carefully to determine what obligations, if any, the entity retains in respect of benefits relating to employee service in the current and prior periods. If the entity retains any obligation (either directly or indirectly), the payment of premiums does not amount to a defined contribution arrangement and the plan remains a defined benefit plan. The entity may retain a defined benefit obligation through a variety of means, such as:

- an obligation to pay the employee benefits directly when they fall due in the event of default by the insurer
- a mechanism for setting future premiums that allows the insurer to reflect actuarial and investments risk changes
- the cover period being less than the full period over which benefits are accrued under the plan. Beyond the original cover period the insurer can decline to provide future cover or increase premiums beyond the fixed amount previously agreed. In this case, the employer remains exposed to actuarial and investment risks for part of its benefit promise
- a related party relationship with the insurer.

In practice, it is likely that the terms and conditions of the insurance contract are such that the entity retains some obligation and exposure to actuarial and/or investment risk and so the plan should normally be accounted for as a defined benefit plan. For example, with a 'final salary' type scheme, future salary increases increase the benefit earned in current and prior periods. It is unlikely (although not impossible) that an insurer would be willing to take on the risks associated with an employer's decision to increase employees' salaries over their entire employment period. Also, as explained in Hot Topic 2007-19, future salary increases are also taken into account in determination of the benefits earned in the current and prior period. Accordingly, in assessing whether the employer has any 'legal or constructive obligation regarding benefits related to employee service in the current or prior periods', it is necessary to consider whether the insurance contract transfers the exposure to future salary increases to the insurer.

If the insurance company bears all of the actuarial and investment risk and has sole responsibility for paying the benefits and the entity has no legal or constructive obligation to cover any loss on the policy, the plan is treated as a defined contribution plan. The payment of fixed premiums under such contracts is, in substance, the settlement of the employee benefit obligation, rather than an investment to meet the obligation (IAS 19.49). Consequently, if the insurance contract:

- covers the entire period over which benefits are accrued
- fixes the employer's contributions at either a fixed periodic amount or a fixed percentage of salaries
- does not leave the employer exposed to any default risk

the insurance plan has the effect of converting the employer's obligations to those of a defined contribution scheme.

**Example**

An entity provides employees with a post-employment retirement plan that provides benefits of 2% of current annual salary that vest immediately. Each year, the entity pays a premium to an independent insurance company to fully guarantee the vested benefits. The premiums under the insurance contract are fixed for five years, after which time the insurance company can set a new premium rate. If the entity is not satisfied with the new premium rate offered, it can cancel the contract and transfer the accumulated surrender value of the existing contract to another insurer.

**Analysis**

In this example, the entity has not transferred all the actuarial and investment risk to the insurer so as to eliminate any future obligation to its employees under the plan. Although the vested benefits are said to be fully guaranteed, this only applies while the entity continues to pay insurance premiums under the contract. It is clear that the insurance company can adjust future premiums to minimise its own exposure to actuarial and investment risk and so pass this exposure back to the entity. Consequently, the entity retains an obligation to pay higher contributions relating to current and prior service periods and the plan is accounted for as a defined benefit plan.
HT 2007-21 Revenue recognition and foreign currency translation

Relevant IFRS
IAS 11 Construction Contracts
IAS 18 Revenue
IAS 21 The Effects of Changes in Foreign Exchange Rates

Issue
If an entity earns revenues denominated in foreign currency:

- how are these revenues translated into the entity's functional currency?
- are related deferred revenue (advance payments) and accrued revenue amounts treated as monetary or non-monetary items for the purposes of IAS 21?

Hot Topic 2006-22 addresses the related issue of the exchange rate to use in forecasting future contract revenues and costs for construction contracts.

Project update
The IASB and FASB (the Boards) have been working together on a joint project to clarify the principles for recognising revenue and to develop a converged revenue standard. A revised exposure draft was published in November 2011. Consistent with the prior proposal, the guidance in the revised exposure draft would replace the current multiple sources of guidance on revenue with a single model; however, the earlier proposals had been amended to reduce disruption to established practices (eg the revised exposure draft includes additional “practical expedients” intended to simplify application in several areas, including embedded financing and onerous obligations). A final standard is now predicted in the first half of 2013. The areas that may be most affected include multiple-element arrangements, revenue subject to variable (eg performance-based) payments, contracts with significant financing and contract costs. This Hot Topic continues to reflect the existing guidance in IAS 18.

Guidance
Revenues denominated in foreign currency are translated into functional currency at the closing (or spot) rate on the dates those revenues are recognised in accordance with IAS 11, IAS 18 or other applicable IFRS (IAS 21.21 and 22). The timing of invoicing does not have any direct effect on the translation of the foreign currency revenue into the reporting entity's functional currency. However, the timing of the receipt of payment for the goods or services rendered should be considered carefully to determine the impact on the amount recognised as revenue on translation from the foreign currency to the functional currency. This analysis involves the determination of whether the received/receivable balance is determined to be a monetary or non-monetary item.

Payments received in arrears
Receivables and amounts recognised for goods and services for which revenue has been recognised, including net unbilled contract revenue recognised in accordance with IAS 11 are generally treated as monetary items because they usually represent amounts to be received in a fixed or determinable number of units of currency (see discussion below).

Accordingly, these amounts are retranslated at the applicable closing rate at each reporting date. Related gains and losses are included in the income statement (IAS 21.28). In our view, these exchange gains and losses are not part of revenue.
Payments received in advance
When the cash is received, the deferred revenue/advance payment is initially recorded in the financial statements in the functional currency at the spot rate on the date of receipt. The assessment of whether this balance should be treated as monetary or non-monetary is often difficult. For non-refundable deposits or advance payments recognised before the revenue recognition criteria of IAS 18 are satisfied, the amount recognised is likely to be classed as non-monetary as this represents, in effect, an obligation to deliver future goods and services and so will not be settled in a fixed or determinable number of currency units. However, if the amount received in advance is refundable, it would be acceptable to classify it as a monetary item.

The determination of the classification of advances recognised under the percentage of completion method of revenue recognition in accordance with IAS 11 or for services under IAS 18 is less clear. Management judgement is needed depending on the facts and circumstances.

If an advance payment is considered as a monetary item, the deferred revenue balance is retranslated at the applicable closing rate at each reporting date. Related gains and losses are included in the income statement (IAS 21.28). In our view, these exchange gains and losses are not part of revenue. Future revenues will continue to be recorded in the functional currency at the spot rate on the date of recognition.

On the other hand, if an advance payment balance is considered to be a non-monetary item, the balance is not retranslated at each reporting date. Instead, the amount recognised is allocated to the future periods over which the services are rendered and no translation differences arise.

Discussion
Translation of revenues denominated in foreign currency
Foreign currency transactions are recorded at the applicable spot rate at the date of the transaction (IAS 21.21). For this purpose, the date of the transaction is determined based on when the transaction qualifies for recognition in accordance with applicable IFRS (IAS 21.22).

Application of these requirements to revenues denominated in foreign currency therefore involves translating the revenues at the spot rate on the date (or dates) that the revenues are recognised in accordance with IAS 11, IAS 18 or other applicable IFRS. This is straightforward in situations such as a sale of goods for which revenue is recognised on a single date and invoicing takes place on or close to that date. Revenue and the related receivable (a financial asset) are both recorded at the applicable spot rate on the date the sale is made. The receivable, which is a monetary asset, is re-translated at the applicable closing rate at future reporting dates whilst it remains outstanding (IAS 21.23(a)).

Foreign currency effects are more complicated where revenue is recognised over a period of time. Revenue on many construction and other service contracts is recognised by reference to the stage of completion of the contract work (subject to various conditions) (IAS 11.22 and IAS 18.20). If cash receipts are closely linked to the timing of revenue recognition then, in our view, application of IAS 21 to foreign currency revenues in this type of contract generally requires:

- determining the amount of revenue denominated in foreign currency to be recognised
- translating each incremental revenue denominated in foreign currency amount into functional currency at the spot rates as the work is performed. In practice, a weekly or monthly average rate is often used as a reasonable approximation. However, this is appropriate only if exchange rates do not fluctuate significantly in the period (IAS 21.22).

However, complications arise when exchange rates change between the timing of recognition of revenue and the receipt of cash.

Revenue-related accruals and deferrals
It is common in many revenue-contracts:

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• for payments to be received in advance of revenue being recognised (giving rise to deferred revenue or advance payments) or
• revenue to be recognised in advance of payment or contractual invoicing (giving rise to accrued revenue or unbilled revenue for contract work).

A question arises as to whether these revenue-related accruals and deferrals are:
• monetary items to be retranslated at each period end at the applicable spot rate under IAS 21.23(a) or
• non-monetary items to be translated at the date of the transaction.

Monetary items are defined in IAS 21 as:
"units of currency held and assets or liabilities to be received or paid in a fixed or determinable number of units of currency" (IAS 21.8).

In our view, revenue-related accruals should be treated as monetary items. This is because accrued or unbilled revenue represents a right to receive a determinable amount of currency (the proportion of the total contract consideration that has been 'earned' to date in accordance with IAS 11, 18 etc).

By contrast:
• non-refundable deferred revenue or advance payments recognised under IAS 18 represent an outstanding performance obligation that will be settled only by future delivery of goods or performance of services and so are non-monetary items
• refundable deferred revenue or advance payments recognised under IAS 18 may be viewed as an outstanding performance obligation that are expected to be settled by future delivery of goods or performance of services (non-monetary) or they could be viewed as monetary because there is the possibility that they will be refunded in cash. Management judgement is needed to determine a suitable accounting policy to be applied consistently
• advances received for construction or service contracts before the related work is performed are more complex because they are calculated as a balancing figure resulting from the mechanics of recognising costs and revenues in accordance with the percentage of completion method in IAS 11. Consequently, management judgement is needed to decide on an accounting policy choice. In practice, some entities recognise these as monetary items on the basis that they represent a determinable amount of currency received or receivable from a customer, but not yet earned in accordance with IAS 11. An alternative view is to treat the balance as a non-monetary item on the grounds that the deferred revenue represents a non-monetary performance obligation (ie a liability to perform further work specified under the contract).

Example

Foreign currency construction contract
A Swiss Franc (SFR) functional construction company undertakes a construction contract with total revenue of US$100,000. Work started on 1 January 20X0 and completed on 31 December 20X0. It is assumed that there are no embedded derivatives that require separation.

• At 30 November 20X0 the work was 60% complete. Accordingly, the cumulative US$ revenue recognised is US$60,000 (US$100,000 * 60%)
• At 31 December 20X0, the work was 100% complete. Accordingly, the cumulative US$ revenue recognised is US$100,000.

The applicable foreign exchange rates are:
• from 1 January to 30 November 20X0: 0.6 SFR = 1.0 US$ (it is assumed there are no movements in this period to simplify the calculations)
• average FX rate for December 20X0: 0.7 SFR = 1.0 US$
• closing rate at 31 December 20X0: 0.8 SFR = 1.0 US$
Scenario 1: payment is 100% in arrears on 31 December X0:
Each month's revenue is translated at that month's average rate, because that is when the transaction is deemed to occur for IAS 21.21 purposes. It is also consistent with the principle that revenue is recognised as the work is performed. Revenue earned to November is US$60,000 and in December is US$40,000.

Revenue is therefore reported as:
From 1 January to 30 November 20X0: US$60,000 * 0.6 = SFR36,000
For December 20X0: US$40,000 * 0.7 = SFR28,000
Total contract revenue = SFR64,000

Unbilled revenue is regarded as a monetary asset and translated to closing rate at each month-end. FX movements are reported as income or expenses but not as part of revenue. Hence a foreign exchange gain of SFR16,000 arises, based on the revaluation of the unbilled revenue. As there are no exchange rate movements between 1 January and 30 November, the cumulative unbilled revenue to 30 November is translated to the 31 December closing rate. The revenue earned in December is translated from that month's average rate to the closing rate:

US$60,000 * (0.8 - 0.6) = SFR12,000
US$40,000 * (0.8 - 0.7) = SFR4,000

On 31 December 20X0, the company collects the consideration of US$100,000, which is equivalent to SFR80,000 based on the spot rate at that date. This in turn corresponds to the total income recorded in SFR (revenue of 64,000 and foreign exchange gains of 16,000). The amount of revenue recognised represents the value of the revenue at the time when revenue was recognised. The gain on foreign exchange is attributable to the Company's decision to enter into an arrangement whereby payment is received at a later date. As such, the gain is not considered as revenue.

Scenario 2: payment is 100% upfront on 1 January 20X0 - accounting policy choice to treat as a monetary item

Contract revenue is SFR64,000 as above. This amount is not affected by the timing of payment.

The advance payment at each period end is treated as a monetary item. There are no exchange rate movements between 1 January and 30 November. Accordingly only the advance payment at 30 November needs to be translated (ie the US$40,000 received but not recognised as revenue at 30 November). A foreign exchange loss of SFR4,000 arises on this amount:

US$40,000 * (0.7 - 0.6) = SFR4,000

The aggregate of the contract revenue and the exchange loss is therefore SFR60,000. This corresponds to the cash collected at 1 January 20X0 (US$100,000) translated at the closing rate (0.6 SFR = 1.0 US$) on that date. Similar to scenario 1, the amount of revenue recognised is based on the exchange rates at the dates when revenue was recognised. It is the Company's decision to accept payment at the beginning of the contract, thus any exposure to fluctuation of exchange rates is borne by the Company.

Scenario 3: payment is 100% upfront on 1 January 20X0 - accounting policy choice to treat as a non-monetary item

The advance payment is translated on receipt and recorded in cash and deferred revenue at SFR60,000. This is considered a non-monetary item. It is not retranslated and so no foreign exchange difference arises.

The deferred revenue of SFR60,000 is recognised as revenue in the income statement as the work is performed, allocated to the periods based on the percentage of completion of the work done.

During the period 1 January through 30 November, 60% of the work is completed and so SFR36,000 is recognised as revenue for the period and released from the deferred revenue balance.

During December, the contract is completed and the remaining balance of deferred revenue is released to income statement and recognised as revenue of SFR24,000 (60-36).

In this scenario, revenue of SFR60,000 is recognised in total but there are no exchange gains or losses.
HT 2007-24 Convertible debt and the effect of the changes to the conversion ratio on equity or liability classification

Relevant IFRS
IAS 32 Financial Instruments: Presentation
IAS 39 Financial Instruments: Recognition and Measurement

Issue
In what circumstances does the issuer of a debt instrument which is convertible into equity shares treat the conversion feature as:

- an equity component; or
- an embedded derivative at fair value through profit or loss?

Note
In July 2009, the IFRS team issued the Liability or Equity Guide - a practical guide to the classification of financial instruments under IAS 32. The guide contains a summary of the guidance in this Hot Topic. This guide is available in the IFRS section of the GTInet website under “external publications”.

Guidance
General
The conversion option in a convertible debt instrument is an embedded derivative. The conversion option is therefore an equity component if, and only if, it satisfies the IAS 32 definition of equity as applicable to derivatives. In particular, a derivative is equity if (and only if):

- it is settled only by issuing a fixed number of shares for a fixed amount of cash or another financial asset - the so-called "fixed for fixed" rule (IAS 32.16(b)(ii)); and
- it contains no "non-equity" settlement alternatives such as an issuer's or holder's option to pay or take cash equal to the fair value of the conversion option as an alternative to delivering shares (IAS 32.26).

The conversion option in a convertible debt instrument might include terms that vary the number of shares to be issued per bond (the "conversion ratio") in certain circumstances. This is sometimes expressed as a change to the exercise price. Changes to the conversion ratio that are purely "anti-dilutive" do not in our view breach the fixed for fixed requirement.

Anti-dilutive changes to the conversion ratio
In our view, the IAS 32.16(b)(ii) fixed for fixed rule should be applied based on the substance of the arrangement. If the conversion ratio varies in certain circumstances, the fixed for fixed requirement may be breached. However, the factors that cause the conversion ratio to vary should be analysed. We consider that:
• adjustments to the conversion ratio whose effect is simply to preserve the rights of the bondholders to the entity's equity relative to other equity shareholders do not breach the fixed for fixed requirement. This type of adjustment is often referred to as "anti-dilutive";
• other adjustments, for example those that link the number or value of the shares to be received on exercise to the entity's share price or some other price or index, breach the fixed for fixed requirement. These conversion options are not equity components.

An adjustment to the conversion ratio preserves the rights of the bondholders relative to other equity shareholders if its effect is to ensure that all classes of equity interest are treated equally.

The practical application of this approach for various common types of adjustment is set out in the Examples section.

**Consequences of failing "fixed for fixed"**

If the conversion option is not equity, it is an embedded derivative within the scope of IAS 39. The embedded conversion option is accounted for as a derivative at fair value through profit or loss. Alternatively, the entire (hybrid or combined) instrument can be designated at fair value through profit or loss (IAS 39.11A).

**Discussion**

**General**

Convertible debt is a popular type of financing arrangement. The inclusion of a written conversion option in a debt instrument enables the issuer to reduce its cash interest payments compared to issuing "straight" (ie non-convertible) debt.

An option to convert a debt instrument into shares is a type of embedded derivative. Most embedded derivatives are within the scope of IAS 39. Embedded derivatives within the scope of IAS 39 need to be separated from the host contract and accounted for at fair value through profit or loss unless they are assessed to be closely related to the host. However, financial instruments issued by an entity that are equity in accordance with IAS 32 are outside the scope of IAS 39 (IAS 39.2(d)). This includes derivatives and embedded derivatives. Accordingly, the embedded conversion option in a convertible debt instrument needs to be assessed to determine if it is equity.

IAS 32 sets out the requirements on distinguishing debt and equity. This Standard also establishes the concept of a "compound instrument" - an instrument that contains both an equity and a liability component. The issuer of a compound instrument presents the equity and liability components separately (IAS 32.28). IAS 32.29 goes on to explain that a bond convertible by the holder into a fixed number of ordinary shares of the issuer is a compound instrument [emphasis added]. IAS 32 also includes extensive guidance on accounting for the issuance, repurchase and conversion of convertible debt (IAS 32.AG30-35 and IE34-50).

**The "fixed for fixed" rule**

Although IAS 32 addresses convertible debt in the context of compound instruments, it is important to note that not every convertible debt instrument is a compound instrument. This is because a convertible debt instrument contains an equity component only if the conversion option meets the definition of equity.

This point is demonstrated by:

• the reference to a "fixed number of ordinary shares" in IAS 32.29 (see above); and
• by the IFRIC's discussion of foreign currency convertible bonds in IFRIC Update (April 2005):

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"The IFRIC discussed ... the classification of the written option in a convertible bond denominated in a foreign currency (a currency other than the functional currency of the entity issuing the bond) ie a written option to exchange a fixed number of its own equity instruments for a fixed amount of cash that is denominated in a foreign currency. The IFRIC noted that although the issue has been raised in the context of a convertible bond it applies equally to freestanding instruments, ie to all contracts entered into by an entity to exchange a fixed number of its own equity instruments for a fixed amount of cash that is denominated in a foreign currency. The IFRIC also noted that the question of determining classification of such instruments as liabilities or equity depends upon whether a fixed amount of a foreign currency represents a fixed amount of cash or other financial asset.

The IFRIC noted that although this matter is not directly addressed in IAS 32, it is clear that when the question is considered in conjunction with guidance in other Standards, particularly IAS 39 Financial Instruments: Recognition and Measurement, any obligation denominated in a foreign currency represents a variable amount of cash …

Consequently, the IFRIC noted that contracts that will be settled by an entity by delivering a fixed number of its own equity instruments in exchange for a fixed amount of foreign currency should be classified as liabilities. The IFRIC decided that it would not take this submission onto its agenda …"

These references in particular demonstrate the importance of the so-called fixed for fixed rule in IAS 32.16(b)(ii). This states that a derivative instrument is equity only if it will be settled "by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments …" [emphasis added].

**Project update**

On 8 October 2009, the IASB published Classification of Rights Issues (Amendment to IAS 32). The Amendment alters IAS 32.16(b)(ii) so that rights, options or warrants to acquire a fixed number of an entity's own equity instruments for a fixed amount of any currency should be treated as equity 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. The Amendment to IAS 32 became effective for annual periods beginning on or after 1 February 2010. Prior to the Amendment, rights issues denominated in a foreign currency failed equity classification and were required to be accounted for as derivative liabilities. Following adoption of the Amendment, rights issues denominated in a foreign currency are an exception to the accounting treatment discussed above. For further information, refer to IFRS Alert 2009-18.

**Applying the fixed for fixed rule to convertible debt with variable conversion terms**

Many convertible bonds include conversion options in which the number of ordinary shares received in exchange for each bond (or conversion price) varies in some circumstances. Common types of variation provision include adjustments in the event of:

- a share split, share consolidation, bonus issue or rights issue
- dividend payments in excess of a certain level
- a change of control of the issuer

The first two types of adjustments are often described as "anti-dilution provisions".

A very narrow or mechanical reading of the fixed for fixed requirement would imply that any such adjustment would result in the conversion option failing the definition of equity. In practice, this interpretation would result in very few convertible bonds being treated as compound instruments (because anti-dilution provisions are included in most convertible bonds). In our view, the fixed for fixed requirement should be interpreted in a slightly broader way, taking account of the economic substance of the arrangement. For example, if the entity subdivides each issued share into two shares (a share split), it seems obvious that the bondholders should be entitled to double the number of shares on exercise. In substance, the bondholders are receiving exactly the same assets in exchange for the same amount of cash. The adjustment to the conversion rate simply preserves the rights of the bondholders to the entity's equity relative to other equity shareholders.
By contrast, the IASB clearly intends that the equity definition is "failed" for instruments in which the issuer is using its own shares as a "currency" to settle what is, in substance, a monetary obligation. This will be the case when:

- the number of shares to be issued is adjusted so that the value of the shares is maintained at a fixed amount; or
- the number of shares or exercise price is indexed to an underlying variable such as a commodity price (IAS 32.AG27(d) and BC10(b)).

By contrast a genuine anti-dilution provision does not underwrite the value of the conversion option. It merely preserves the value of the option relative to the other ordinary shares in specified circumstances.

In practice, the terms of convertible bond must be analysed carefully to determine the substance of the conversion feature. Judgement will be required to decide whether a conversion option is fixed in economic terms.

### Conversion features that are not equity components

If a conversion option or other feature "fails" the definition of equity, it is an embedded derivative within the scope of IAS 39. As with any other embedded derivative, an assessment is then required of whether the embedded feature is "closely-related" to the host (debt) instrument.

IAS 32.28 establishes that principle of separation when the conversion feature is equity. Moreover, IAS 39.AG30(f) explains that an embedded equity conversion feature in a convertible debt instrument is not closely related to the host debt instrument from the holder's perspective. Although IAS 39 does not directly address the closely related test for the issuer when the conversion feature is not equity, we consider that such a feature cannot be closely related (based both on these analogies and on the economic differences between a debt contract and a share warrant).

Accordingly, the embedded conversion option must be separated and accounted for as a derivative at fair value through profit or loss. Alternatively, the entire convertible debt instrument can be designated at fair value through profit or loss on initial recognition in accordance with IAS 39.11A.

### Examples

The following two tables set out our analysis of whether or not specific contract terms create an equity instrument or component. The first table focuses on the conversion feature in a convertible bond. The second table indicates our views on certain types of standalone share options and warrants. This division is made on the basis of the types of arrangement commonly encountered in practice. The underlying technical analysis applies equally to embedded conversion options and to standalone options and warrants.

#### Convertible bonds

<table>
<thead>
<tr>
<th>Nature of conversion feature</th>
<th>Is the conversion feature an equity component?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Different exercise dates - conversion ratio is a fixed amount per bond, but the conversion option can be exercised on various dates.</td>
<td>Yes. Example 9 to IAS 32 (IAS 32.IE34-36) makes clear that a conversion option for a fixed number of shares that is exercisable at any time is an equity component. This is the case even through the carrying value (eg amortised cost) of the host debt typically varies over its expected life.</td>
</tr>
<tr>
<td>Conversion ratio changes from one exercise date to another on a predetermined basis - the conversion ratio is adjusted on different dates by an amount that is predetermined at inception.</td>
<td>Yes. This is a point of interpretation. In our view it is reasonable to regard a conversion feature as meeting the &quot;fixed for fixed rule&quot; if the conversion ratio changes only with time, but is fixed and predetermined (ie known in advance) at any point in time.</td>
</tr>
<tr>
<td>Nature of conversion feature</td>
<td>Is the conversion feature an equity component?</td>
</tr>
<tr>
<td>-----------------------------</td>
<td>-----------------------------------------------</td>
</tr>
<tr>
<td><strong>Issuer conversion option</strong> - the issuer rather than the holder has the right to convert the instrument into a fixed number of shares</td>
<td>Yes. Although IAS 32 mainly discusses options written by the issuer to the holder, the same principles apply to issuer call options. An issuer call option will have a positive value to the issuer and will therefore result in recording a debit within equity. The liability to be recorded on initial recognition will exceed the proceeds received on issuing the compound instrument.</td>
</tr>
<tr>
<td>Conversion ratio or exercise price changes based on entity's share price - the conversion option contains a clause or formula that varies the conversion ratio or exercise price depending on the issuer's share price (based either on a &quot;stepped&quot; or continuous formula).</td>
<td>No. This breaches the fixed for fixed requirement. The effect is normally to guarantee the value of the shares the bondholders are entitled to. This is similar to the entity using its shares as currency. Further, this does not preserve the rights of bondholders relative to other equity shareholders (other shareholders do not receive extra shares if the share price falls).</td>
</tr>
<tr>
<td>Conversion ratio changes upon a share split or bonus issue - the conversion ratio is expressed as a fixed number of shares but is increased proportionately if the issuer subdivides its shares or issues new shares without consideration (bonus shares).</td>
<td>Yes. The effect of a proportionate adjustment in these circumstances is to preserve the rights of the bondholders relative to other equity shareholders.</td>
</tr>
</tbody>
</table>
| Conversion ratio changes upon a rights issue - a convertible bond provides for a change to the conversion ratio upon a rights issue. | Possibly. A rights issue can be analysed into:  
- a bonus issue of "free" ordinary shares; and  
- an issue of new shares at market price.  
An adjustment for the bonus issue component of a rights issue does not in our view breach the fixed for fixed requirement. An adjustment that alters the conversion terms based on changes in the market price (ie the second element) does not comply with the fixed for fixed requirement. |
| Conversion ratio changes upon a dividend payment - convertible bond contains a clause that adjusts the conversion ratio or price if the issuer pays dividends to existing shareholders. | Probably. If no dividends were expected to be payable on the underlying shares at the time of setting the conversion price, then clauses which adjust the conversion ratio to take account of subsequent dividend payments can generally be considered anti-dilutive and therefore consistent with the fixed for fixed test. This is on the basis that the subsequent adjustments to the conversion ratio maintain the relative rights of the convertible bondholder and the existing shareholders.  
A similar logic would apply if a specified level of dividends were anticipated at the time of setting the conversion price – a special dividend in excess of that specified level of dividends, which is in effect a return of excess capital. |
### Nature of conversion feature

<table>
<thead>
<tr>
<th>Conversion ratio changes upon a change of control - entity issues a convertible bond that is convertible at an improved ratio if the issuer is acquired by another entity (ie undergoes a change of control) before the maturity date of the bonds.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Is the conversion feature an equity component?</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Conversion ratio changes if the entity issues shares at a lower share price - entity issues a convertible bond for which the conversion ratio is improved if the entity subsequently issues new shares at a lower valuation than the share price when the bonds where issued.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Is the conversion feature an equity component?</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Contingently convertible bond - entity issues a convertible bond for which the conversion option is for a fixed number of shares but becomes exercisable only if a contingent event occurs or fails to occur.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Is the conversion feature an equity component?</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Convertible bond with variable conversion rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Is the conversion feature an equity component?</td>
</tr>
</tbody>
</table>
subject to a cap or floor - an entity issues an instrument that is settled in a variable number of shares but is subject to a cap to prevent excessive dilution of the existing shareholders through the issue of new shares.

number of shares. It therefore fails the fixed for fixed requirement unless the factors that vary the conversion terms are anti-dilutive.

<table>
<thead>
<tr>
<th>Nature of conversion feature</th>
<th>Is the conversion feature an equity component?</th>
</tr>
</thead>
</table>
| Foreign currency convertible bonds - convertible bond is issued in a currency that is not the functional currency of the issuer. | No*. At its meeting in April 2005, the IFRIC concluded that derivative contracts that may be settled by an entity by delivering a fixed number of its own equity instruments in exchange for a fixed amount of foreign currency are financial liabilities. A convertible bond denominated in a foreign currency therefore has no equity component - the fixed amount of the foreign currency liability that can be exchanged for shares is a variable amount of cash in the functional currency of the issuer. The convertible bond is therefore a host debt instrument and an embedded foreign currency derivative.  
* Note: Refer to the project update box regarding Amendments to IAS 32 made in October 2009. If certain conditions are met, rights, options or warrants to acquire a fixed number of an entity’s own equity instruments for a fixed amount of any currency should be treated as equity. This is an exception to the above rule. |

Standalone options and warrants

<table>
<thead>
<tr>
<th>Nature of arrangement</th>
<th>Equity instrument?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Option entitling holder to acquire a fixed percentage of share capital at a fixed price per share - an entity issues an option or warrant entitling the holder to acquire (say) 10% of the company's issued share capital (or fully diluted share capital) at a fixed price per share.</td>
<td>Probably. Although the number of shares does potentially vary in such circumstances (in that the number of shares that will be issued is not known until the date of conversion), this feature is typically designed to preserve the relative economic rights of the various equity shareholders. If however the feature is designed so as to benefit the holder relative to other equity shareholders, the fixed for fixed criteria would be breached.</td>
</tr>
<tr>
<td>Contracts to exchange a fixed number of equity instruments for a specified non-controlling interest - a parent entity issues an option for a minority shareholder to exchange its holding of shares in a subsidiary for a fixed number of equity shares in the parent</td>
<td>Yes - at consolidated level. Non-controlling interest shares are a form of equity in the parent entity’s consolidated financial statements. A contract to exchange one type of equity for another on fixed terms is an equity instrument.</td>
</tr>
<tr>
<td>Options and warrants that can be cash-settled - an option or warrant entitling the holder to shares but a further option for the issuer to settle the difference between the exercise price and the value of the share on</td>
<td>No. An instrument that includes settlement alternatives is equity only if all of those alternatives would result in equity classification (IAS 32.26).</td>
</tr>
<tr>
<td><strong>Written put options</strong> - an option written by the entity that entitles the holder to sell shares back to the entity in exchange for cash.</td>
<td><strong>No.</strong> This contract includes an obligation to transfer cash to the holder. A liability must be recognised equal to the present value of the amount payable on exercise, with the corresponding credit recognised in equity (IAS 32.23). This accounting therefore differs from the normal accounting for a derivative, which records the asset or liability on a net fair value basis. The “gross” accounting for a written put over own shares reflects the fact that own shares are not an asset in IFRS.</td>
</tr>
</tbody>
</table>
HT 2008-01 Disclosing the impact of new Standards and Interpretations

Relevant IFRS
IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors
IAS 10 Events after the Reporting Period

Issue
When an entity has not adopted a new Standard or Interpretation that has been issued but is not yet effective, IAS 8 paragraphs 30 and 31 (IAS 8.30-31) require the entity to disclose known or reasonably estimable information relevant to assessing the possible impact that application of the new Standard or Interpretation will have on the entity's financial statements in the period of initial application. There is diversity in practice in the application of this requirement.

This Hot Topic addresses some of the practical difficulties to consider, such as:

• Does the disclosure requirement of IAS 8.30 apply to Standards and Interpretations issued before the date of issue of the financial statements, or only to Standards and Interpretations issued before the statement of financial position date?
• Is it necessary for the financial statements to list every new Standard, amended Standard or Interpretation that has been issued but is not yet effective, even if they are expected to have no material effect on the reporting entity?
• Are quantitative disclosures needed of the expected impact of the initial application of the new Standard or Interpretation?
Project update
The desire to reduce the volume of disclosure requirements in IFRSs is widespread and numerous reports have been published on the matter. The European Financial Reporting Advisory Group (EFRAG), the Autorité des Normes Comptables (ANC) in France, and the Financial Reporting Council (FRC) in the United Kingdom have published a discussion paper Towards a Disclosure Framework for the Notes that sets out key principles that are required for an effective disclosure framework. The discussion paper lists major points that need to be considered when developing the disclosure framework. Among them are materiality considerations so that the only information disclosed is that information which is necessary to understand an entity’s financial performance and position.

On this topic, the FRC also published a report Cutting Clutter: Combating clutter in annual reports which outlines recommendations for reducing clutter under existing reporting requirements (including IFRSs). This report called for action to reduce barriers to reducing clutter – focusing on materiality among other topics. Specifically, the report highlights that IAS 1 states that "An entity need not provide a specific disclosure required by an IFRS if the information is not material." The FRC notes that despite this guidance in IAS 1, many entities continue to disclose immaterial information and this is precisely what they mean by ‘clutter’. The FRC cited a "lack of confidence in making the judgment between disclosures that are material and those that are not" as the key reason for including all disclosures given by interviewees. The FRC found that it is apparent that the lack of clarity around what materiality means from a disclosure perspective continues to be a significant barrier in both preparing and auditing financial statements.

This views expressed in this Hot Topic are consistent with the discussion paper and report noted above.

Guidance
In assessing how to meet the requirements of IAS 8.30, entities should consider all pronouncements issued up to the date that the financial statements are authorised for issue. In some cases, the impact of the new Standard or Interpretation may not be material or its scope may be such that it is not relevant to the operations of the entity. In our view, it is not necessary to list new Standards and Interpretations that are not relevant or whose impact is not expected to be material. However, the disclosure should make clear that the entity has at least considered every pronouncement.

The specific wording of the disclosure note should be appropriately tailored in order to provide relevant and useful information. The specific disclosures described in IAS 8.31 are not mandatory but are instead matters to consider. If quantitative disclosures are 'reasonably estimable' at the time of preparing the financial statements then it would be appropriate to include them. Often this will not be practicable.

Discussion
Date of review
IAS 8.30 does not restrict disclosure to new Standards and Interpretations issued before the statement of financial position date. Therefore, disclosure in accordance with IAS 8.30 should take into consideration all Standards or Interpretations issued but not adopted before the date that the financial statements are authorised for issue (see IAS 10 for guidance in identifying this date.)

Prior to finalising the financial statements, a check should be made, eg by visiting the IASB Website (www.ifrs.org), to ensure that all new or amended Standards/Interpretations that have been issued prior to the disclosure date have been considered and included as appropriate in the disclosures. This check should be done as close as practically possible to the date the financial statements are authorised for issue and dated. As a practical expedient, entities might wish to specify a cut-off date shortly before the date of sign-off.
Standards and Interpretations to be listed

The question arises of whether it is necessary for the financial statements to list every new Standard, amended Standard or Interpretation that has been issued but is not yet effective. IAS 8.31 requires that entities should consider disclosing the titles of new Standard or Interpretations [emphasis added]. However, in practice some of these pronouncements might be expected to have no material impact on the reporting entity or their scope is irrelevant to the entity's operations. A common approach is nonetheless to provide a complete list because this clearly meets the requirements of the Standard and reduces the possibility that some new pronouncements will be overlooked. Sometimes separate lists are disclosed, distinguishing between those pronouncements relevant to the entity's operations and those that are not.

However, the introduction to IAS 8 notes that the Standard requires disclosure of an impending change in accounting policy when an entity has yet to implement a new Standard or Interpretation that has been issued but not yet come into effect. In addition, it requires disclosure of known or reasonably estimable information relevant to assessing the possible impact that application of the new Standard or Interpretation will have on the entity's financial statements in the period of initial application (IAS 8.IN13) (emphasis added). This suggests that it is acceptable to disclose only those new pronouncements that are expected to have a material impact on the disclosures or amounts recognised in future financial statements or those pronouncements whose possible impact is yet to be determined.

Where a complete list is not provided, we recommend including a statement to the effect that the impact of all other Standards and Interpretations not yet adopted is not expected to be material.

Expected impact

The extent to which it will be practicable to assess the impact of a new pronouncement is likely to be influenced by the time interval between its publication and the authorisation for issue of the relevant financial statements and by the complexity of the new Standard or Interpretation. IAS 8.31 lists a number of matters to consider in providing the required disclosures, including a discussion of the impact that the initial application of the Standard or Interpretation is expected to have or a statement that the impact is not known or is not reasonably estimable. The level of detail disclosed is a matter of judgement and should be tailored to reflect the specific circumstances.

It is clear from IAS 8.BC31 that the matters listed in IAS 8.31 are not intended to be mandatory disclosure requirements and need only be disclosed where the information is known or is reasonably estimable. In particular, BC31 notes that the disclosure requirements are not intended to be more onerous than those of US GAAP (ASC 250-10-S50-1, 250-10-S99-5). However, market regulators and other users of the financial statements in different countries may develop different expectations as to the level of detail to be disclosed. It is therefore important to consider carefully what 'reasonably estimable' is interpreted to mean in your local environment.

Some entities are required by local regulations to produce interim financial statements in accordance with IAS 34. IAS 34.28 requires an entity to 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. Such a requirement may increase the expectation that the quantitative impact of a new Standard or Interpretation is known or is reasonably estimable at an earlier date. IAS 34 does not specifically require the disclosures in IAS 8.30 to be included in condensed interim financial statements. It may however be considered useful information for users and so its inclusion should be considered.
When a new Standard or Interpretation is expected to be relevant to an entity's operations to such an extent that it will result in a change of accounting policy or even of detailed disclosures it may require a change in the entity's accounting systems. Consequently, quantification of the expected impact for the purpose of this IAS 8 disclosure requirement is often not practicable. However, where possible, identification of the elements of the financial statements to be affected and how they are expected to change should be disclosed.

Example

The example on the following page demonstrates a common level of disclosure that we consider acceptable to satisfy the requirements of IAS 8.30-31. However, the manner of accounting, presentation and disclosure illustrated in this example should not be considered the only acceptable result of the application of IAS 8.30. Ultimately, the reporting entity's management is responsible for the form and content of financial statements as required by IFRS and therefore may find other approaches to compliance preferable over those presented.

Standards, amendments and interpretations to existing Standards that are not yet effective and have not been early adopted by the group in the 31 December 2012 financial statements

At the date of authorisation of these financial statements, certain new standards, amendments and interpretations to existing standards have been published by the IASB but are not yet effective, and have not been adopted early by the Group.

Management anticipates that all of the relevant pronouncements will be adopted in the Group's accounting policies for the first period beginning after the effective date of the pronouncement. Information on new standards, amendments and interpretations that are expected to be relevant to the Group's financial statements is provided below. Certain other new standards and interpretations have been issued but are not expected to have a material impact on the Group's financial statements.

IFRS 9 Financial Instruments (IFRS 9)

The IASB aims to replace IAS 39 Financial Instruments: Recognition and Measurement (IAS 39) in its entirety with IFRS 9. To date, the chapters dealing with recognition, classification, measurement and derecognition of financial assets and liabilities have been issued. These chapters are effective for annual periods beginning on or after 1 January 2015. Chapters dealing with impairment methodology and hedge accounting are still being developed. On 28 November 2012, the Board issued an exposure draft proposing limited modifications to IFRS 9's financial asset classification model to address application issues. The Group's management have yet to assess the impact of this new standard on the Group's consolidated financial statements. However, Management does not expect to implement IFRS 9 until all of its chapters have been published and they can comprehensively assess the impact of all changes.

Offsetting Financial Assets and Financial Liabilities (Amendments to IAS 32)

The Amendments to IAS 32 add application guidance to address inconsistencies in applying IAS 32's criteria for offsetting financial assets and financial liabilities in the following two areas:

- the meaning of 'currently has a legally enforceable right of set-off'
- that some gross settlement systems may be considered equivalent to net settlement.

The Amendments are effective for annual periods beginning on or after 1 January 2014 and are required to be applied retrospectively. Management does not anticipate a material impact on the Group's consolidated financial statements from these Amendments.
HT 2008-02 Loan commitments

Relevant IFRS
IAS 18 Revenue
IAS 37 Provisions, Contingent Liabilities and Contingent Assets
IAS 39 Financial Instruments: Recognition and Measurement

Project update
This Hot Topic reflects the requirements of IAS 39 Financial Instruments: Recognition and Measurement (IAS 39) and not those of IFRS 9 Financial Instruments (IFRS 9). IFRS 9 will eventually replace IAS 39 in its entirety. At this stage, IFRS 9 addresses the classification and measurement of financial assets and financial liabilities, along with derecognition. The requirements for financial liabilities and derecognition were carried forward unchanged (with the exception of some changes to the fair value option for financial liabilities to address the issue of own credit risk). On 28 November 2012, the Board issued an exposure draft proposing limited modifications to IFRS 9’s financial asset classification model to address application issues. IFRS 9 is effective for annual periods beginning on or after 1 January 2015 (early adoption permitted). Work continues on Phases 2 and 3 of the project, which address impairment and hedge accounting, respectively.

Issue
Accounting for loan commitments that are outside the scope of IAS 39. Specifically:

- Are loan commitments outside the scope of IAS 39 for both the borrower and the lender?
- Are both option-type and forward-type loan commitments outside the scope of IAS 39?
- How should loan commitments that are outside the scope of IAS 39 be accounted for?
- What is the accounting treatment of changes in the fair value of a loan during the commitment period?

IA 39 'scope-out' for loan commitments
IAS 39.2(h) states that loan commitments are outside IAS 39’s scope except for commitments described in IAS 39.4. Broadly, IAS 39.4 states that the following loan commitments are within IAS 39's scope:

- commitments that the entity designates at fair value through profit or loss
- commitments that can be settled net in cash or by delivering another financial instrument
- commitments to provide a loan at a below market interest rate.

This Hot Topic focuses on loan commitments that are outside the scope of IAS 39 (ie commitments to which IAS 39.4 does not apply). Loan commitments that are of the type described in IAS 39.4 are accounted for as derivatives, at fair value through profit or loss.
**Guidance**

**Types of loan commitment outside the scope of IAS 39**

In our view the IAS 39.2(h) scope exemption applies to:

- both the (potential) lender and the (potential) borrower
- both option-type commitments (ie contract commitments that provide an entity with an option to borrow at a future date) and forward-type commitments (ie contracts that oblige the parties to enter into a borrowing arrangement at a future date).

**Accounting for loan commitments outside the scope of IAS 39**

**Lender**

For the lender, IFRS includes some specific requirements as follows:

- the commitment itself is accounted for in accordance with IAS 37 (IAS 39.2(h)). Accordingly, a provision is recorded if the commitment is or becomes onerous
- commitment fees received when it is **probable** that a loan will be originated are deferred and recognised as an adjustment to the loan's effective interest rate (EIR). If the commitment expires without making a loan, the commitment fee is recognised as revenue on expiry (IAS 18.IE.14(a)(ii))
- commitment fees received when it is **not probable** that a loan will be originated are deferred and recognised as revenue over the commitment period (IAS 18.IE.14(b)(ii)).

**Borrower**

IFRS does not include specific requirements for the borrower. In our view it is appropriate that the borrower accounts for commitments and associated fees paid in a similar manner to the lender. Accordingly:

- commitment fees paid when it is probable that a loan will be originated should be treated as a prepayment and recognised as an adjustment to the loan's EIR. If the commitment expires without making a loan, the commitment fee is recognised as an expense
- other commitment fees paid are recorded as an asset and amortised over the commitment period or on some other systematic basis
- any asset recorded in respect of commitment fees is subject to the impairment requirements of IAS 36.

**Accounting for loans made pursuant to a loan commitment**

Assuming the loan will be measured on an amortised cost basis (ie that it will not be designated at fair value through profit or loss), our preferred approach is to record the loan at its fair value reflecting market interest rates and the borrower's credit standing at the **commitment** date. No gain or loss should then arise on initial recognition.

**Loan date or commitment date accounting?**

On 1 January X1 a bank writes an option to a company permitting the company to borrow CU1m over 5 years at 10% (a market interest rate) at that date. The loan can be drawn-down at any time in the next 12 months. On 31 December X1, the company draws the loan. At that date, market interest rates have increased to 11%. As a result, the fair value of the loan at 31 Dec X1 is estimated as CU963,000. Is the loan recorded at CU1m or CU963,000?

Our preferred approach is to record the loan at its commitment date fair value of CU1m. The alternative approach would lead to the loan being recorded at its loan date fair value of CU963,000. The difference of CU37,000 would then be an immediate gain for the company and an immediate loss for the bank.

**Discussion**

**General**

Many companies enter into agreements with banks and other lenders that provide an option or an obligation to borrow money at a future date. Typically a fee is paid by the potential borrower. Such agreements may provide financial flexibility, reduce liquidity risk and provide protection against future increases in borrowing costs (eg resulting from increases in interest rates or a deterioration in credit standing).
The terms and conditions of these agreements vary widely. Some agreements entitle a company to borrow up to a pre-specified amount over a stated period and are replenished as repayments of outstanding balances are made (a revolving credit facility). This is an example of an option-type arrangement; the company has a right to borrow but is not obliged to do so. Less commonly, an agreement might give rise to an obligation to originate a loan at a future date. Agreements sometimes fix the interest rate or margin, or specify that the rate will be set at the loan date.

**Types of loan commitment outside the scope of IAS 39**

As explained above, IAS 39.2(h) scopes out loan commitment other than those described in IAS 39.4. However, the term loan commitment is not defined in IAS 39 itself. This has led to questions as to which types of arrangement should be considered loan commitments for this purpose. IAS 39.BC15 and 16 state that:

- **BC 15** Loan commitments are *firm commitments* to provide credit under pre-specified terms and conditions. …..In effect, it is a *written option* for the potential borrower to obtain a loan at a specified rate.

- **BC 16** To simplify the accounting for holders and issuers of loan commitments the Board decided to exclude particular loan commitments from the scope of IAS 39…” [emphasis added]

Taken together, these quotes indicate that the IASB intended that the IAS 39.2(h) scope exclusion should apply to both option and non-option type commitments, and also to both the borrower and the lender.

**Accounting for loan commitments outside the scope of IAS 39**

**Lender**

The guidance and IFRS references set out above are largely self-explanatory.

IAS 39.9 requires that all fees or points paid that are an 'integral part of the EIR' are brought into the calculation of the EIR. IAS 18 then provides guidance on when commitment fees received are an integral part of the EIR. Such fees received are an integral part of the EIR if it is probable that the commitment will result in a specific loan being made (IAS 18.IE14).

Accordingly, the treatment of commitment fees depends in part on an assessment of the probability of the underlying loan being advanced. This assessment will involve some judgment for option-type commitments. For non-option type commitments, it is of course certain that a specific loan will be made so any fees paid will be an integral part of the EIR.

In practice, one of the more difficult issues (for the lender) is determining if a loan commitment is onerous (and should therefore be provided for in accordance with IAS 37). In our view, a commitment should be regarded as onerous if:

- an immediate impairment loss would arise on origination of the loan or
- the cost of funding the loan exceeds the interest receivable on it.

An immediate impairment loss is likely to be quite rare. This would arise only if the lender does not expect the borrower to be able to repay the funds advanced.

**Borrower**

Borrower accounting for loan commitments that are outside IAS 39's scope is largely not addressed in IFRS. Accordingly an entity should develop its own accounting policy to address this type of transaction. One point that is however explicit is that IAS 39.9 requires that the borrower (as well as the lender) includes fees that are an integral part of the EIR in the calculation of the EIR. In the absence of further specific guidance as to how to assess whether commitment fees are an integral part of the EIR, it seems appropriate to use the guidance applicable to the lender in IAS 18.
Some commentators question whether it is appropriate to recognise an asset in respect of commitment fees paid if draw-down is not probable. These commentators note that the IASB Framework's definition of an asset is met only if it is expected that future economic benefits will flow to the entity. Moreover, the Framework indicates that assets are recognised only if it is probable that the future economic benefits will flow to the entity. These arguments might be used to support an accounting policy of immediate expensing of 'non-probable' commitment fees.

Despite these arguments, our preferred view is that a right to borrow is an asset that should be recognised in the financial statements. This view is supported by:

- taking a broader view of economic benefits. The economic benefit of a right to borrow is not restricted to the loan itself (the receipt of which would not typically increase the entity's net assets). Rather, it is the financial security, flexibility and reduction in liquidity, market and credit risk conferred by the right
- analogy to the generally accepted accounting treatment for similar transactions such as prepaid insurance premiums
- virtue of the fact that a right to borrow meets the definition of a financial asset (even though it is scoped out of IAS 39)
- recording the associated expense in a similar manner to the recognition of revenue by the lender.

If an asset is recorded for fees paid that are not integral to the EIR, this asset should be amortised on a systematic basis. In practice, straight-line amortisation over the commitment period may be a reasonable approach in many cases. However, the amortisation policy needs to reflect the terms of the commitment.

If the fees paid were not considered an integral part of the EIR at the commitment date and a loan is originated, the unamortised portion of any asset recognised should not be included in the calculation of the EIR. If the right to borrow expires once the loan is originated, the asset should be expensed at that point.

An asset recorded in relation to a loan commitment may become impaired. Examples of factors that could indicate impairment include:

- a reduction in the holder's (ie the potential borrower's) funding needs as a result of securing alternative sources of finance
- a change in future investment plans
- a significant decline in market interest rates.

**Accounting for loans made pursuant to a loan commitment**

If a loan commitment specifies a fixed interest rate or margin, the fair value of the underlying loan might change between the commitment date and the date of the loan. This change might reflect movements in market interest rates and/or the borrower's credit standing. If the loan is recognised initially at its fair value on the loan date (in accordance with IAS 39.43), an immediate gain or loss would then arise. Alternatively, the loan might be recorded at a fair value reflecting market interest rates and the borrower's credit standing at the commitment date.

This is a difficult issue on which IAS 39 appears to give conflicting guidance. IAS 39.43 would seem to require fair value on the loan date (adjusted for applicable transaction costs) with a consequent immediate gain or loss on draw-down. Such an approach seems however to conflict with the IASB's objective in excluding many loan commitments from IAS 39's scope. The IASB explains that the effect of this scope out is that changes in the fair value of applicable loan commitments are not recognised or measured (IAS 39.BC16). Recognising an immediate gain or loss is equivalent to recognising this same fair value movement (albeit on a deferred basis).

Our preferred approach, partly on the grounds of simplicity, is to recognise the loan at its fair value reflecting market interest rates and the borrower's credit standing at the commitment date. This can be described as a 'commitment date' approach. However, the alternative 'loan date' approach can also be justified.

The practical importance of this issue is reduced somewhat by the fact that many loan commitments include conditions that entitle the bank to cancel the commitment if the borrower's credit standing declines significantly.
Examples

Revolving credit facility
An entity enters into a revolving credit facility on 1 January X1. The facility entitles the entity (subject to various covenants and conditions) to borrow up to CU10m on a revolving basis over the next five years at the London Inter-Bank Offered Rate (LIBOR) plus 3%. The entity pays an upfront fee of CU100,000. The stated interest rate is a market interest rate for the entity in question, without taking the commitment fee into consideration. The intention is to draw down only if working capital needs increase above expectations or other sources of finance are not available. Accordingly, management does not consider that it is probable that the loan will be drawn down.

Analysis
In this case it is not probable that a specific loan will be originated. Moreover, the fact that the specified borrowing rate is on market terms indicates that the fees paid/received are not an integral part of the EIR. Accordingly, the borrower should record the CU100,000 as an asset and amortise this amount over the 5-year term. The pattern of amortisation should reflect the manner in which the economic benefits are consumed. In this case, because the right to borrow does not expire on draw-down there is no need to accelerate the amortisation if some or all of the facility is drawn down. If the availability facility was reduced on each drawdown, the amortisation pattern should reflect this.

If the borrower took the alternative view that the right to the loan does not qualify for recognition as an asset in accordance with IFRS, the entire fee paid is expensed immediately.

The lender records the CU100,000 received as deferred revenue on 1 January X1 and releases this amount to income over the 5-year commitment period.

If it is considered probable that the loan will be drawn down, both the borrower and the lender would defer the commitment fee until the drawdown date. This amount would be brought into the calculation of the EIR at that date.

Fixed loan commitment
An entity enters into an arrangement with a bank on 1 January X1 that obliges it to borrow and the bank to lend CU1m on 31 December X1, repayable on 31 December X6. An upfront fee of CU50,000 is paid to the bank. The loan carries a fixed interest rate of 10%. This is a market interest rate for the entity in question taking into consideration the upfront fee. The 10% rate reflects market conditions and the entity's credit rating at 1 Jan X1. No other fees are incurred.

During 20X1, market interest rates decline such that the entity could have borrowed at 9.5% at 31 Dec X1.

Analysis
In this case the CU50,000 appears to be an integral part of the EIR. The loan is certain and the interest rate on the loan is 'at market' only when the CU50,000 fee is considered. Accordingly, the fee is deferred as an asset by the borrower and as deferred income by the lender. No amortisation is recorded during the period. On origination of the loan, the fee is included in the EIR calculation and deducted in arriving at the loan's initial carrying amount (assuming the loan is to be measured at amortised cost using the effective interest method).

Based on our preferred commitment date accounting approach, the initial carrying amount of the loan is based on market conditions at the commitment date. Accordingly, the initial carrying value is not adjusted for the decline in interest rates over the commitment period.

From the borrower's perspective, the accounting entries on the commitment date and loan date are as follows:
The EIR of the loan is determined based on the initial carrying value of CU950,000. This EIR is subsequently used to determine interest income and expense.
Commodity contracts and IAS 39

Relevant IFRS

IA 39 Financial Instruments: Recognition and Measurement

Project updates

This Hot Topic reflects the requirements of IAS 39 Financial Instruments: Recognition and Measurement (IAS 39) and not those of IFRS 9 Financial Instruments (IFRS 9). IFRS 9 will eventually replace IAS 39 in its entirety. At this stage, IFRS 9 addresses the classification and measurement of financial assets and financial liabilities, along with derecognition. The requirements for financial liabilities and derecognition were carried forward unchanged (with the exception of some changes to the fair value option for financial liabilities to address the issue of own credit risk). On 28 November 2012, the Board issued an exposure draft proposing limited modifications to IFRS 9’s financial asset classification model to address application issues. IFRS 9 is effective for annual periods beginning on or after 1 January 2015 (early adoption permitted). Work continues on Phases 2 and 3 of the project, which address impairment and hedge accounting, respectively.

Issue

This Hot Topic provides general guidance on accounting for commodity contracts, with a particular focus on determining whether such contracts are within the scope of IAS 39.

Scope

This Hot Topic focuses on contracts to buy or sell a commodity such as iron ore, crude oil, coal, ethanol, sugar, soybeans, aluminum, rice, wheat, gold or silver. The issues discussed, and the related requirements of IAS 39, also apply to contracts to buy or sell any non-financial item. However, most of the practical and interpretive issues arising in practice relate to commodity contracts.

Contracts that require payments linked to a commodity price or index, but are not contracts to buy or sell the underlying commodity, are likely to be derivative financial instruments or financial instruments with embedded derivatives. An example is a debt contract with interest payments linked to the price of gold. These types of contract are not addressed in the Hot Topic.

Guidance

Most contracts to buy or sell a commodity do not meet the definition of a financial instrument. Nonetheless IAS 39.5 specifies that IAS 39 applies to contracts to buy or sell a non-financial item that:

- can be settled net in cash or
- can be settled by exchanging financial instruments;

unless such contracts were entered into and continue to be held for the purpose of the receipt or delivery of the non-financial item in accordance with the entity’s expected purchase, sale or usage requirements [emphasis added]. This requirement is commonly referred to as the ‘own-use’ exemption.

This guidance is summarised in the Appendix to this Hot Topic and discussed in more detail below.

Discussion

General
Determining whether a commodity contract is within the scope of IAS 39 can be a complex exercise and may involve judgement. It is however important to reach the correct conclusion because contracts to which IAS 39 applies will mainly be derivatives measured at fair value through profit or loss (FVTPL). Contracts to which IAS 39 does not apply will not usually be recognised in the financial statements until delivery takes place (unless they are onerous contracts).
In part the complexity reflects the diversity of commodities markets and the many different features of commodity contracts. However, IAS 39’s requirements also give rise to a number of interpretative questions (some of which have been considered by the IFRIC). Fortunately, in many cases determining whether IAS 39 applies is straightforward and reasonably intuitive. It is likely that an entity in the commodities trading business will enter into contracts that are within IAS 39’s scope. Conversely, companies that buy commodities solely for use in production are less likely to be required to apply IAS 39 to their purchase contracts. An initial analysis of whether IAS 39 applies therefore involves distinguishing between:

- contracts entered into for trading, speculative and hedging purposes
- normal purchase or sale contracts.

Especially in more difficult cases, a careful analysis of the contracts’ terms and conditions, the purpose for which they are held and the manner in which they will be settled is necessary. The following paragraphs provide additional explanation and guidance on factors to consider in performing this analysis.

**Can the contract be settled net in cash?**

IAS 39.6 specifies four ways in which a contract to buy or sell a non-financial item can be settled net in cash:

- the contract terms permit net cash settlement (IAS 39.6(a))
- the contract terms do not explicitly permit net cash settlement, but the entity has a past practice of settling similar contracts net in cash (IAS 39.6(b))
- the entity has a past practice for similar contracts of taking delivery of the underlying item and selling it within a short period of time to generate a profit from short-term price fluctuations or a dealer's margin (IAS 39.6(c))
- the non-financial item is readily convertible into cash (IAS 39.6(d)).

If any of these conditions apply, the contract is regarded as capable of net cash settlement. The four different ways are considered in turn below.

**Contract terms permit net cash settlement**

The normal way of settling a contract to buy or sell a non-financial item is by exchanging the item for the agreed price (described as ‘gross physical settlement’). However, some contracts are ‘net cash settled’. Net cash settlement is the process of one party paying the other an amount of cash equivalent to the value of the contract, with no physical delivery of the underlying item. A commodity contract that includes an option allowing for one or both parties to net cash settle is within the scope of IAS 39 unless the own-use exemption applies (see below).

**Net cash settlement**

An entity enters into a contract to supply 1,000 barrels of crude oil for CU100/barrel (CU100,000) in 3 months’ time. The contract permits the supplier to pay or receive an amount of cash equal to the difference between CU100,000 and the value of 1,000 barrels of crude oil at the West Texas Intermediate (WTI) spot price. This contract permits net cash settlement and is therefore within the scope of IAS 39 unless the own-use exemption applies.

A net cash settlement option is by its nature usually readily identifiable in the contract. An issue that arises in practice is whether contracts that include break fee clauses (ie payments to cancel the contract) or penalties for non-performance should be regarded as being capable of net cash settlement. The substance of such clauses should be assessed. In our view a clause that has the purpose and effect of compensating the counter-party for non-performance should be distinguished from an option to settle the value of the contract net in cash. A key feature of a net cash settlement provision is likely to be that the settlement payment is linked to the value of the underlying non-financial item.
Break clause
A steel manufacturer signs a contract to supply 50 tonnes of standard plate steel for delivery in six months. The contract permits either party to cancel in the first 60 days for a one-off fee of CU50,000 (intended to compensate the other for administrative costs).

In our view, a fixed sum break clause of this nature is not a net cash settlement provision. However, a break fee that varies based on changes in value of the underlying steel would be a net cash settlement provision.

Past practice of net cash settlement
Even if a contract does not explicitly permit net cash settlement, the buyer and seller might agree to net cash settle. If the entity has a past practice of net cash settling similar contracts, all contracts in this class are regarded as net cash settled. These contracts cannot be own use contracts, even if some of the contracts will be physically settled (IAS 39.6).

For this purpose, net cash settlement includes:

- net cash settlement with the counterparty
- entering into one or more offsetting contracts
- selling the contract prior to its exercise or lapse (IAS 39.6(b)).

This form of net cash settlement gives rise to a number of issues on which IAS 39 has little or no guidance. In particular, judgement is required to determine:

- whether specific circumstances amount to a 'past practice' of net cash settlement
- how to interpret the term 'similar contracts'.

In our view, the term 'past practice' should be interpreted quite strictly. We consider that a past practice is established by net cash settling more than an insignificant portion of contracts in the class under review. A past practice is not established as a result of highly infrequent net cash settlements or settlements that are demonstrably a consequence of unforeseen circumstances.

Past practice of net settlement - unforeseen event
A bread manufacturing company enters into forward purchase agreements for a portion of its expected wheat requirements. It intends to take physical delivery of the wheat for use in its operations. However, after signing the contracts the company experiences an outbreak of contamination at one of its major factories, forcing it to shut down pending investigation and clean-up. The company therefore negotiates a net cash settlement with its supplier rather than taking delivery of wheat that it will be unable to use.

This cash settlement is clearly attributable to an unforeseen (and hopefully one-off) event. Accordingly, the company has not established a past practice of net cash settlement.

Past practice of net settlement - settlement of portion of contract portfolio
A glass manufacturing company is anxious to ensure it has adequate supplies of zirconium - an essential commodity for which demand has exceeded supply in recent years. Accordingly, the company routinely contracts to purchase 125% of its expected annual requirement in advance. As its actual requirements become apparent, it enters into offsetting sale agreements for the excess quantities. The purchase contracts are indistinguishable, and the company does not attempt to segregate them.

In this example, the company routinely net cash settles approximately 20% of its commodity contracts (a not insignificant proportion). The contracts are similar and are not segregated into trade and physical contracts at inception. The entire portfolio of contracts is therefore within the scope of IAS 39. None of these contracts is eligible for the own use exemption.

Determining whether the contracts in a group of contracts are 'similar' requires judgement based on specific facts and circumstances. However, contracts for traded commodities are often in a standard form and are therefore clearly 'similar' (eg LME Copper Grade A Futures Contracts).
In our view the similarity or otherwise of a group of contracts depends on the business purpose for which the contracts are held as well as the terms of the contracts. If an entity has some contracts for trading (net cash settlement) purposes and other similar contracts for physical settlement, it is in our view appropriate to consider these as separate portfolios if the entity segregates the contracts at inception. The contracts held for physical settlement may then be outside IAS 39's scope (based on the own-use exemption). Such an approach would however be undermined if the entity subsequently decides to net cash settle more than an insignificant amount of the contracts in the physical settlement portfolio.

**Similar contracts held for different purposes**

A company in the coffee business has a manufacturing operation and a trading operation. It enters into similar coffee bean purchase contracts for both operations. Management intends to take delivery of the coffee beans in some cases for the manufacture and sale of ground coffee. Other contracts acquired for trading purposes will be closed out by entering into offsetting sale contracts. Management designates each contract at inception based on its intended purpose. The two contract portfolios are managed and monitored separately.

In this example, the contracts in the trading portfolio are within the scope of IAS 39. The contracts in the physical delivery portfolio will be outside the scope of IAS 39 provided the designation is not 'tainted' by net cash settlement.

If management decided not undertake the work involved in separate designation and monitoring, all of the contracts would be within the scope of IAS 39.

**Taking delivery of the underlying item and selling it within a short period**

Contracts that will result in physical delivery are within the scope of IAS 39 if the buyer sells the commodity within a short period to generate a dealing or trading profit. Such contracts cannot be own-use contracts.

Although IAS 39 does not provide detailed guidance on application of this requirement, it will normally be clear whether the activities of an entity that takes delivery of a commodity are of a trading nature. Some commodity exchanges, such as the London Metals Exchange (LME), provide warehousing facilities to assist traders in taking delivery. A characteristic of trading is that there is no conversion of the underlying commodity i.e. the commodity is sold in the form in which it was purchased.

**Trading or wholesaling?**

Trading activities should be distinguished from wholesaling and distribution. Although a wholesaler does not convert the product, it typically adds value by purchasing commodities in larger lots and repacking and redistributing them in smaller lots. An example of wholesaling involving a commodity might be the supply of fuel oil to commercial and domestic customers. Contracts to buy or sell a commodity for wholesale purposes are not in our view caught by IAS 39.6(c). Such contracts are therefore outside the scope of IAS 39 if they are for own-use.

**Non-financial item is readily convertible into cash**

Even if an entity takes delivery of the underlying commodity, the contract is regarded as net cash settled if the commodity is readily convertible into cash. It is of course possible to convert almost any commodity into cash. In applying this requirement it is therefore important to consider whether a specific commodity is readily convertible into cash. In our view a commodity is almost always readily convertible into cash if it is traded in an active market with the characteristics set out in IFRS 13.72 (quoted prices in an active market). This assessment should take into consideration:

- the grade and quantity of the commodity
- the delivery location specified in the contract.

This is because active markets in commodities usually specify the grades and quantities and sometimes delivery points. Commodities of a grade that is not traded may not be readily convertible. Similarly, some commodities might be readily convertible in a 'trading hub' but not in other locations.
Grade and quantity
The LME facilitates trading in a range of metals including copper. LME copper contracts specify trading in 'Grade A cathodes conforming to BSEN 1978:1998 in lot sizes of 25 tonnes'. Accordingly, copper of this grade and quantity is readily convertible into cash. However, copper and copper alloys are also bought and sold commercially in numerous other standard grades, specifications and quantities. Most of these forms of copper are not traded in active markets and would not therefore be considered readily convertible into cash for the purpose of IAS 39.6(d).

Location
Coal is commonly bought and sold at a number of trading hubs around the world such as ARA (Amsterdam-Rotterdam-Antwerp), Richards Bay (South Africa) and Newcastle (Australia). Quoted coal prices commonly refer to the grade, location and shipping terms (eg FOB Richards Bay (6,000 kcal/kg). This contract specifies the calorific content of the coal and that the seller is responsible for delivery of the coal to the buyer's specified carrier in Richards Bay). In our view a contract for Richards Bay 6,000 kcal/kg coal will always be capable of net cash settlement because there is an active market for this product in this location. By contrast a contract for delivery of coal to a location that is not a trading hub (from which shipping costs to the nearest hub are significant) might not be regarded as being capable of net cash settlement under IAS 39.6(d). Such a contract might of course be capable of net cash settlement for other reasons.

Is the contract for ‘own use’?
Contracts that are capable of being net cash settled because:

- the contract terms permit net cash settlement or
- the non-financial item is readily convertible into cash

are outside the scope of IAS 39 if, and only if, they were entered into and continue to be held for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements. Contracts that are exempt from IAS 39 on these grounds are commonly referred to as 'own use contracts'. Important matters to note concerning own use contracts include:

- contracts cannot be own use if the entity has a past practice:
  - of settling similar contracts net in cash
  - for similar contracts, taking delivery of the underlying item and selling it within a short period of time to generate a profit from short-term price fluctuations or a dealer’s margin
- a contract that is regarded as net cash settled and is also a written option cannot be an own-use contract (IAS 39.7) (see below).

The conditions to meet the own use exemption include that the contract 'continues to be held for the purpose of receipt or delivery …' [emphasis added]. The assessment of own use therefore requires an ongoing evaluation of the purposes for which contracts are held. Management representations that certain contracts are own use would be called into question if a significant number of similar contracts are subsequently net cash-settled. This is primarily an audit matter.

Receipt or delivery
Application of the own use exemption has led to questions concerning the meaning of ‘receipt or delivery’ for this purpose. It is clear that this condition should be met if the supplier physically delivers the commodity to the customer (assuming that IAS 39.6(c) does not apply). The position is less clear when:

- market structure interposes an intermediary between the supplier and the end-customer, such as a grid operator in some electricity markets or
- the supplier fulfils its obligations by arranging for another party to deliver the commodity.

The IFRIC has considered the first question and published the following rejection note in August 2005:

"The IFRIC considered the application of the ‘own purchase, sale or usage requirements’ scope exemption in paragraph 5 of IAS 39 where:

a) the market design or process imposes a structure or intermediary (eg a gold refiner or an electricity market operator) that prevents the producer from physically delivering its production to the counterparty of the hedge pricing contract; and
b) in some cases, physical delivery is to the intermediary for the spot price, even if the producer is protected from spot price risk by a separate contract that effectively sets a fixed price for the producer's production.

The IFRIC noted that ‘delivery’ for the purposes of the paragraph 5 exemption is not necessarily restricted to the physical delivery of the underlying to a specific customer, as physical delivery is not a condition of the exemption. The IFRIC was of the view that delivery of gold to a refiner in return for an allocation of an equivalent quantity of refined gold was not delivery, but that allocation of that refined gold to a customer’s account could be considered delivery. [The IFRIC] decided not to develop guidance on the meaning of ‘delivery’ as it was not aware of any evidence of significant diversity in practice.

[The IFRIC indicated] that a synthetic arrangement that results from the linking of a non-deliverable contract entered into with a customer to fix the price of a commodity with a transaction to buy or sell through an intermediary would not satisfy the paragraph 5 scope exemption.

In the second situation (the supplier arranging for another party to deliver), we consider that an evaluation of the substance of the arrangement is required. An entity in the commodities broking or trading business might take sales orders from customers and then enter into contracts with suppliers to deliver the commodity direct to the customer. In this scenario the broker/trader is acting as principal, is not delivering from its own production and is not carrying out any conversion of the commodity. For those reasons, in our view these sale and purchase contracts are not in substance own use contracts for the broker/trader (although this is ultimately a matter of interpretation).

By contrast, a mining entity might forward sell part of its expected production but later experience an unexpected production shortfall. The mining entity might decide to discharge its commitments by subcontracting to a third party. In contractual terms, the sale and purchase contracts relating to these excess commitments are similar to the broker/trader’s contracts. However, we consider that there is a stronger argument that the contracts are own use in this case.

### Aluminum trader

An aluminum trader's business model involves:

- entering into physically settled aluminum supply contracts with commercial and industrial users throughout the world
- arranging delivery by entering into purchase contracts for delivery direct to the customer.

It is likely that aluminum is readily convertible into cash. Accordingly, these contracts should be assessed to determine if they fall within the IAS 39.5 own use exemption. Although it could be argued that the contracts are entered into for the entity’s own purchase and sale requirements, we consider that this does not reflect the substance of this entity’s activities. The trader does not produce or consume aluminum in its operations and does not convert the commodity in any way. We therefore believe that both the sale and the purchase contracts are within the scope of IAS 39.

### Written options

IAS 39.7 states that a written option contract that can be settled net in cash (ie has a net cash settlement provision or the underlying item is readily convertible into cash) cannot be an own use contract. IAS 39 therefore applies to such contracts). These contracts cannot be own-use because an entity that grants another party an option to buy or sell a commodity cannot decide whether the option is exercised (and therefore whether delivery will occur). Accordingly, an entity in this position cannot argue that the contract is primarily intended to meet its sale, purchase or usage requirements.

This requirement has led to questions over what is meant by a 'written option' for this purpose. In our view, this requirement is intended to capture contracts containing volumetric optionality (ie contracts with an option over how much of the underlying commodity is bought or sold). We do not believe it is intended to address contracts with embedded price caps, floors or other features that might be economically equivalent to cash-settled, embedded options. Contracts that contain such pricing features should be assessed to determine:

- whether these features are embedded derivatives
- if so, whether the embedded derivative should be separated from the host contract for accounting purposes (see IAS 39.AG33(b) in particular).
Many commentators also take the view that a contract should be regarded as a written option only if the entity that writes the option receives a net premium. This is based on the guidance in IAS 39.IG.F1.3. However a net premium may not always be readily apparent, as it might be incorporated into the contract pricing (instead of being paid upfront).

**Electricity contract with volumetric variability**

An electricity generator enters into a supply contract with a commercial customer. No cash is paid or received on signing the contract. The contract is for the supply of 1,000MWh of electricity at CU50/MWh over the next 6 months, but also entitles the customer to take an additional 250MWh at the same price in this period. A similar contract without this volume flexibility would be priced at CU48/MWh. Electricity is regarded as readily convertible into cash in this market.

This contract contains volume variability, which is at the option of the customer. Also, the customer is paying a premium for this flexibility in the form of a higher price per unit. This contract is therefore within the scope of IAS 39 (given that the underlying item is readily convertible into cash in this market).

In our view, the entire contract should be accounted for in accordance with IAS 39. We do not consider that it is appropriate to split the contract into a fixed portion of 1,000 MWh and a written option portion of up to 250MWh.

Electricity contracts have given rise to many questions. This is partly because electricity cannot normally be stored economically. The sector has therefore developed practices intended to continuously balance supply and demand.

Many such contracts contain volume variability and contracts are often cash settled in order to keep supply commitments in line with production. The IFRIC made the following comments concerning energy supply contracts to retail customers in a rejection note in March 2007:

"Under paragraph 7 of IAS 39 a written option to buy or sell a non-financial item that can be net settled (as defined in paragraph 5) cannot be considered to have been entered into for the purpose of meeting the reporting entity's normal purchase, sale and usage requirements. The application of this paragraph is illustrated in the current guidance.

The submission was primarily concerned with the accounting for energy supply contracts to retail customers.

Analysis of such contracts suggests that in many situations these contracts are not capable of net cash settlement as laid out in paragraphs 5 and 6 of IAS 39. If this is the case, such contracts would not be considered to be within the scope of IAS 39.

In the light of the above, the IFRIC expected little divergence in practice and therefore decided not to take the item on to the agenda."

**Accounting consequences of being within or outside IAS 39's scope**

**Contracts within IAS 39's scope**

Most contracts with the scope of IAS 39 will meet the definition of a derivative in IAS 39.9. Commodity contracts normally have no initial investment, and their value will vary in accordance with the value of the commodity in question.

A commodity contract within IAS 39's scope that is also a derivative is accounted for at FVTPL.

**Contracts accounted for as derivatives but physically settled**

Sometimes a contract that is within IAS 39's scope is physically settled. This could occur if, for example, the entity net cash settles other similar contracts. Assuming the contract is accounted for as a derivative through FVTPL, the contract will be recognised immediately prior to settlement at the difference between the contract price and the spot price of the underlying commodity (adjusted as appropriate for other factors such as delivery obligations). On delivery, sale and purchase of inventory also need to be accounted for. The following example illustrates this from the vendor's perspective.
## Gold contract accounted for net and settled gross

On 1 January X1 a gold refiner contracts to deliver a fixed quantity of gold for CU1m in six months' time. The contract is assessed in accordance with IAS 39.5 -7 and is considered to be a derivative within the scope of IAS 39. On 30 June X1, the market price of this quantity of gold has fallen to CU900,000. The contract is settled by physical delivery of the gold on 30 June X1. The cost of the inventory is CU875,000.

At 30 June X1, the contract has a fair value to the refiner of CU100,000 (asset).

### Analysis

During the 6 months to 30 June X1 the refiner will record a net gain of CU100,000 representing the increase in the fair value of the contract. This should not be presented as revenue.

On delivery on 30 June X1 the refiner:

- records a new financial receivable of CU1m (assuming no discounting is required) for the consideration due
- recognises revenue
- derecognises inventory and records the costs of sale
- de-recognises the derivative financial asset.

There is a question where the debit entry corresponding to the de-recognition of the derivative asset should be recorded. We suggest that it is recorded as an adjustment to revenue. The 'sale' is thus characterised as a delivery of gold at fair value on the delivery date. The proceeds are characterised as CU100,000 to settle the derivative and CU900,000 for the gold. The accounting effect is the same as if the contract price is fair value at the delivery date and the refiner enters into a separate derivative to offset price changes from the contract date to the delivery date.

### Accounting entries from 1 Jan X1 to 30 June X1

<table>
<thead>
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</thead>
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<td>Derivative financial asset</td>
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<tr>
<td>Income statement gain</td>
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</tbody>
</table>

### Accounting entries on 30 June X1

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
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</thead>
<tbody>
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<td>Revenue</td>
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<td>Inventory</td>
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</tr>
<tr>
<td>Cost of sales</td>
<td>875,000</td>
</tr>
</tbody>
</table>

### Contracts outside IAS 39’s scope

Contracts to buy or sell a commodity that are outside the scope of IAS 39 will not normally be recognised in the financial statements until delivery. On delivery, a sale or an inventory purchase is recognised in the normal way. However, if a commodity contract is or becomes onerous, a provision is recorded in accordance with IAS 37.

In our view a commodity contract should not be considered onerous solely on the grounds that it is unfavourable to market (eg for the seller the agreed price is less than current market prices). A contract is onerous if the economic benefits to be received are less than the unavoidable costs of the contract obligations.

*******************************************************************************

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Appendix
Decision tree to determine if a contract to buy or sell a non-financial item is within the scope of IAS 39

Does contract explicitly permit net settlement in cash or by exchanging financial instruments?
- Yes: IAS 39 APPLIES
- No: Does entity have a past practice of net cash settling similar contracts?
  - Yes: IAS 39 APPLIES
  - No: Does entity have past practice for similar contracts of taking delivery of the item and selling within a short period of time?
    - Yes: IAS 39 APPLIES
    - No: Is the non-financial item to be purchased or sold readily convertible into cash?
      - Yes: Is the contract a written option contract?
        - Yes: IAS 39 APPLIES
        - No: Is contract for receipt/delivery of non-financial item in accordance with entity’s purchase, sale or usage requirements?
          - Yes: IAS 39 APPLIES
          - No: IAS 39 DOES NOT APPLY
HT 2008-04 Rental guarantees on investment properties

Relevant IFRS
IAS 40 Investment Property
IAS 39 Financial Instruments: Recognition and Measurement
IFRS 4 Insurance Contracts

Project updates
IFRS 9
This Hot Topic reflects the requirements of IAS 39 Financial Instruments: Recognition and Measurement (IAS 39) and not those of IFRS 9 Financial Instruments (IFRS 9). IFRS 9 will eventually replace IAS 39 in its entirety. At this stage, IFRS 9 addresses the classification and measurement of financial assets and financial liabilities, along with derecognition. The requirements for financial liabilities and derecognition were carried forward unchanged (with the exception of some changes to the fair value option for financial liabilities to address the issue of own credit risk). On 28 November 2012, the Board issued an exposure draft proposing limited modifications to IFRS 9’s financial asset classification model to address application issues. IFRS 9 is effective for annual periods beginning on or after 1 January 2015 (early adoption permitted). Work continues on Phases 2 and 3 of the project, which address impairment and hedge accounting, respectively.

IFRS 4
The IASB is presently working on an insurance contracts project that aims to provide a single source of principle-based guidance to account for all types of insurance contracts. The existing IFRS 4 is an interim standard that allows insurers to continue using various existing accounting practices that have developed in a piecemeal fashion over many years. The Board issued an exposure draft in 2010 and targets re-exposure in the first half of 2013. This Hot Topic reflects the existing guidance in IFRS 4.

Issue
How should the purchaser of an investment property account for a rental guarantee and payments received under the rental guarantee in relation to the acquired investment property? Specifically:

- is the rental guarantee a separate asset?
- if the guarantee is a separate asset, what kind of asset does it represent?
- how should the cash inflows resulting from the rental guarantee be recognised?

Guidance
If the rental guarantee is material, an assessment should be made of whether or not the rental guarantee is separable from the property. A rental guarantee will be separable from the property if the acquirer can either transfer the guarantee without selling the property or if the property can be sold without the guarantee being transferred with it.

If the rental guarantee is separable, then it should be separated out from the value of the property and accounted for as a separate asset. If on the other hand the rental guarantee is not separable then it should be accounted for with the property as one asset.

Where the rental guarantee is accounted for separately from the property, the entire purchase price must initially be allocated to both assets based upon their relative fair values. Our view is that the asset recognised in respect of a rental guarantee will usually be accounted for under IAS 39. If the rental guarantee is dependent upon a financial variable such as market rents, then we believe it meets the definition of a derivative and should be accounted for at fair value through profit and loss. If on the other hand, the guarantee is dependent upon a non-financial variable specific to the party such as occupancy levels in the property, then we believe that the asset would be classified as 'available-for-sale'.

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In rare cases, a rental guarantee may meet the definition of an insurance contract. For this to be the case, there must be uncertainty over whether money will be received under the guarantee or not and payments under the guarantee must be determined by a non-financial variable that is specific to a party to the agreement.

**Discussion**

It is common when an investment property is purchased for the purchaser to receive a rental guarantee from the vendor as an incentive to enter into the sale. Often the guarantee will relate to occupancy levels, although guarantees may also be given relating to changes in the market value of rents, and other variables.

**Should a separate asset be recognised for the rental guarantee?**

The question arises then as to how the purchaser of an investment property should account for a rental guarantee and payments received under the rental guarantee in relation to the acquired investment property.

The first question that needs to be addressed in such a situation is whether the rental guarantee should be recognised as a separate asset.

Alternative viewpoints can be taken. Some would say that the rental guarantee should be incorporated in the fair value of the investment property and should not be separated from it, citing IAS 40.50 which states that "...an entity does not double-count assets or liabilities that are recognised as separate assets or liabilities". Further, rental guarantees will be immaterial and that real estate companies therefore consider the investment property and the rental guarantee as a whole. The fair value of the investment property therefore includes the value of the rental guarantee. The opposite view would be that the acquisition of the property and the rental guarantee represent two separate components of a single transaction and should therefore be recognised separately.

Our view is that the answer depends on whether the rental guarantee is separable from the property or not. A rental guarantee will be separable from the property where the acquirer can either transfer the guarantee without selling the property or where the property can be sold without the guarantee being transferred with it.

Where the rental guarantee is separable, it should be separated out from the value of the property and accounted for as a separate asset. If on the other hand the rental guarantee is not separable then it should be accounted for with the property as one asset. When assessing whether a rental guarantee is separable or not, it should be borne in mind that the value of a guarantee is often immaterial, meaning it may not be necessary to separate out the guarantee in any case.

**If the rental guarantee is a separate asset, what kind of asset does it represent?**

Where the rental guarantee does need to be recognised as an asset separately from the property, the first thing that needs to be done is to allocate the purchase price to the two assets. As the assets are acquired in a single transaction, this requires allocating the entire purchase price to the two assets. In the absence of any specific guidance in IAS 40 on how to deal with such a situation, we recommend that the principle set out in IFRS 3 is followed, which says in relation to the acquisition of a group of assets that does not constitute a business that "...the acquirer shall identify and recognise the individual identifiable assets acquired...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..." (IFRS 3.2(b)).

Having done this, the next question that needs to be addressed is what kind of asset does the rental guarantee represent? There are two possible views here:

**View A - rental guarantee recognised as a prepayment for an insurance contract**

Under view A, the rental guarantee contract is seen as meeting the definition of an insurance contract in which the purchaser is acting as the policyholder, meaning that their (ie the policyholder’s) rights and obligations are outside the scope of IAS 32 and IAS 39.
Under this view, the rental guarantee would be initially recognised as a prepayment for an insurance contract at cost (assessed as its relative fair value). Subsequently the prepayment for the rental guarantee would be amortised on an appropriate basis over the term of the guarantee period.

**View B - financial instrument (rental guarantee recognised as a (group of) derivative(s))**

Under view B, the rental guarantee is deemed not to meet the definition of an insurance contract as there is not a specified uncertain future event (it being known from the start that payments will need to be made under the guarantee). This means that the rental guarantee falls within the scope of IAS 39.

Whether the rental guarantee is accounted for as a derivative or as an available for sale financial asset will depend upon the terms of the rental guarantee as discussed below. Under either classification, the rental guarantee will be measured at fair value both initially and on an ongoing basis until the term of the guarantee period expires.

**Our view**

Our view in such a situation, is that (as with many matters under IFRS), the answer will depend upon the terms of the rental guarantee.

**Where there is no uncertain future event**

Where a rental guarantee is separable from the property but does not involve an uncertain future event, then the rental guarantee will be accounted for under IAS 39 as it fails to meet the definition of an insurance contract.

An insurance contract is defined under IFRS 4, Appendix A as "a contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder."

**Example 1**

V is the vendor of an investment property that is 90% let. On 1 January 2008, V sells the investment property to the purchaser P and provides P with a rental guarantee to compensate for rental income being less than 100% of the rent that would be receivable on a fully let property during the next 2 years (i.e. until 31 December 2009).

Looking at this definition in the context of the above example, it is not possible to say that there is an uncertain future event. The property is not fully occupied, and therefore payments will definitely be received. Consequently, the rental guarantee falls within the scope of IAS 39.

The question that follows from this, is what type of financial asset does the rental guarantee give rise to under IAS 39 - specifically whether the guarantee is a derivative or an available for sale financial asset. Again the answer will depend upon the terms of the rental guarantee and how they interrelate with the definition of a derivative.

IAS 39.9 defines a derivative as a financial instrument or other contract within the scope of IAS 39:

"...with all three of the following characteristics:

(a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying');

(b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and

(c) it is settled at a future date."
The rental guarantee is settleable at a future date and the amount paid for it is negligible relative to the amount paid to acquire the property and therefore gain exposure to the overall rental value of the property, meaning that parts (b) and (c) meet the definition of a derivative. The key determinant then of whether a rental guarantee falls within this definition or not, will be the underlying factor (see (a) in the definition above).

If the underlying is a financial variable or a non-financial variable that is not specific to a party to the contract, it is clear that the definition is met. The guarantee will then be accounted for as a derivative with changes in its fair value recognised in profit or loss. Should the guaranteed event arise so that the owner of the investment property is reimbursed for the loss of rental income in the period, there would be no effect on income as this will have already been reflected in the fair value movements of the derivative; payments received would be treated as settlements rather than revenue.

### Example 2

V is the vendor of an investment property that is 90% let. On 1 January 2008, V sells the investment property to the purchaser P and provides P with a rental guarantee under which V will compensate P for rental income being less than 100% of the rent that would be receivable on a fully let property during the next 2 years (i.e. until 31 December 2009). The amount of compensation that will be paid will vary in accordance with the market index of rents for commercial property in the country over that period. The guarantee is considered separable.

The guarantee depends upon a financial variable (the market index of rents for the country as a whole) and therefore meets the definition of a derivative. It should be measured both initially and subsequently at fair value with changes in fair value being recorded in profit or loss (IAS 39.43, 46 and 55(a)).

If however the guarantee relates to a non-financial variable which is specific to a party to the contract, then it fails the definition of a derivative and should be accounted for as an available for sale financial asset. Again the asset will be measured both initially and subsequently at fair value; however, the changes in its value will be recognised in other comprehensive income (IAS 39.55(b)).

### Where there is an uncertain future event

In the above example, the rental guarantee was deemed not to meet the definition of an insurance contract as there is not a specified uncertain future event - both parties know at the time of entering the guarantee that part of the property is unlet, meaning that it is certain that payments will be made under the rental guarantee.

It is possible however to imagine some situations where a rental guarantee relates to a specified uncertain future event involving insurance risk and therefore meets the definition of an insurance contract, even if such situations are likely to be rarely encountered in practice. Insurance risk is defined in IFRS 4 as "risk, other than financial risk, transferred from the holder of a contract to the issuer", with financial risk being defined as "the risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract" (IFRS 4.Appendix A).

### Example 3

V is the vendor of an investment property that is 100% let at the time of sale. V sells the investment property to the purchaser P. Under the terms of the current tenants' leases, they will be able to exercise a break clause in five years' time. V provides P with a rental guarantee to compensate for up to one year's loss of rent should the tenants exercise their break rights after five years.

At the time of entering the contract there is a specified uncertain future event, namely whether the tenants will exercise their break rights or not. This is a discrete event. The risk (of a tenant exercising a break clause) is specific to a party to the contract and is not a financial risk; it would therefore seem legitimate to treat the rental guarantee as an insurance contract.
The rights and obligations of an insurance contract policyholder (the purchaser of the property in the scenario given) are outside the scope of IAS 32 and IAS 39 (see IFRS 4.BC73, IAS 39.2(e) and IAS 32.4(d)). Neither are they addressed by IFRS 4, the scope of which only applies to issuers of insurance contracts. In the absence of any specific Standard dealing with how the policyholder (i.e. the purchaser) should account for the asset that it holds, reference should then be made to the Conceptual Framework. Conceptual Framework.4.51 states:

“When economic benefits are expected to arise over several accounting periods and the association with income can only be broadly or indirectly determined, expenses are recognised in the income statement on the basis of systematic and rational allocation procedures…”

We therefore believe an appropriate treatment would be to amortise the asset (which is effectively viewed as a prepayment) in a way that reflects the consumption of economic benefits in the particular circumstances of the situation required.

In this scenario, there is a secondary question relating to presentation which will arise should the guaranteed event occur so that the owner of the investment property is reimbursed for the loss of rental income in the period. When the break clause is exercised, the insured event occurs with the consequent effect that the purchaser of the investment property will recognise a separate asset for the amount of the reimbursement for the period concerned. A number of ways of presenting this asset can be envisaged. For example, it could be argued that the payment does not represent a payment received for services, and should therefore be presented as 'other income' or alternatively that the payment should be deducted from the carrying amount of the investment property on the grounds that it effectively represents a discount given by the seller of the property.

Should such a situation occur, our preference would be to recognise the reimbursement as income on the grounds that it is compensating the purchaser of the investment property for lost revenue. The nature of these payments should of course be disclosed in order to assist the reader of the financial statements in understanding the financial performance achieved and making projections of future results.
HT 2008-05 Accounting for the contribution of assets or businesses to a joint arrangement by a party to the joint arrangement on formation

Relevant IFRS
IAS 28 Investments in Associates and Joint Ventures
IFRS 2 Share-based Payment
IFRS 3 Business Combinations
IFRS 11 Joint Arrangements

Issue
A party may contribute assets or businesses to a joint arrangement in exchange for equity interests (shares where the entity is an incorporated entity) in that entity. The issue is how the joint arrangement (either a joint venture or a joint operation) should record that asset or business. Specifically, should it record it at its:

- fair value or
- predecessor carrying amount (ie the joint operation or joint venture records the asset or business at the value that it was recorded at in the financial statements of the party making the contribution)?

Scope
This Hot Topic only addresses the accounting that should be applied by the joint arrangement (either a joint operation or joint venture) receiving non-monetary contributions upon its initial formation. It does not address the accounting to be applied by the parties to the joint arrangement.

Guidance
Accounting for the contribution of an asset or group of assets to the joint arrangement by a joint operator or joint venturer in exchange for equity instruments of the joint arrangement is within the scope of IFRS 2 and should be accounted for in accordance with the provisions of that standard.

However, there is no specific guidance in IFRS on how the joint arrangement should account for a business contributed by a party to the joint arrangement in exchange for its equity instruments, as such a transaction is scoped out of IFRS 3 (IFRS 3.2(a)) and IFRS 2 (IFRS 2.5). Our view is that IFRS 3, by analogy, can be applied by the joint arrangement, despite the fact that the transaction is outside the mandatory scope of IFRS 3. Alternative approaches may also be acceptable, such as the use of predecessor values or application of fresh start accounting. IFRS 2.5 prohibits the use of IFRS 2. Management should use their judgement and apply the requirements of IAS 8.10-12 to determine the most appropriate accounting policy to provide relevant and reliable information to users of the financial statements.
Project updates
Consolidation package
In May 2011 the IASB issued three new standards (IFRS 10 Consolidated Financial Statements, IFRS 11 Joint Arrangements, and IFRS 12 Disclosures of Interests in Other Entities) and amended two (IAS 27 Separate Financial Statements and IAS 28 Investments in Associates and Joint Ventures) – sometimes referred to as the consolidation package. IFRS 10 redefines ‘control’ and provides extensive new guidance on applying the revised definition. The new model applies to both traditional entities and to special purpose entities (replacing IAS 27 and SIC-12 Consolidation – Special Purpose Entities). The guidance in IFRS 10 applies only to consolidated financial statements. The requirements for separate financial statements are unchanged and remain in IAS 27. The amended version of IAS 28, now renamed IAS 28 Investments in Associates and Joint Ventures, also remains substantively unchanged from the previous version. IFRS 11 supersedes IAS 31 Interests in Joint Ventures and SIC-13 Jointly Controlled Entities – Non-Monetary Contributions by Venturers. The new guidance is effective for annual periods beginning on or after 1 January 2013. Cross-references and terminology (new definitions in IFRS 11) in this Hot Topic have been updated to reflect these changes.

Proposed Improvements to IFRSs 2011-2013
At this time, IFRS 3.2(a) refers to ‘the formation of a joint venture’ which is the terminology used prior to the ‘consolidation package updates’ noted above. In November 2012, the IASB included a proposed amendment in the Improvements for IFRSs 2011-2013 Cycle exposure draft. This amendment aims to clarify the scope of IFRS 3 and confirm that the scope is not changed after the adoption of IFRS 11 by updating the wording to refer to the formation of all types of joint arrangements (joint ventures and joint operations). It also clarifies that the scope exclusion in IFRS 3.2(a) only addresses the accounting in the financial statements of the joint arrangement itself (and not the accounting for the interest in a joint arrangement in the financial statements of a party to the joint arrangement).

Discussion
IFRS 11 addresses accounting by the entities that have an interest in arrangements that are controlled jointly (ie joint arrangements). It does not address how the joint arrangement should present its financial statements. Also, IFRS 2 excludes from its scope transactions in which an entity acquires goods as part of net assets acquired in a business combination as defined in IFRS 3, including the contribution of a business on the formation of a joint venture (IFRS 2.5).

(Note that the IFRS 2 scope exemption applies only to the formation of the joint arrangement and so in certain situations, IFRS 2 may be applicable to the joint arrangement’s subsequent issuance of equity instruments.)

Consequently, an issue arises when a jointly controlled entity prepares its separate financial statements as to whether it should account for a non-cash contribution received at the book value recorded by the joint venturer or joint operator prior to the transfer (predecessor amount) or at its fair value. The analysis of this issue is simplified if the contribution of an asset and the contribution of a business are considered separately.

Contribution of an asset
A party to a joint arrangement contributes an item of plant, property and equipment to a joint arrangement (eg a joint operation or joint venture as determined in accordance with IFRS 11) upon its formation in return for which it acquires an equity interest in the entity. Should the entity record the asset received at its predecessor amount or at its fair value?

Analysis
IFRS 2.5 states that IFRS 2 shall not be applied to the contribution of a business on the formation of a joint venture. It does not exclude from the scope the contribution of an asset or group of assets that does not constitute a business as defined in IFRS 3. Consequently, measurement of assets contributed in the formation of a joint arrangement should follow the provisions of IFRS 2.10, which states that:

"for equity-settled share-based payment transactions, the entity shall measure the goods or services received, the corresponding increase in equity, directly, at the fair value of the goods or services, received unless that fair value cannot be estimated reliably. If the entity cannot estimate reliably the fair value of the goods or services received, the entity shall measure their value, and the corresponding increase in equity, indirectly, by reference to the fair value of the equity instruments granted."

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Therefore, the contribution by a party to the joint arrangement of an asset in exchange for shares in the joint venture or joint operation would be measured at the fair value of the goods received, if it can be reliably estimated.

**Contribution of a business**

The parties to the joint arrangement each contribute a business to the joint operation or joint venture upon its formation in exchange for equity interests in the entity. Should the joint operation or joint venture record the value of the businesses received at their predecessor amounts or at fair value?

**Analysis**

IFRS 11.34 addresses transactions between a joint operation and a joint operator from the perspective of the joint operator while IAS 28.30 addresses the contribution of a non-monetary asset to a joint venture in exchange for an equity interest in the joint venture, from the perspective of the contributor. IFRS does not address the accounting to be adopted by the joint operation or joint venture itself. Therefore in determining whether the entity should record the asset at its predecessor amount or at its fair value, the requirements of other Standards need to be considered.

Although the transaction in question is a business combination IFRS 3.2 states:

"This IFRS does not apply to: (a) the formation of a joint venture* ."

* See *Improvements to IFRS* 2011-2013* discussion above for upcoming changes to the ‘joint venture’ wording.

(Note that this exemption only applies on the formation of a joint arrangement; the acquisition of a business by an existing joint venture or joint operation from a party to that joint arrangement is within the scope of IFRS 3).

The transaction is therefore outside the scope of IFRS 3. Also, IFRS 2.5 specifically provides that IFRS 2 shall not be applied to this type of transaction. In the absence of any other guidance in IFRS, entities should apply the requirements of IAS 8.10-12 to develop an appropriate accounting policy. In our view, an appropriate outcome of this analysis is to apply IFRS 3 by analogy.

However, other accounting policies could also be appropriate. One possible approach is to record the assets using predecessor values (similar to an approach often applied in accounting for common control business combinations - see Hot Topic 2006-21). Another approach that is sometimes advocated is referred to as 'fresh start accounting'. This method is not specified in IFRS but is applied to some transactions under other national accounting frameworks. Broadly, this method assumes that neither business contributed by the joint operators or joint venturers survives as an independent reporting entity after the formation of the joint operation or joint venture. Instead, a new reporting entity with no reported ‘history’ is created, starting with the formation of the joint arrangement, with assets acquired and liabilities assumed recognised at their fair values on the formation date. There are diverse views in the application of the fresh start accounting method where one view suggests recognition of goodwill while in another view, goodwill is not recognised.

Management should use their judgement to determine the accounting policy choice that would provide the most reliable information. The approach adopted should be explained in an accounting policy note together with the judgements that management has made in selecting such a policy (IAS 1.122).
**Example**

**Contribution of a business by a joint venturer on formation of the joint venture**

Two venturers each contribute a business to an entity upon its initial formation. The book value of each business contributed is CU100 (representing solely tangible assets) and the fair value of each business as a whole is CU200. The fair values of separately identifiable assets and liabilities of each business are: property, plant and equipment of CU110, intangible assets of CU60, and a deferred tax liability of CU10.

**How should the joint venture record the contributions it has received?**

If predecessor accounting is used, the tangible assets of CU200 can be recognised at their previous book values.

If fresh start accounting is used, then tangible assets of CU220, intangible assets of CU120 and a deferred tax liability of CU20 can be recognised. The difference of CU80 may or may not be recognised as goodwill depending on the accounting policy used in applying fresh start accounting.

If IFRS 3 is applied by analogy, one of the combining entities will be recognised as the accounting acquirer (IFRS 3.B18). Consequently, its assets and liabilities will continue to be recognised at predecessor values (tangible assets of CU100) and the other, accounting acquiree, will be measured at fair value. Consequently, property, plant and equipment of CU210 (100 + 110), intangible assets of CU60 (nil + 60), a deferred tax liability of CU10 (nil + 10) and goodwill of CU40 (200 - 110 - 60 - 10) should be recognised.
HT 2008-06 Accounting for client money

Relevant IFRS
IAS 1 Presentation of Financial Statements
IAS 32 Financial Instruments: Presentation

Issue
If an entity holds money on behalf of clients:

- Should the client money be recognised as an asset in the entity's financial statements?
- Where the client money is recognised as an asset, can it be offset against the corresponding liability to the client on the face of the statement of financial position?

Client money
In this Hot Topic the term 'client money' is used to describe a variety of arrangements in which the reporting entity holds funds on behalf of clients. Client money arrangements are often regulated and more specific definitions of the term are contained in some regulatory pronouncements. The guidance in this Hot Topic is not specific to any particular regulatory regime.

Guidance
Recognition
Entities should recognise client money as an asset (and an associated liability) if the general IFRS definition of an asset is met. This requires a careful analysis of the contractual terms and conditions and economic substance of the arrangements for holding client money to determine whether:

- the client money is a resource controlled by the entity
- economic benefits associated with the client money are expected to flow to the entity.

If both conditions apply, the client money should be recognised as an asset of the reporting entity. This determination may involve significant judgement in which case disclosures should be made in accordance with IAS 1.122.

Offset
If a client money arrangement results in recognising cash at a bank as an asset and an associated liability to a client, it is not appropriate to offset those items.

Discussion
General
Entities may hold money on behalf of clients under many different contractual arrangements, for example:

- a bank may hold money on deposit in a customer's bank account
- a fund manager or stockbroker may hold money on behalf of a customer as a trustee
- an insurance broker may hold premiums paid by policyholders before passing them onto an insurer
- a lawyer or accountant may hold money on behalf of a client, often in a separate client bank account where the interest earned is for the client's benefit.

These arrangements are often subject to regulation as well as industry custom and practice. Because of the variety of arrangements it is not possible to provide a uniform answer to the question of whether client money should be recognised as an asset. The contractual terms and conditions and economic substance of each arrangement must therefore be analysed to determine whether or not the client money is a financial asset of the reporting entity as defined in IAS 32.
Recognition
The definition of a financial asset includes cash (IAS 32.11). Where the reporting entity has legal title to cash (eg because funds are held in a bank account to which the entity is the contractual beneficiary) there is clearly a financial asset in most circumstances. However, the IAS 32.11 definition also requires that to be a financial asset the item in question must also be an asset. Accordingly, entities should recognise client money as an asset (and an associated liability) if the general IFRS definitions of an asset and liability are met:

"An asset is 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. 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" (Conceptual Framework 4.4(a),(b)).

Project update
As part of its Memorandum of Understanding Agreement, the IASB and FASB (the Boards) undertook a project, Conceptual Framework, to create a sound foundation for future accounting standards that are principles-based, internally consistent and internationally converged. In September 2010 the IASB and the FASB announced the completion of the first phase (Phase A) of their joint project by publishing Objectives and Qualitative Characteristics. The new framework builds on existing IASB and FASB frameworks. The project has since been paused until the IASB concludes its ongoing deliberations about its future work plan. At this stage the elements phase of the project is not complete and the definitions of key terms (such as asset, liability, equity, income, expense and gain) therefore remain unchanged; however, the referencing has been updated throughout this Hot Topic to reflect the new publication.

There is no specific guidance in IFRS on applying these definitions to cash or client money arrangements. The relevant legal, regulatory and contractual requirements should therefore be carefully reviewed and judgement applied if necessary to determine whether the 'control' and 'benefits' tests have been met.

The terms 'control' and 'benefits' are not themselves defined in this context. In applying these terms to client money arrangements we consider:

- the evaluation of control should take account of the extent to which the reporting entity is able to determine the use of the monies
- the 'benefits' test should take account of which party obtains the risks and rewards associated with ownership.

In some cases the analysis will be straightforward. A bank which holds money on deposit in a customer's bank account should record a financial asset (cash) on initial receipt and a financial liability (customer deposits). The bank has control of the cash and is able to use it to fund its investing and lending activities or to meet operating costs. It also has a financial liability to the customer who is able to draw on the funds and receives interest income. A lawyer which holds client money in a separate bank account would not recognise an asset where the funds may only be disbursed pursuant to the client's instructions and the lawyer is not entitled to any interest income. In this second example neither the 'benefits' nor 'control' test has been met. In other cases the substance of the contractual arrangements may not be as clear and a more detailed analysis will be required.

In applying the asset recognition criteria, we believe the following matters should be considered:

- the extent (if any) that the entity has the right to use of the funds. This will include consideration of whether the entity has the right to control the investment policy in relation to the funds and the ability to commingle the funds (ie the ability to use one client's money to settle another client's account or to include its own cash in the same bank account as the client money or to use the funds for its own purposes and replace them when settlement is due to clients)
- whether the entity obtains the benefit of interest income earned from the funds. Where the entity retains all of the interest or pays a lower rate of interest to clients, it receives an economic benefit from the client money which indicates that an asset should be recognised
whether the entity bears the credit risk associated with bank accounts in which funds are placed on deposit. Where the entity is contractually obliged to compensate clients if the deposit-holding bank fails (or there is a constructive obligation to reimburse any losses) this indicates that an asset should be recognised.

- the status of the funds in the event of the insolvency or bankruptcy of the reporting entity. If the funds are available to fund general claims from creditors this indicates that they are an asset of the reporting entity. Conversely, the funds are less likely to be the reporting entity’s asset if they are ring-fenced and only available to reimburse the clients.

The legal capacity in which the reporting entity holds client monies is also important. The contractual arrangements for holding client money, considered in conjunction with applicable laws, regulations and established custom and practice will determine the rights and obligations of the reporting entity. However, the way in which the legal arrangement is described is relevant only as far as it affects the applicable rights and obligations. In other words, the substance of the contractual arrangement should be considered in addition to its legal form.

The following factors should be considered in this context:

- the terms and conditions of an agency agreement where one exists. An agency agreement may have the effect that the risks and rewards of the client money remain with the client and may also restrict the reporting entity’s control over the funds. The reporting entity will typically earn an agent’s fee for providing services to the client. A fee earned in exchange for services is not the same as obtaining the benefits associated with ownership of the funds.

- the entity may hold the funds as a trustee or in a similar fiduciary capacity, supported by law. Such arrangements may serve to ring-fence client monies and will also be relevant to the evaluation of risks and rewards and of control. In these cases the entity has fiduciary responsibilities and is obliged to discharge them with due care. This fiduciary duty is not the same risk as the risk of ownership of the funds (an example of the latter being credit risk - see above).

- specific regulations applicable to the arrangements, which may for example specify the type of bank account in which funds are to be held and restrict the use of those funds. If the entity is a regulated entity, the regulator may establish specific rules to protect customer assets which will be relevant to the application of the recognition criteria, for example, rules on the use of separate legal trust client bank accounts and restrictions on commingling of funds (see above).

Application of this guidance will often involve professional judgement. Where judgement is significant appropriate disclosures should be made in the financial statements in accordance with IAS 1.122. The entity's accounting policy should be applied consistently and disclosed in accordance with IAS 1.117 if significant.

**Disclosure by trustees**

Where a bank engages in significant trust activities, and concludes that it holds assets which are not assets of the bank and which are therefore not included in its statement of financial position, disclosure of those assets and an indication of the extent of them was required by IAS 30.55 because of the potential liability if the bank were to fail in its fiduciary duties. IAS 30 has been superseded by IFRS 7 Financial Instruments: Disclosures which does not contain any equivalent disclosure requirement. Nevertheless entities should consider disclosure of the nature and extent of such activities in the overall interest of the fair presentation of the accounts.

**Offset**

IAS 32 sets out the conditions under which financial assets and financial liabilities should be offset:

“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…”

(IAS 32.42)
IAS 32.45 defines a right of set off as 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. Client money will ordinarily be held in a bank account with a third party financial institution and hence the financial asset and financial liability will be due from and to different counterparties. Offsetting will therefore not be appropriate in most circumstances.

Guidance note
The IASB published Disclosures – Offsetting Financial Assets and Financial Liabilities (Amendments to IFRS 7) in December 2011 (effective for annual periods beginning on or after 1 January 2013) which modifies existing disclosure requirements to allow users of financial statements to better evaluate the effects (or potential effects) of netting arrangements.

Examples
Money transfer services
A post office provides money transfer services collecting payments for utilities such as gas and electricity from customers and remitting these amounts to the utility companies. The post office acts as a payment agent for the utility companies and earns a commission for the service it provides. The funds are held in trust bank accounts on behalf of the utility companies who bear the credit risk. Interest earned is for the benefit of the utility companies. The post office does not have the ability to commingle client funds with other funds.

Analysis
We believe that an asset should not be recognised in the post office's financial statements in respect of the client money held. The post office does not have an economic interest in the funds as:

- the post office is acting as agent on behalf of the utility companies
- the funds are held in a separate trust bank account with a legal status, which restricts their use by the post office
- the post office does not appear to have the risks and rewards of ownership of the funds in that it does not bear the risk of losses should the bank holding the funds fail nor does it receive the benefit of the interest income.

Futures and options broker
A broker purchases futures and options by order of and on behalf of its clients under the terms of client brokerage agreements. It receives a fee from the client for these services. The broker calls margins gross from clients and pays these amounts net to counterparties. Regulations require the broker to fund overdue margin calls and the client's money and the broker's money is commingled in the same bank accounts. The broker pays a lower rate of interest to clients than it earns from investment of the client money. Clients bear the credit risk in the event of failure of the bank holding the funds. The broker is at risk where the client defaults on gross margin calls.

Analysis
We believe that an asset should be recognised in the broker's financial statements in respect of client monies held as the broker:

- benefits directly from the interest rate spread on the funds
- commingles client money with its own money
- bears the liability for margin calls whether or not they are compensated for by the client and hence may have to top up the funds.
HT 2008-07 Leasehold restoration provisions

Relevant IFRS
IAS 16 Property, Plant and Equipment
IAS 17 Leases
IAS 37 Provisions, Contingent Liabilities and Contingent Assets

Issue
Many property leases contain clauses under which the lessee has to make good dilapidations or other damage which occurs to the property during the course of the lease. The issue is when a liability should be recognised in relation to such obligations.

Project update
The IASB and FASB (the Boards) have been working together to develop a new single approach to lease accounting that would ensure that all leases (other than short-term leases) would be recognised in the statement of financial position – ie no more operating or finance distinction. A revised exposure draft is expected in Q1 2013. This Hot Topic does not consider or discuss the new proposals.

Background
This Hot Topic addresses the accounting for leasehold restoration provisions in relation to properties occupied under operating leases. Leasehold restoration provisions are unlikely to be commonly encountered under finance leases, and the Hot Topic therefore has not been written with such situations in mind. Should a leasehold restoration provision exist in respect of a property occupied under a finance lease, the accounting required may differ.

Guidance
The appropriate accounting treatment depends on the lessee's obligations established by the lease agreement.

Where the lessee is obliged to remove assets that it has installed in the leased property (referred to in some countries as dismantlement or reinstatement provisions), it is appropriate to record a liability for the present value of the future cost of removal of the assets at the date they are installed. This amount is included as part of the cost of the asset in the same way as decommissioning costs are treated under IAS 16 (IAS 16.16(c)).

Where there is an obligation to return the property to the lessor at the end of the lease term in a specified condition, a liability should be recognised as damage and wear and tear occur to the property. Whilst it will be clear in some situations that damage has occurred and a liability therefore needs to be recognised, it is less clear when a liability should be recognised for damage which occurs gradually during the course of the lease due to general wear and tear. In our view, it is not acceptable to recognise a liability based on the simple passage of time as to do so would not comply with IAS 37. Instead, a reliable estimate should be made of the amount that would need to be paid to discharge the obligation that has arisen as at the end of the year. Building up a provision evenly over the term of the lease based on the estimated costs at the end of the lease might nonetheless give a reasonable approximation if wear and tear arises evenly over the course of the lease (and the repair costs are proportionate to the amount of wear and tear) but will not be appropriate in all cases.

Discussion
Under IAS 37.14, a provision shall be recognised when:

"(a) an entity has a present obligation (legal or constructive) as a result of a past event;
(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
(c) a reliable estimate can be made of the amount of the obligation."
In the case of an owner-occupied property, it is not possible to recognise a provision for repairs and maintenance expenditure, as the owner is under no obligation to incur the expenditure; the owner may choose not to make the repairs or carry out the maintenance and so avoid the expense.

However, many property leases contain clauses under which the lessee has to make good dilapidations or other damage which occurs to the property during the course of the lease. Such situations are different from ones where the property is owner-occupied, as a legal obligation to repair the property may arise from the lease agreement (depending upon its terms and conditions).

If the lease agreement creates an obligation to repair the property a liability should be recognised when an obligating event (being wear and tear, or other damage to the property) occurs. In these circumstances a present obligation exists and it is probable this will result in a transfer of economic benefits. In our view it should also be possible to make a reliable estimate of the obligation in almost all cases. It is not appropriate to recognise a liability before the obligating event (being the damage to the property) occurs because there is no present obligation. Similarly if the lessee continuously maintains the property to the condition required by the lease then no further obligation arises and no provision is recorded.

The following paragraphs explain how these principles apply to a number of common situations.

**Obligation to remove installed assets**
If a lease contract requires the lessee to remove any assets it has installed in the leased property (such as internal walls or partitions) the removal obligation arises immediately upon installation. In such a situation, it is appropriate to recognise a liability for the cost of removal (sometimes known as dismantlement or reinstatement costs) at inception, and include it as part of the cost of the asset in the same way as decommissioning costs are treated under IAS 16 (IAS 16.16(c)). Such a treatment is of course dependent on the installed items meeting the criteria for recognition as property, plant and equipment in accordance with IAS 16.

**Requirement to return the property to the lessor at the end of the lease term in a specified condition**
Some lease agreements specify that the property must be maintained by the lessee and returned to the lessor in its original state at the end of the lease. In such scenarios, it is clear that a present obligation arises when wear or tear or damage occurs to the property. For example, if a window is broken or a wall is knocked down then it will be appropriate to recognise a liability for the costs of repairing the property for the damage that has occurred.

The same principle applies to general wear and tear of the property to the extent that this involves the property falling below its specified condition. However, it may in practice be more difficult to determine both when an obligation is triggered and the amount of that obligation.

**Requirement to replace items or purchase new items**
In some situations, the lease may require the lessee to replace items (eg carpets) at the end of the term, regardless of the physical state of those existing items. In other situations, the lessee may be required to purchase or construct an asset for the lessor as part of the lease agreement (eg the lessee may be required to improve the property by say constructing a road which makes it easier to access the property).

In our view the substance of the lessee's obligations should be assessed. In some cases it might be determined that the obligation is in substance a payment for the use of the property asset (rather than a mechanism for maintaining the asset). In such cases our view is that the expenditure effectively comprises part of the minimum lease payments. Under IAS 17.33 lease payments under an operating lease are recognised as an expense on a straight-line basis over the term of the lease unless another systematic basis is more representative of the time pattern of the user's benefit.

**The amount of the provision**
In principle, the amount to be recorded should be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period (IAS 37.36). This amount would reflect:

- the extent of damage and wear and tear at the period end
the time value of money.

Some entities might propose an accounting policy based on building up a provision evenly over the lease term equal to the estimated costs at the end of the lease. This approach is not strictly consistent with IAS 37’s measurement requirements. Such an approach might nonetheless give a reasonable approximation if wear and tear arises evenly over the course of the lease (and the repair costs are proportionate to the amount of wear and tear) but will not be appropriate in all cases.
HT 2008-09 Consolidated financial statements when an entity ceases to be a parent entity

Relevant IFRS
IAS 27 Separate Financial Statements
IFRS 10 Consolidated Financial Statements

Issue
If an entity has been a parent entity during an annual reporting period, but is no longer a parent at the end of the reporting period (period-end), is it required to prepare consolidated financial statements?

Interaction with local law
This Hot Topic considers the requirements of IFRS as issued by the IASB. In some jurisdictions the requirement to prepare consolidated financial statements is determined by local law. For example, in some European Union (EU) member states local law does not require consolidated financial statements if the reporting entity has no subsidiaries at the period-end. Moreover, the EU 'IAS Regulation' applies directly only to publicly quoted entities that are required to prepare consolidated financial statements in accordance with applicable local law. Accordingly, in some EU countries publicly quoted entities that have no subsidiaries at period-end are not required to apply IFRS.

These and similar legal requirements do not alter the requirements of IFRS as issued by the IASB. However, the issue addressed in this Hot Topic may not arise in practice in jurisdictions in which the consolidation requirement is governed by local law.

Guidance
In our view consolidated financial statements should be prepared if the reporting entity has been a parent entity at any time during the reporting period (unless it is exempted from so doing in accordance with IFRS 10.4). An entity that has disposed of its last or only subsidiary prior to period-end should therefore prepare consolidated financial statements that include those subsidiaries' results and cash flows up to the date control was lost.

Project update
In May 2011 the IASB issued three new standards (IFRS 10 Consolidated Financial Statements, IFRS 11 Joint Arrangements, and IFRS 12 Disclosures of Interests in Other Entities) and amended two (IAS 27 Separate Financial Statements and IAS 28 Investments in Associates and Joint Ventures) – sometimes referred to as the consolidation package. IFRS 10 redefines 'control' and provides extensive new guidance on applying the revised definition. The new model applies to both traditional entities and to special purpose entities (replacing IAS 27 and SIC-12 Consolidation – Special Purpose Entities). The guidance in IFRS 10 applies only to consolidated financial statements. The requirements for separate financial statements are unchanged and remain in IAS 27. The new guidance is effective for annual periods beginning on or after 1 January 2013. Cross-references to IAS 27 in this Hot Topic have been updated to reflect these changes.

Discussion
Our view
IFRS 10 does not directly address whether consolidated financial statements should be presented by an entity that has been a parent entity during an annual period but has no subsidiaries at the period-end. In the absence of specific guidance, questions have arisen as to whether consolidated financial statements are required in this situation. Although the view taken will not affect the statement of financial position (statement of financial position) at the period-end, it will have a significant effect on the reported results and cash flows and also on comparative information.
Our view is that consolidated financial statements are needed if an entity has been a parent entity at any time during the reporting period (a reporting period view). This view is supported by a number of observations:

- IFRS 10.B88 states in part, “An entity includes the income and expenses of a subsidiary in the consolidated financial statements from the date it gains control until the date when the entity ceases to control the subsidiary…”
- IFRS 10 does not contain a scope exemption for an entity that disposes of its last subsidiary during the period
- although it might be argued that IFRS 10 is ambiguous in this respect, IFRS in general considers transactions and events over the course of the reporting period, not only the position at period-end
- if (for example) an entity that was a parent at the end of the previous reporting period and has since disposed of its subsidiaries does not present consolidated financial statements for the current period, the effect would be that:
  - it never reports the results of losing control of its last subsidiary(ies) as required by IFRS 10.25-26
  - it would need to restate comparative information in order for it to be comparable. It is not clear that IFRS provides any basis for restating comparatives in these circumstances given that there is no change of accounting policy
- if the view is taken that IFRS 10's references to a parent entity relate only to an entity that meets the definition of a parent at period-end, there is no guidance on how to account for investments in subsidiaries that were held during the period. IAS 27’s requirements on separate financial statements apply only to
  - accounting for investments in subsidiaries, joint ventures and associates when an entity elects, or is required by local regulations, to present financial statement (IAS 27.2)
  - parent entities that are exempted from consolidation in accordance with IFRS 10.4.

**Alternative view**

An alternative view, supported by some commentators, is that consolidated financial statements are not required by IFRS 10. This view is based on an argument that IFRS 10’s requirement to prepare consolidated financial statements applies only to an entity that is a parent at the period-end (a reporting date view). Support for this view is drawn from IFRS 10.4 which states, in part:

*An entity that is a parent shall present consolidated financial statements…*

A parent is defined in IFRS 10, Appendix A as:

*An entity that controls one or more entities*.

These paragraphs can be read as implying that the consolidation requirement does not apply if the entity is not a parent at the period-end. Accordingly it is argued that IFRS does not address the required accounting by the former parent entity in these circumstances. If this view is accepted, the former parent entity then needs to develop an accounting policy on how to report its investments in subsidiaries during the time it held them. This accounting policy might draw by analogy on IAS 27’s guidance on separate financial statements (although this is not the only possible approach).

We acknowledge that IFRS 10 is somewhat unclear in this regard. However, we consider that the arguments in favour of consolidation are considerably stronger than for the alternative view.
Investments in associates and joint ventures

An investor may have held an investment in an associate during the reporting period but have disposed of it by the period-end. IAS 28 *Investments in Associates and Joint Ventures* requires that investments in associates and joint ventures are accounted for in accordance with the equity method with limited exceptions. The exemptions include if the entity is a parent that is exempt from preparing consolidated financial statements by the scope exception in IFRS 10.4(a) or if the criteria in IAS 28.17(a)-(d) apply (IAS 28.17). When an entity prepares separate financial statements, it shall apply IAS 27.10.

IAS 28.22-24 are explicit that equity accounting continues until the entity’s investment ceases to be an associate or a joint venture. Accordingly, there is no ambiguity as to how to account for an investment in an associate or joint venture that has been disposed of by the period-end and no basis for changing the previous accounting post-disposal.

This point can cause confusion in part because some local GAAPs require equity accounting only in consolidated financial statements. By contrast, IAS 28 requires equity accounting in all IFRS financial statements unless an exemption applies. Accordingly, IAS 28 requires equity accounting regardless of whether the reporting entity (investor) is also a parent entity.

Where a parent entity investor also prepares separate financial statements, IAS 28.44 requires that an investment in an associate or a joint venture be accounted for in the entity’s separate financial statements in accordance with IAS 27.10 (ie at cost or in accordance with IAS 39).
HT 2008-10 Application of new IFRSs issued after the reporting period

Relevant IFRS
IAS 1 Presentation of Financial Statements
IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors

Issue
If a new IFRS (which for this purpose includes amendments to IFRSs and IASs and also new Interpretations) is issued after the end of a reporting period but before the date of authorisation for issue of the financial statements, is it available for early application in that reporting period?

Guidance
In our view an entity may apply a new IFRS even if it is issued after the end of a reporting period, provided that the new IFRS permits early application.

Discussion
Most (but not all) new IFRSs permit early application (i.e. application in advance of the specified effective date). This has led to questions over whether new IFRSs may be applied in a reporting period if they are issued after the end of that period. This question is not addressed directly in IFRS.

For example:
- IAS 1.17 states that 'in virtually all circumstances, an entity achieves a fair presentation by compliance with applicable IFRSs'. However, it is not clear whether this reference to 'applicable IFRSs' is to IFRSs in existence at the reporting date or at the date of approval of the financial statements.
- IAS 8 makes various references to initial application of a Standard or Interpretation (see for example IAS 8.14(a), and IAS 8.30), but does not address whether initial application is possible for pronouncements issued after the period end.

In the absence of specific guidance, we believe it is appropriate to permit entities to apply new IFRSs that permit early application if they are published before the date of approval of the financial statements. We believe that new IFRSs will result in improvements to financial reporting in comparison to previous requirements. We consider that entities should be permitted to make improvements to their accounting policies at the earliest opportunity.

Specific early application and transition requirements in each new IFRS sometimes include limitations or prohibitions on early application. Such requirements take precedence over the general guidance in this Hot Topic if there is any conflict.
Will entities want to do this?
Entities will not typically wish to amend their accounting policies after the period-end date. However, in some cases new IFRSs permit or require changes that entities would prefer to apply as soon as possible. For example, the February 2008 amendments to IAS 32 Financial Instruments: Presentation required some types of 'puttable' financial instrument to be classified as equity instruments rather than as liabilities. Some entities decided to apply the new requirements as soon as possible (including in their 31 December 2007 financial statements) as they believed that this improved the reporting of this type of instrument.

Example
An entity prepares financial statements to 31 December each year. The entity is preparing its financial statements for the year ended 31 December 2012. The 2012 financial statements will be approved by the board of directors in March 2013. In February 2013, the IASB publishes amendments to an IFRS. Early application of the amendments is allowed. Application of these amendments will require the entity to change one of its accounting policies.

Is the entity permitted to adopt the amendments and change its accounting policies in its 2012 financial statements?

Analysis
Yes - in our view the entity is permitted to apply the amended IFRS in preparing its 2012 financial statements.
HT 2008-11 IAS 1 and the requirement for a third statement of financial position (balance sheet)

Relevant IFRS
IAS 1 Presentation of Financial Statements
IAS 8 Accounting Policies, Changes in Accounting Policies and Errors

Issue
This Hot Topic explains the circumstances in which IAS 1 requires an additional statement of financial position (balance sheet).

Guidance note
The Annual Improvements to IFRSs 2009-2011 (the Improvements) issued in May 2012 (effective for annual periods on or after 1 January 2013) by the IASB clarify the requirements for providing comparative information in cases of changes in accounting policies, retrospective restatements or reclassifications. The amendment to IAS 1.10(f) states that an entity must present a statement of financial position as at the beginning of the preceding period in this situation (i.e., a third balance sheet), but the related notes to this opening statement of financial position are no longer required to be presented. The Board’s decision to give this relief was based on the fact that circumstances in which an entity changes an accounting policy, makes a retrospective restatement or a reclassification in accordance with IAS 8 are considered narrow, specific and limited. The IASB added IAS 1.40A(b) to remind preparers that the concept of materiality should be considered when determining if a third balance sheet is required.

Further, the IASB amended IAS 1 to clarify that when an entity presents additional comparative information (that is not required by IFRSs), the information should be presented in accordance with IFRSs and comparative information in the related notes must be presented (IAS 1.38-41). This Hot Topic incorporates the aforementioned Improvements.

Guidance
IAS 1 requires an additional statement of financial position if during the current period the entity:

- changes one or more of its accounting policies retrospectively or
- makes a retrospective restatement in order to correct an error or
- reclassifies items in its financial statements and

the change/restatement/reclassification has a material effect on the information in the statement of financial position at the beginning of the preceding period (IAS 1.40A).

When an entity is required to present an additional statement of financial position as outlined above, it must disclose the information required by IAS 1.41-44 and IAS 8; however, it need not present the related notes to the opening statement of financial position as at the beginning of the preceding period.

A requirement for an additional statement of financial position is not triggered by:

- changing an accounting policy prospectively
- ‘recycling’ a gain or loss from other comprehensive income to profit and loss, which is referred to as a ‘reclassification adjustment’ in IAS 1.92-96.
Discussion

General
The IASB amended IAS 1 in 2007 to require an additional statement of financial position in certain circumstances. The amendment was intended to assist users in assessing trends and making comparisons between periods. The IASB had previously proposed a general requirement for three statements. This proposal was controversial and the IASB decided to limit it to situations in which retrospective changes have been made to the financial statements.

In its Annual Improvements 2009-2011 Cycle issued in May 2012 (see Guidance note above), the Board:

a. addressed a request to clarify the appropriate date for the opening statement of financial position in cases of changes in accounting policies, retrospective restatements or reclassifications (the beginning of the preceding period)
b. specified that the related notes to this opening statement of financial position in (a) above are no longer required to be presented
c. added IAS 1.40A(a) to clarify when an opening statement of financial position provides useful information and should therefore be required
d. added IAS 1.40A(b) to remind preparers that the concept of materiality should be considered in applying the guidance in IAS 1.40A(a)
e. clarified that in the case of providing comparative information beyond minimum requirements, additional financial statement information need not be presented in the form of a complete set of financial statements for periods beyond the minimum requirements (IAS 1.38C, IAS 1.BC32E)
f. clarified that when additional comparative information is provided by an entity (that is not required by IFRSs), the entity should present comparative information in the related notes for that additional information (IAS 1.38D).

As a practical matter, some entities decide to include a third statement of financial position every year, even if it is not required in some years. This enables entities to maintain a more consistent format and layout from one year to the next and may therefore save on design and printing costs.

Circumstances requiring an additional statement of financial position

Retrospective change of accounting policy
The term 'accounting policies' is defined in IAS 8.5 as:

"the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements".

This is a broad definition. Accounting policies cover the preparation and presentation of financial statements as a whole and are not (for example) restricted to the recognition and measurement of amounts in the primary statements.

IAS 8 requires that voluntary changes of accounting policy are applied retrospectively except where this is impracticable (IAS 8.19(b) and 23). Changes in accounting policies resulting from initial application of an IFRS are also applied retrospectively unless the IFRS specifies prospective application.

Changes in accounting policies should be distinguished from changes in estimates (IAS 8.32) and also from initial application of accounting policies to new types of transactions or events (IAS 8.16).

Retrospective restatement
We believe the term 'retrospective restatement' in IAS 1 refers to the correction of a material prior period error. This term is defined in IAS 8.5 as follows:

"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."
Errors must be corrected by retrospective restatement in accordance with IAS 8.42, subject to an impracticability constraint (IAS 8.43). Accordingly, an additional statement of financial position is normally required when an entity corrects a material prior period error.

Reclassification of items in the financial statements
We believe the term 'reclassification' should be understood in the same way as IAS 1.41’s references to a change in the presentation or classification of items in the financial statements. On making such a change, comparative amounts are also reclassified unless this is impractical.

Reclassification of items in the financial statements
Examples of reclassifications of items that will trigger a need for an additional statement of financial position if the reclassification has a material effect on the information in the statement of financial position at the beginning of the preceding period include:

- a change from a liquidity-based statement of financial position to a current and non-current classification and vice versa (see IAS 1.60)
- a change in the analysis of expenses in profit or loss from 'by nature' to 'by function' and vice versa (IAS 1.99)
- a revision of the entity's interpretation of its normal operating cycle resulting in changes in the classification of certain assets and liabilities between current and non-current (IAS 1.66 and 69)
- a reclassification of certain types of asset, liability, income, expense or cash flow from one primary statement caption to another (e.g., a change in the classification of cash flows relating to some derivatives between the operating and financing sections).

Circumstances not requiring an additional statement of financial position
Prospective changes of accounting policy
IAS 1.40A is clear that the requirement for an additional statement of financial position is triggered by retrospective changes of accounting policy, when the retrospective application has a material effect on the information in the statement of financial position at the beginning of the preceding period. The requirement does not therefore apply to changes made prospectively.

Prospective changes of accounting policy
Examples of prospective changes in accounting policy that do not trigger a need for an additional statement of financial position include:

- a voluntary change in accounting policy that is impracticable to apply on a retrospective basis
- a change in accounting policy on adopting a new IFRS which specifies prospective application such as:
  - a change from a policy of expensing borrowing costs to capitalisation made in accordance with the transitional provisions of IAS 23 Borrowing Costs
  - adoption of the 2008 version of IFRS 3 Business Combinations
  - the initial application of a policy to revalue property, plant and equipment or intangible assets in accordance with IAS 16 Property, Plant and Equipment or IAS 38 Intangible Assets. This is treated as a revaluation and therefore dealt with prospectively (IAS 8.17).

Reclassification adjustments
Reclassification adjustments are described in IAS 1.92-96. Reclassification adjustments refer to the 'recycling' of gains and losses initially recorded in other comprehensive income (equity) into profit or loss for specific types of transactions.

Some confusion has arisen as to whether a 'reclassification adjustment' as described in IAS 1.92 has the same meaning as when an entity 'reclassifies items in the financial statements' as referred to in IAS 1.40A(a). In our view these terms have different meanings (although the use of such similar terms is clearly unhelpful).
Accordingly, we consider that reclassification adjustments as referred to in IAS 1.92 do not trigger a requirement for an additional statement of financial position. Reclassification adjustments are a current year item, not a retrospective adjustment of a previous year item.

Reclassification adjustments
Examples of reclassification adjustments (reclassifications of gains and losses from other comprehensive income to profit or loss) include:

- reclassification of gains or losses on sale or impairment of available-for-sale financial assets
- reclassification of gains or losses on a cash flow hedging instrument from the cash flow hedging reserve as the hedged item affects profit or loss
- recognition in profit or loss of a foreign currency translation reserve on disposal of a foreign operation.

In our view these reclassification adjustments do not trigger a requirement for a third statement of financial position.

Project update
This Hot Topic makes reference to wording and the requirements of IAS 39 Financial Instruments: Recognition and Measurement (IAS 39) and not those of IFRS 9 Financial Instruments (IFRS 9). IFRS 9 will eventually replace IAS 39 in its entirety. At this stage, IFRS 9 addresses the classification and measurement of financial assets and financial liabilities, along with derecognition. The requirements for financial liabilities and derecognition were carried forward unchanged (with the exception of some changes to the fair value option for financial liabilities to address the issue of own credit risk). On 28 November 2012, the Board issued an exposure draft proposing limited modifications to IFRS 9’s financial asset classification model to address application issues. IFRS 9 is effective for annual periods beginning on or after 1 January 2015 (early adoption permitted). Work continues on Phases 2 and 3 of the project, which address impairment and hedge accounting, respectively.

Situations where retrospective application is impractical
As explained above, IAS 1 and IAS 8 require that reclassifications, most accounting policy changes and error corrections are applied retrospectively (including as at the beginning of the preceding period) except where this is impractical (emphasis added) (IAS 1.41, IAS 8.23 and 43). In the case of accounting policy changes and error corrections, the requirement is then to adjust comparative information to apply the new policy or correct the error from the earliest date practicable (IAS 8.25 and 45). These requirements might result in:

- partially retrospective and partially prospective application of some changes or corrections
- fully prospective application of some changes or corrections.

We expect these situations to be rare. However, if practicability constraints lead to fully prospective application we believe the requirement for an additional statement of financial position does not apply.

Immaterial changes
An entity might make immaterial changes to its accounting policies, classifications, etc. These immaterial changes do not give rise to a requirement for an additional statement of financial position. Assessments of materiality depend on facts and circumstances and involve professional judgement. This position was confirmed by the Improvements issued in May 2012. IAS 1.40A(b) was added to ensure preparers considered materiality:

‘An entity shall present a third statement of financial position as at the beginning of the preceding period in addition to the minimum comparative financial statements required in paragraph 38A if:

- it applies an accounting policy retrospectively, makes a retrospective restatement of items in its financial statements or reclassifies items in its financial statements and
- the retrospective application, retrospective restatement or the reclassification has a material effect on the information in the statement of financial position at the beginning of the preceding period.’
HT 2008-14 Acquisition date fair value and subsequent selling price

Relevant IFRS
IFRS 3 Business Combinations
IFRS 5 Non-current Assets Held for Sale and Discontinued Operations

Issue
This Hot Topic provides guidance on the implications of a post-combination sale on the acquisition date fair value of an asset in an acquired business combination. Specifically:

- in what circumstances should an acquisition date fair value be adjusted as a result of a post-combination asset sale
- does the IFRS 3 concept of a 'measurement period' also apply to assets acquired in a business combination that are classified as held for sale and measured in accordance with IFRS 5?

IFRS 3 and acquisition date fair values
IFRS 3 requires that most assets acquired and liabilities assumed in a business combination are recognised at their fair value by the acquirer. IFRS 13 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (ie an exit price).

Guidance
Adjustments to acquisition date fair values as a result of a subsequent sale
A post-acquisition sale of an asset acquired in a business combination may provide new information about the asset's acquisition date fair value. The acquisition date fair value should be adjusted to take account of this information only when:

- the selling price indicates that the original acquisition date fair value is an error or
- the asset's fair value was determined provisionally, the sale occurs within the measurement period specified by IFRS 3 and the selling price provides relevant new information about the fair value at the acquisition date.

The assessment of whether the selling price provides new information about fair value at the acquisition date depends on the facts and circumstances.

Assets classified as held for sale
We believe the concept of a measurement period adjustment applies equally to assets classified immediately upon acquisition as held for sale, and measured in accordance with IFRS 5.

Held for sale classification
IFRS 3.31 requires that the acquirer measures an acquired non-current asset (or disposal group) that is classified as held for sale at the acquisition date in accordance with IFRS 5 at fair value less costs to sell in accordance with IFRS 5.15-18. Such a classification is appropriate only if IFRS 5's criteria are met.

Discussion
General
IFRS 3 includes the concept of a 'measurement period'. The relevant requirements are set out at IFRS 3.45-50.

In summary, the measurement period allows an acquirer to:

- report the assets acquired, liabilities assumed, non-controlling interests and consideration transferred on a provisional basis (IFRS 3.46)
- update the provisional amounts to reflect relevant new information obtained within the IFRS 3 measurement period (as if the accounting for the business combination had been completed at the acquisition date).
The measurement period concept exists for pragmatic reasons. The IASB describes its purpose as to:

provide an acquirer with a reasonable period after the acquisition date, a measurement period, during which to obtain the information necessary to identify and measure the items specified' and 'to resolve concerns about the quality and availability of information at the acquisition date for measuring the fair values of particular items at that date' (IFRS 3.BC390-391).

**Duration of measurement period**

The IFRS 3 measurement period ends on the earlier of:

- the date the acquirer receives the information it was seeking about facts and circumstances that existed as of the acquisition date or learns that more information is not obtainable
- one year from the acquisition date.

**Adjustments to acquisition date fair values as a result of a subsequent sale**

**Correction of an error**

In rare circumstances, a reported acquisition date amount might need to be amended because the original amount contained a material prior period error. In principle, an error could arise even if the original amount was a provisional amount. IFRS 3.47 states:

‘...the sale of an asset to a third party shortly after the acquisition date for an amount that differs significantly from its provisional fair value measured at that date is likely to indicate an error in the provisional amount.’

This leads to the problem of distinguishing between legitimate measurement period adjustments and errors. The concept of a measurement period does of course envisage that new information will be obtained and that this may result in an adjustment. Accordingly, we suggest that assessing whether a provisional amount is an error should take account of the provisional nature of the original estimate. In practice we expect that adjustments to provisional amounts in the measurement period will rarely be treated as errors. However, the ability to report provisional amounts should not be viewed as a permission to report amounts that are demonstrably unreasonable or without basis.

An error might arise as a result of:

- clerical mistakes in determining the original amount
- inappropriate inputs and assumptions (ie inputs and assumptions that are inconsistent with those that market participants could be reasonably expected to make in pricing the asset or liability)
- use of a valuation method which is not generally accepted
- a failure to take reasonable account of existing information that should have been considered in making the estimate (or provisional estimate).

**Measurement period adjustments**

If the original acquisition date fair value is not considered to be an error, entities should consider whether the sales price should result in a measurement period adjustment. Such an adjustment is possible only if:

- the original acquisition date fair value was a provisional amount
- the sale transaction occurs within the measurement period
- the sales price provides new evidence as to facts and circumstances that existed as of the acquisition date.
This third point is the only difficult one. The acquisition date fair value should reflect circumstances at the measurement date (ie the acquisition date). The sale price in a post-combination sale might represent the fair value at the transaction date. This amount is unlikely to be identical to the acquisition date fair value as prices generally move over time. The entity should therefore consider both the sale price and any factors that might have caused the fair value to change between the acquisition date and the sale date. In our view, the provisional fair value should be amended only if the sale price and any 'add-backs' to reflect estimated fair value movements between the two dates are, taken together, a more reliable basis for estimating the acquisition date fair value when compared to the provisional estimate. In other words the acquirer should use the best information available (including information derived from the sale) in finalising the provisional amounts.

IFRS 3.47 provides some guidance on making the assessment. This requires the acquirer to consider 'all pertinent factors'. Such factors might include:

- the assumptions in the provisional estimate and the extent to which they involve significant judgment
- whether the acquirer can identify a reason for a change to provisional amounts
- the length of time between the acquisition date and the post-combination sale
- the changes in the market during that time (including inflation and time value of money)
- volatility in the market for those type of assets
- any modifications to the asset or changes in its performance
- whether the sale transaction was an unforced, arm's length sale to an unrelated party (and therefore representative of fair value at the sale date).

**Assets classified as held for sale**

IFRS 3.31 states that:

>'The acquirer shall measure an acquired non-current asset (or disposal group) that is classified as held for sale at the acquisition date in accordance with IFRS 5 Non-current Assets Held for Sale and Discontinued Operations at fair value less costs to sell in accordance with paragraphs 15-18 of that IFRS.'

This direct reference to IFRS 5 for the measurement of 'held for sale' assets has led some commentators to question whether the concept of a measurement period also applies to this category of assets. In our view the measurement period does apply. This is on the grounds that the measurement period is intended to allow acquirers some more time to identify and measure the items specified in IFRS 3.46 as of the acquisition date (IFRS 3.BC390). This permission is not restricted to items measured at fair value, but rather applies to all of the 'provisional amounts recognised at the acquisition date' (IFRS 3.45). Held for sale assets are part of the accounting for a business combination, even though IFRS 5 is applied for measurement and presentation purposes. Fair value estimates are also needed for the IFRS 5 assets (along with estimated costs to sell) and these might be incomplete at the first post-combination reporting date.

Having said that, to be classified as held for sale the assets in question must meet IFRS 5's strict criteria. These include that the asset must be ready for immediate sale, the sale must be highly probable and expected within 12 months and appropriate management commitment to sell (IFRS 5.6-8A). If those conditions are met at the acquisition date, the acquirer might be expected to have a better idea of their fair value compared to other assets such as customer-related intangibles. However, this is a matter of facts and circumstances and does not affect the general principle.
HT 2008-15 Contracts requiring payments linked to future sales

Relevant IFRS
IA 32 Financial Instruments: Presentation
IA 37 Provisions, Contingent Liabilities and Contingent Assets
IA 38 Intangible Assets
IA 39 Financial Instruments: Recognition and Measurement

Issue
This Hot Topic considers the appropriate accounting for contracts that require an entity to make payments based on future entity revenues or product sales. In particular, when will such a contract require a liability to be recognised?

Scope of this Hot Topic
Hot Topic 2006-29 provides more specific guidance on arrangements in which a service provider makes commission payments to an intermediary based on the revenues generated from customer introductions. Also, where arrangements involving payments linked to sales are within the scope of a specific IFRS, the requirements of that IFRS should be applied. Examples include:
- employee sales commissions and bonus arrangements (IAS 19 Employee Benefits)
- sales-based leases (IAS 17 Leases)
- contingent consideration based on the acquiree's post-combination revenues (IFRS 3 Business Combinations).

This Hot Topic also considers contractual arrangements rather than statutory obligations such as sales-based taxes.

Guidance
The most common type of contract in this category is a license to use another entity's intellectual property in exchange for sales-based royalties. In many situations it is appropriate to account for such an arrangement by recording a liability and an associated expense on an accrual basis as sales are made. This is because the licensor does not acquire the underlying intellectual property but rather 'uses' it each time a sale is made.

Other contracts requiring payments linked to future revenues or product sales can give rise to more complex accounting issues. The terms and conditions of such arrangements differ extensively. This Hot Topic provides general guidance on some of the key matters to consider. However, careful evaluation of all relevant facts and circumstances will be required to determine an appropriate IFRS treatment in each case.

Project update
This Hot Topic reflects the requirements of IAS 39 Financial Instruments: Recognition and Measurement (IAS 39) and not those of IFRS 9 Financial Instruments (IFRS 9). IFRS 9 will eventually replace IAS 39 in its entirety. At this stage, IFRS 9 addresses the classification and measurement of financial assets and financial liabilities, along with derecognition. The requirements for financial liabilities and derecognition were carried forward unchanged (with the exception of some changes to the fair value option for financial liabilities to address the issue of own credit risk). On 28 November 2012, the Board issued an exposure draft proposing limited modifications to IFRS 9’s financial asset classification model to address application issues. IFRS 9 is effective for annual periods beginning on or after 1 January 2015 (early adoption permitted). Work continues on Phases 2 and 3 of the project, which address impairment and hedge accounting, respectively.

Project update
The IFRIC received a request for clarification on how to account for contingent payments for the separate purchase of a single item of property, plant and equipment (PPE) or an intangible asset. In its May 2012 meeting, the IFRIC agreed that the principles that the IASB is developing in the Leases project should be used as the basis for the accounting for contingent payments for the separate purchase of PPE and intangible assets. The IFRIC discussed this topic in its November 2012 meeting and will continue to deliberate this topic in its upcoming meetings.
Contracts for non-financial items

Pre-delivery
If the contract requires payments linked to future revenues in exchange for goods, services or use of the counter-party's intellectual property it is 'executory' until the non-financial item (goods, services or intellectual property) has been delivered. In most circumstances no liability or asset is recorded in relation to an executory contract. However:

- if the executory contract is onerous a liability is recorded in accordance with IAS 37 (IAS 37.3)
- the contract is within the scope of IAS 39 if (in summary) it is cash-settled and it is not an 'own-use' contract (see IAS 39.5-7 and Hot Topic 2008-03).

Post-delivery
Once the non-financial item has been (wholly or partly) delivered the contract may no longer be executory. In the case of the simple, sales-based royalty agreement described above, the uncompleted part of the contract (ie the obligation to pay future royalties as the underlying intellectual property is used in future sales) remains executory. Accordingly, a liability is recognised only to the extent of royalties due on past sales.

However, in other situations 'delivery' may have occurred in the past but the contract payments are linked to sales in the future. In such cases the obligation to make payments linked to future sales may give rise to a liability in accordance either with IAS 32/39 or IAS 37. Our preferred view is that this situation gives rise to a financial liability in accordance with IAS 32/39 to the extent that the future payments relate to goods or services that have been delivered in the past. We also believe that this 'IAS 32/39 view' is the only credible interpretation when:

- the obligation is linked to entity-wide revenues (IAS 32.25) or
- if the arrangement includes a contractual obligation to make (or attempt to make) the sales that will trigger payments.

An alternative view can also be supported if the arrangement is linked to specific sales (eg sales of a specific product) and does not include a contractual obligation to make those sales. In this case it can be argued that there is no contractual obligation to pay cash (and hence no financial liability in IAS 32/39 terms). Under this alternative view we consider that the arrangement should be analysed to determine if a liability should be recognised in accordance with IAS 37.

If a liability is recognised, the corresponding debit will be recorded either as an expense or as the appropriate type of asset. The 'cost' of the asset corresponds to the amount of the liability assumed (plus any other payments paid and costs that are included in accordance with applicable IFRSs). For licensing arrangements involving intellectual property, judgement will often be required to determine whether, in substance, the arrangement is a purchase of an intangible asset or an executory contract.

Financial instruments
As noted above, a contract that was for receipt or delivery of a non-financial item at inception may become a financial liability once receipt or delivery has occurred. A contract that requires the reporting entity to make payments linked to future sales in exchange for cash (or another financial asset) is a financial instrument from inception.

The guidance in Hot Topic 2006-17 Financial instruments with payments based on profits of the issuer should be applied to these contracts.
Implications of applying IAS 32/39 or IAS 37

If the obligation is a financial liability within the scope of IAS 32/39, it is measured at fair value on initial recognition (adjusted for transaction costs in some circumstances) - IAS 39.43. Fair value should take into account the expected level of future sales and consequent payments. Subsequently the liability is measured in accordance with the appropriate IAS 39 measurement category. An assessment should also be made as to whether the contract contains an embedded derivative and, if so, if it requires separation from the host contract.

If IAS 37 is applied, a provision should be recognised if an outflow of benefits is considered probable and a reliable estimate can be made of the amount (IAS 37.14). In our view the entity's present obligation arises as a result of entering into the contract, not as a result of making the sales that trigger payments. If an outflow of benefits is not probable, the obligation is a contingent liability and no provision is recorded (IAS 37.10 and 27). When a provision is recorded, the amount provided is the best estimate of the expenditure required to settle the obligation (IAS 37.36). This amount may be similar to fair value. Accordingly, the most important difference between applying IAS 37 rather than IAS 39 is that the former contains a 'probability recognition threshold' while the latter does not.

Some might argue that 'present obligation' for the purpose of IAS 37 exists only when a sale is made that will trigger payment under the contract. We do not support this view for the reasons explained in the Discussion section.

Discussion

General

Many types of contract require an entity to make payments based on future entity revenues or product sales. Types of contract that may operate in this way include:

- licences to use another entity’s intellectual property in exchange for royalty payments
- some franchising arrangements
- some 'in-licensing' (or revenue sharing) arrangements in the pharmaceutical and other sectors
- agreements to pay sales commissions to employees or intermediaries
- sales-based leases.

As noted in the guidance section, this Hot Topic does not address agreements within the scope of IAS 17 or IAS 19. Also, Hot Topic 2006-29 provides more specific guidance on arrangements in which a service provider makes commission payments to an intermediary. This Hot Topic considers contractual arrangements rather than statutory obligations such as sales-based taxes.

It is sometimes assumed that there is no liability in relation to sales-based payment obligations until a sale is made. This is not always the correct approach. Careful evaluation of all relevant facts and circumstances will be required to determine the appropriate IFRS treatment in each case. The key matters to consider include:

- whether the contract is 'executory'
- if not, whether IAS 39 or IAS 37 applies
- when IAS 37 applies, the point at which a present obligation arises.

Executory contracts

Executory contracts are defined as:

'contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent' (IAS 37.3)

Generally no liability is recorded for such contracts. This is because they are outside the scope of IAS 37 unless they are onerous (IAS 37.3) and are also outside the scope of IAS 32 and 39 if they are contracts for receipt or delivery of a non-financial item (IAS 32.AG20).

An example of an executory contract is a purchase order for goods that have neither been delivered nor paid for. We also consider that licensing arrangements in which the licensee does not (in substance) acquire the underlying intellectual property can be viewed as executory. Support for this view can be drawn from IAS 32's discussion on operating leases:
Accordingly, many sales-based licenses, royalty agreements and similar arrangements are considered executory and no liability is recorded until sales are made. Franchise agreements are often also treated as executory contracts because the franchisor has ongoing obligations to provide services (marketing, training and product development for example). As an aside, this approach may have the effect that the associated expense is recognised by the licensee or franchisee in a manner that is consistent with revenue recognition by the licensor or franchisor (see IAS 18 Appendix 18(c) and 20).

**Project update**

The IASB and FASB (the Boards) have been working together on a joint project to clarify the principles for recognising revenue and to develop a converged revenue standard. A revised exposure draft was published in November 2011. Consistent with the prior proposal, the guidance in the revised exposure draft would replace the current multiple sources of guidance on revenue with a single model; however, the earlier proposals had been amended to reduce disruption to established practices (eg the revised exposure draft includes additional "practical expedients" intended to simplify application in several areas). A final standard is now predicted in the first half of 2013. The areas that may be most affected include multiple-element arrangements, revenue subject to variable (eg performance-based) payments and contracts with significant financing and contract costs.

The proposed revenue recognition guidance is not considered in this Hot Topic; the Hot Topic continues to reflect the guidance in IAS 18 Revenue.

**Non-executory contracts**

Once delivery has occurred, contracts that were executory become non-executory. In the case, say, of a royalty-based technology licensing agreement, 'delivery' occurs as the technology is used by the licensee in selling its products or services. A liability and an associated expense therefore arise as sales are made. The future right to use the same technology in exchange for additional royalties remains executory. The question of whether IAS 37 or IAS 39 applies has limited practical importance because the recognised liability is typically short-term.

Complications arise in cases where delivery has occurred in the past but payments are linked to sales in the future (especially as those sales are usually uncertain in timing and amount). An example of this situation is an 'in-licensing' arrangement in the pharmaceutical sector. Such arrangements typically involve an early-stage drug development company transferring its rights to an unproven drug compound to a commercial pharmaceutical company. The latter company undertakes all further development, testing and commercialisation and pays the early stage developer a fee based on any future product sales. The majority of such arrangements never reach the commercial sale stage, as a result of the risks and uncertainty inherent in developing and commercialising new drug products. In this type of situation, the effect of applying IAS 37 may differ from the effect of applying IAS 32/39.

**Applying IAS 32/39**

Most contracts for non-financial items become financial instruments once delivery has occurred. At that point the contract establishes a right for one party to receive cash and an obligation of the other to pay cash. If those cash payments are uncertain (or contingent), this has an effect on measurement. It does not negate the existence of a financial asset of one party and a liability of the other (IAS 32.AG8 for more discussion on this point).

Accordingly, we believe that arrangements such as the in-licensing agreement outlined above give rise to a financial liability for the pharmaceutical company. Under this analysis, the liability is measured at fair value on initial recognition. An intangible asset is recognised if IAS 38's criteria are met.

We believe that an alternative analysis is also supportable if the obligor is contractually able to 'control' the future sales that would trigger payment (ie to prevent those sales from taking place). The obligor does not have this ability if:

- the payment obligation is linked to total entity revenues - the entity is not realistically able to stop generating revenues whilst remaining a going concern. IAS 32 is clear that a contingent settlement based on revenue is not within the control of the entity (IAS 32.25) or
• the entity is contractually obliged to sell the products that will trigger payment (or use its best efforts to do so).

In such cases we believe IAS 32/39 must be applied to the recognition and measurement of the liability.

If on the other hand the entity is able to decide not to sell the products that would trigger the payments, a case can be made that there is no contractual obligation to pay cash. If that argument is applied, an analysis should then be carried out based on IAS 37.

Applying IAS 37

The first question to ask in applying IAS 37 is when an arrangement such as the pharmaceutical revenue-sharing gives rise to a 'present obligation as a result of a past event' (see definition of liability in IAS 37.10). In our view the entity's present obligation arises as a result of signing the contract. This view is consistent with IAS 37's approach to warranties and guarantees (IAS 37 Appendix C Examples 1 and 9).

Some may argue that a present obligation exists only when a sale is made that will trigger payment. The argument for this view is that the entity can avoid the expenditure by its future actions (IAS 37.17-19). However, we believe the former view is better supported by the Standard and a better reflection of the economic substance of these arrangements.

If a present obligation exists, the second question is whether an outflow of economic benefits is 'probable', which IAS 37 defines as more likely than not (IAS 37.23). If the outflow is probable, a provision is recorded if a reliable estimate can be made of the obligation (IAS 37.14). If not, the obligation is a contingent liability and no provision is recorded (IAS 37.10 and 27). Disclosure is required unless the probability of any outflow in settlement is remote (IAS 37.10 and 27). 'Remote' is not defined.

The requirement for a 'reliable estimate' to be possible in order to record a provision merits consideration. IAS 37.26 indicates that cases when no reliable estimate is possible should be 'extremely rare'. Nonetheless, in situations such as the early stages of drug development, the range of possible outcomes and the uncertainties may well be so great as to call into question the ability to make a reliable estimate. This will require careful analysis of facts and circumstances, and will often involve professional judgement. Disclosure will be required if no liability is recognised for this reason (IAS 37.26 and 86).

Examples

Example 1 - technology license

Entity A signs an agreement with Entity B to use patented technology in a specified product for a period of 10 years. The license is non-exclusive. Entity A is not permitted to sell or sub-license the technology, or to use it for any purpose other than the specified product. Entity A is obliged to make payments to Entity B in the form of a royalty of 5% of product revenues.

Analysis

In this arrangement Entity B is providing ongoing access to its technology to Entity A in exchange for royalties. Entity B appears to have retained control over this technology - evidenced by the facts that: (i) the license is non-exclusive; and (ii) the uses to which Entity B may put the technology are highly restricted. Accordingly, the arrangement is most appropriately viewed as an executory contract. Royalties are accounted for as payable when units of product are sold by the distributor and calculated in accordance with the terms of the arrangement.

It should be noted that rights under licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights are within the scope of IAS 38 and are excluded from the scope of IAS 17 Leases (IAS 17.2(b) and IAS 38.6). It could be argued that this licensing agreement gives rise to an asset that should be recognised in accordance with IAS 38. However, given that there is no upfront payment and our view that IFRS does not require a liability to be recognised, such an analysis would result in the recognition of an intangible asset at zero cost.
Example 2 - pharmaceutical revenue sharing arrangement
Entity C is a biotechnology company that has developed and patented a new compound. Early stage laboratory tests indicate some potential for the compound to form the basis for a commercial drug but significant further development, trials and regulatory approvals would be required.

Entity C enters into an agreement with pharmaceutical company D in which it transfers all rights under the patent to D in exchange for an entitlement to 20% of all sales revenue from any drug that Entity D brings to market that incorporates this compound. Entity D is also entitled to sell the technology to a third party, in which case the contract stipulates a formula to determine the compensation to be paid to C. Entity D intends to continue to assess and develop the compound (but is under no obligation to do so) but estimates that the probability of bringing a commercial drug to market is less than 25%.

Analysis
In this example, Entity C has ‘delivered’ all of its obligations under the contract and has transferred rights equivalent to ownership to Entity D. Accordingly, and in contrast to Example 1, the contract is not an executory contract. Therefore, it is necessary to consider whether a liability should be recognised.

Under an ‘IAS 39 view’, a contractual obligation exists that may result in payments based on future drug sales. This gives rise to a financial liability. This liability is recognised at its fair value, which will reflect the probability of future sales being made. An intangible asset is also recognised in accordance with IAS 38. Because Entity D’s rights exist through separate acquisition, the condition that an intangible asset exists only if the entity expects an inflow of economic benefits is always considered to be met (IAS 38.25).

In this example, Entity D has a realistic discretion to avoid making payments - in other words settlement is conditional and Entity D is able to control the outcome of the contingency. We therefore believe it is acceptable to analyse the obligation under ‘IAS 37 view’. Under this alternative view, an obligating event has occurred (the signing of the contract), and as noted above the contract is not an executory contract. However, the outflow of economic benefits is not ‘probable’ because there is only a 25% chance that a commercial drug will be developed. IAS 37 therefore treats this obligation as a contingent liability and no liability is recorded (IAS 37.13(b)(ii) and 27). If the assessment of future commercialisation improves to become ‘more likely than not’, a liability is then recognised for the amount Entity D would rationally pay to settle (IAS 37.23 and 37).

Example 3 - e-commerce development agreement
Website development company E agrees to develop and provide content for company F’s website, which represents F’s only sales channel. Company F agrees to pay a fixed fee plus 5% of revenues generated from the website in the first two years of operation. Company E will also provide ongoing support services but these are covered by a separate agreement and paid for at a fair market rate.

Analysis
In this example, company E has delivered all of its obligations under the development contract in exchange for a fee which is part fixed and part revenue-based. In our view company F has a financial liability that includes both the fixed and variable components. The revenue-based component is linked to total revenue (ie to all the revenue generated by Company F via its website, which represents the only sales channel). Company F does not therefore have a realistic discretion to avoid payment, although the amounts involved are uncertain. It should therefore record this liability at fair value, taking account of the expected level of sales.

Company E should apply the requirements of IAS 38 and SIC 32 Web Site Costs to determine whether these costs should be recorded as one or more intangible assets.
HT 2008-16  \hspace{1cm} \textbf{Paid absences}

\textbf{Relevant IFRS}
IAS 19 Employee Benefits

\textbf{Issue}
This Hot Topic highlights the requirements of IAS 19 and identifies the factors to be considered in properly classifying paid absences to determine the appropriate recognition and measurement requirements.

\textbf{Paid absences}
Employee benefits related to paid absences include payments for annual leave, sick leave, maternity/paternity leave, jury service, military service, long-term disability absence, sabbatical leave and paid leave granted for other agreed reasons. There are practical difficulties in applying the requirements of IAS 19 to these paid absences.

The terms and conditions of the leave entitlement need to be analysed carefully to identify whether the paid absence is a long or short-term, accumulating or non-accumulating, vested or non-vested benefit in order to determine the appropriate accounting policy under IAS 19.

\textbf{Guidance}
The primary objective of IAS 19 is to recognise:

- a liability when an employee has provided service in exchange for employee benefits to be paid in the future
- an expense when the entity consumes the economic benefit arising from service provided by an employee in exchange for employee benefits.

Entitlements to paid absences should be categorised and analysed as:

- accumulating - entitlements that can be carried forward and used in future periods
- non-accumulating - entitlements that expire at the end of the period.

The cost of accumulating compensating absences is recognised as employees render the service that increases their entitlement to future paid absences. The cost of non-accumulating paid absences is recognised when the absences occur (IAS 19.13, 57(a), 71).

The timing of recognition of the cost of the benefit is equally applicable to both short-term and long-term accumulated benefits (see discussion section below), although the method used to measure the liability recognised is different:

- short-term: measure at the undiscounted amount of the obligation (IAS 19.11)
- long-term: measure at present value using the guidance in IAS 19.56-98 and IAS 19.113-115 for the recognition and measurement of defined benefit plans (IAS 19.155). These ‘other long-term employee benefits’ require the same recognition and measurement as for post-employment benefits (but all changes in the carrying amount of liabilities for other long-term employment benefits are presented in profit or loss).

Where the payment of the accumulated benefit is contingent on a future event, such as completion of future service or the employee becoming sick (ie it is a non-vesting benefit), the probability of the future event occurring affects the measurement of the obligation but does not determine whether that obligation exists (IAS 19.15, 72, BC25). If the employees will be paid for any unused entitlement on leaving employment, then the benefit is vesting. The measurement will take into account the timing of payment.
Yes
Accumulating benefit?

No
Recognise cost of benefit obligation when absences occur (IAS 19.13 & 157)

Yes
Vesting benefit?

No
Take into account possibility that employees will leave before utilising the benefit in measurement of the cost of the benefit obligation (IAS 19.15 & 72)

Yes
Benefits expected to be settled wholly before 12 months after period-end?

No
Long-term paid absence measured using the guidance similar to that of defined benefit plans (IAS 19.155) but all changes in the carrying amount of liabilities for other long-term employment benefits are recognised in profit or loss.

Yes

Short-term paid absence: cost recognised as service rendered, measured at undiscounted expected cost of benefit obligation (IAS 19.13)
Discussion

General
The underlying objective of IAS 19 is the recognition of a liability when the entity receives services in exchange for future employee benefits and recognition of an expense when the entity consumes the benefit of employee services.

Therefore, for paid absences, IAS 19 requires that a liability is recorded if:

- the benefit entitlement may be carried forward to be paid in the future (i.e., the benefit is accumulating)
- the benefit entitlement is increased as a result of services rendered (i.e., the benefit relates to the employer's 'consumption' of employee services).

To apply the second requirement it is essential to identify the relationship between the services rendered by the employees and the benefits to which they become entitled through that service.

The other factor that affects the accounting is whether the benefit is classified as short-term or long-term (see below).

Together, these factors determine:

- if a liability should be recorded for future benefits based on employee services received
- if so, how that liability should be measured.

Accumulating and non-accumulating absences
Employees' entitlement to paid absences fall into two categories - accumulating and non-accumulating.

Accumulating paid absences are those that are carried forward and can be used in future periods if the current period's entitlement is not used in full (IAS 19.15). Accumulating benefits are clearly linked to some extent to the services rendered. To satisfy the objective of IAS 19, the cost of providing these benefits is accrued over the period that the service contributes to the level of benefit entitlement (IAS 19.13, 57(a)(i) and 71).

Non-accumulating absences do not carry forward. If the employee does not take the relevant paid absence in the current period then the entitlement lapses. The entitlement to non-accumulating absences is not directly related to services rendered and is usually available to all employees or to all employees within certain categories. Sick leave and maternity leave usually fall into this category.

This distinction between accumulating and non-accumulating is referred to explicitly in IAS 19 for short-term paid absences (IAS 19.14). For long-term paid absences, the link between accumulating and non-accumulating absences is not so clearly stated. However, it is clear that the recognition of a liability for long-term benefits accrues as the employees render the services that entitle them to future benefits (IAS 19.57(a)(i), 71 and 72). This applies the same principle and recognition treatment to long-term accumulating benefits as is expressly required by IAS 19.13(a) for accumulating short-term benefits. Therefore, in our view, the timing of recognition of the cost of the benefit is the same for both short-term and long-term accumulating benefits.

This is demonstrated by the treatment of long-term disability benefit (IAS 19.157). This type of benefit may be accumulating or non-accumulating, depending on the specific terms of the employment contract. If the level of benefit depends on service rendered (i.e., is accumulating), an obligation arises when the service is rendered and so a liability for the cost of providing that benefit is accrued as the service is rendered. However, if the level of benefit is the same for any disabled employee regardless of the level or amount of service rendered (i.e., is non-accumulating), the expected cost of those benefits is recognised when an event occurs that causes a long-term disability.

Recognition of the cost of non-accumulating and accumulating absences
The employer entity recognises the cost of non-accumulating paid absences when the absences occur (IAS 19.13(b)) because the employee service rendered does not increase the amount of the benefit (IAS 19.18 and 157).
The employer entity recognises the cost of accumulating paid absences as employees render service that increases their entitlement to future paid absences, to reflect the accruing obligation (IAS 19.13(a) and IAS 19.71).

Accumulating paid absences may be either vesting (in other words, employees are entitled to a cash payment for unused entitlement on leaving the entity) or non-vesting (when employees are not entitled to a cash payment for unused entitlement on leaving).

For a non-vesting benefit, future payment may be contingent on the occurrence of a future event (eg the employee completing future service or becoming sick). The possibility that the employee will leave before they utilise an accumulated non-vesting benefit affects the measurement of the obligation, but does not determine whether the obligation exists (IAS 19.15, 72 and BC25).

**Common types of paid absence**

**Holiday pay**
Holiday pay is most commonly expressed as an annual number of days paid vacation. Some arrangements permit employees to carry forward some or all of any unused entitlement. If an employee is entitled to 24 days paid vacation leave per annum, this is characterised as 2 days per month. If an employee joins or leaves part-way through a year, the entitlement is usually time-apportioned. The benefit is therefore related to service. A liability is recorded to the extent of any accrued unused entitlement that may be carried forward.

**Sick pay**
Sick pay entitlements enable the employee to continue to be paid on days when they are not well enough to work. Paid sick leave might be capped at a certain number of days and payments might be limited to a proportion of normal salary. Typically, this cap is not related to service and the employee cannot carry forward unused days. In this fact pattern, an expense for sick pay is recognised only as the sickness absences occur. However, some other arrangements do require a liability to be recognised - see Examples section below.

**Maternity/paternity pay**
Maternity or paternity pay entitlements are usually set at a certain number of days and payments might be limited to a proportion of normal salary. Typically, this entitlement is not related to service and the employee cannot carry forward unused days. Consequently, an expense for maternity/paternity pay is recognised only as the relevant absences occur.

**Sabbatical leave**
Some arrangements entitle employees to be released from their normal employment duties for a period of paid sabbatical leave to do research, study, travel, participate in charitable or other vocational activities or sometimes just to rest. The entitlement is usually based on service and therefore is usually an accumulating benefit. A liability is recorded to the extent of any accrued unused entitlement that may be carried forward.

**Long-term disability benefit**
Long-term disability benefit entitlement might be capped at a certain number of days (though this may be several years) and is usually limited to a proportion of normal salary. If the level of benefit depends on service, an obligation arises when the service is rendered and a liability is recorded to the extent of any accrued unused entitlement that may be carried forward. Measurement of that obligation reflects the probability that payment will be required and the length of time for which payment is expected to be made. If the level of benefit is the same for any disabled employee regardless of years of service, the expected cost of those benefits is recognised when an event occurs that causes a long-term disability (IAS 19.157).

**Measurement of the cost of accumulating absences**
Paid absences can be either short-term or long-term employee benefits. IAS 19 defines short-term benefits as 'employee benefits (other than termination benefits) that are expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related service'. Other long-term benefits are all employee benefits other than short-term employee benefits, post-employment benefits and termination benefits.

As explained above, this distinction does not affect the timing of recognition of a liability but does have an impact on the method used for measuring the liability. When an employee has rendered service to an entity during an accounting period, the entity shall recognise a liability measured as follows:
• short-term accumulating paid absences: the undiscounted expected cost of the benefits that have accrued to the reporting date in exchange for services received (IAS 19.11 and 13(a))
• long-term paid absences: the present value of the expected cost of the benefit obligation measured using the guidance similar to that of defined benefit plans (IAS 19.155). These ‘other long-term employee benefits’ require the same recognition and measurement as for post-employment benefits (except all changes in the carrying amount of liabilities for other long-term employment benefits are recognised in profit or loss).

In either case, the expected cost is recognised to the extent that future payments for individual employees exceed the future payments that would have been expected in the absence of the accumulation feature (IAS 19.16 and IAS 19.BC27). (Again, this is stated explicitly in the context of short-term paid absences but in our view, the same principle should be applied to long-term paid absences.) This method is demonstrated in the following examples.

**Examples**

### Accumulating paid sick leave

An entity has 100 employees, who are each entitled to five working days of paid sick leave for each year. Unused sick leave may be carried forward for one calendar year. Sick leave is taken first out of the current year's entitlement and then out of any balance brought forward from the previous year (a LIFO basis). At 31 December 20X1, the average unused entitlement is two days per employee. The entity expects, based on past experience which is expected to continue, that 92 employees will take no more than five days of paid sick leave in 20X2 and that the remaining eight employees will take an average of six and a half days each.

The entity expects that it will pay an additional 12 days of sick pay as a result of the unused entitlement that has accumulated at 31 December 20X1 (one and a half days each, for eight employees). Therefore, the entity recognises a liability equal to the undiscounted cost of 12 days of sick pay.

In this example the benefit is short-term, non-vesting and accumulating.

### Accumulating paid sick leave with non-accumulating base-level

An entity has 100 employees, who are each entitled to a minimum of five working days of paid sick leave for each year. Any unused sick leave from this basic entitlement may not be carried forward. In addition, employees are entitled to one additional day of paid sick leave for each year of service completed. These additional days can be carried forward until the employee leaves, at which time the entitlement lapses. Sick leave is taken first out of the current year's entitlement and then out of any balance brought forward from the previous year (a LIFO basis). At 31 December 20X1, the average unused accumulating entitlement is seven days per employee. The entity expects, based on past experience which is expected to continue, that 92 employees will take no more than five days of paid sick leave in 20X2 and each year thereafter and that the remaining eight employees will take an average of seven days each.

In this case, the basic entitlement of five days is non-accumulating and so no liability is recognised in this respect at the reporting date.

The benefit of the additional days is accumulating but non-vesting. As the benefit of the accumulating extra days is expected to be settled over a number of years. This is a long-term benefit and so the entity will recognise a liability to provide the additional days that have accumulated to date. The entity will measure the liability using the guidance similar to that of defined benefit plans (IAS 19.155), consistent with the recognition and measurement as for post-employment benefits (but all changes in the carrying amount of liabilities for other long-term employment benefits are recognised in profit or loss). The measurement of this liability will reflect the expected pattern of absences and the expected number of entitlement lapses due to employees leaving without taking their full entitlement.
HT 2008-17 Methods of amortising intangible assets

Relevant IFRS
IAS 38 Intangible Assets

Issue
This Hot Topic provides guidance on selecting an appropriate amortisation method for intangible assets in accordance with IAS 38 with particular reference to:

- the straight-line method
- unit of production method
- revenue-based methods.

Guidance
IAS 38.97 requires that the amortisation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity. A variety of amortisation methods can be applied. IAS 38.98 mentions the straight-line method, the diminishing balance method and the unit of production method.

Methods of amortisation based on expected future revenues (revenue-based methods) are not mentioned. However, we consider that a revenue-based method is appropriate in limited cases when expected future revenues are a reliable 'proxy' for the economic benefits embodied in the asset and the pattern in which the benefits are expected to be consumed.

Although IAS 38 envisages the use of various different methods, it requires the straight-line method if the pattern of consumption of future economic benefits cannot be determined reliably (IAS 38.97).

Project update
In December 2012, the IASB has issued Exposure Draft ED/2012/5: Clarification of Acceptable Methods of Depreciation and Amortisation (Proposed amendments to IAS 16 Property, Plant and Equipment and IAS 38 Intangible Assets) relating to selecting an appropriate depreciation and/or amortisation method. The proposed amendments would clarify that a method of depreciation or amortisation based on the revenue expected to be generated from using the asset in an entity's business is not appropriate. This is because this method reflects a pattern of generation of economic benefits from operating the business (of which the asset is a part), rather than the consumption of the economic benefits embodied in the asset.

The proposal is broadly consistent with the views in this Hot Topic although, if finalized, the actual wording of any amendment and the accompanying Basis for Conclusions would need to be considered carefully in determining a depreciation or amortization policy. The comment deadline for the proposal is 2 April 2013.

Discussion
Selecting an appropriate amortisation method
The amortisation method selected by the entity should reflect the pattern of consumption of the economic benefits embodied in the intangible asset. Selecting an appropriate amortisation method is a matter of professional judgment based on the specific characteristics of the asset and the facts and circumstances surrounding its use or exploitation.

Straight-line method
The straight-line method will be appropriate where the consumption of economic benefits is based on the passage of time, for example patents and licenses granted for a finite period of time. In addition, the straight-line method is the default method where the pattern in which the asset's future economic benefits are expected to be consumed cannot be determined reliably.
**Unit of production method**

The unit of production method is likely to be more appropriate for intangible assets associated with depleting resources, for example rights to extract oil and gas resources, where the benefits embodied in the asset relate directly to the resources consumed.

**Revenue-based methods**

There may also be circumstances where a method of amortisation based on the pattern of expected future revenues could be used (revenue-based method). Revenue-based methods are appropriate only when expected future revenues are a reliable 'proxy' for the economic benefits embodied in the asset and the pattern in which the benefits are consumed. This will apply only in limited cases. This is partly because revenues are a measure of the results of using an asset (usually along with other assets, people and processes) rather than a measure of the economic benefits embodied within the asset. Revenue based methods are more likely to be suitable for assets that are licensed or otherwise generate revenues directly and reasonably independently of other assets.

Revenue-based methods determine the amortisation charge from expected revenues. As noted, revenues result from using an asset and do not necessarily reflect the consumption of the benefits inherent in the intangible asset itself. For example, consider an entity that has a five-year exclusive license to distribute a product. In the first year the entity decides not to distribute the product because it wants to achieve maximum sales from a previous generation product. In this case, the license represents a single right to distribute the product for a finite time period and it is appropriate to amortise the licence in the first year because the product could have been distributed, ie the benefits inherent in the license were available and have diminished by a fifth regardless of the actions of the entity. This is consistent with the requirement in IAS 38.97 for amortisation to commence when the intangible asset is available for use.

The relevance of 'expected to be consumed' in IAS 38.97 is that amortisation should be charged according to the pattern of consumption of economic benefits that the entity envisages at the outset rather than being related to the actual revenues achieved. For example, if 20% of revenues are normally expected in the first month after a film's cinema release, 20% of the amortisation is charged in the first month. The same amount of amortisation is charged even if actual revenues are disappointing as this percentage still reflects the proportionate consumption of the economic benefits embodied in the asset. (Such a situation may of course also give rise to impairment issues to be accounted for in accordance with IAS 36.) Similarly, if the revenues are higher than anticipated, this does not justify charging more amortisation.

The expected pattern of consumption of the economic benefits embodied in the asset is considered each period in a similar way to the reconsideration of the depreciation method applied to property, plant and equipment in IAS 16.61.
Examples

Example 1 – Telecommunications provider
Entity A has recognised an intangible asset at cost in respect of licenses acquired to provide telephone services. The licenses permit entity A to operate services in a specific geographical area for a finite time period. The price paid was not dependent on the number of potential customers but represented the best offer that fulfilled the technical specifications in a competitive tender process. The licenses relate to a geographical area where Entity A has no previous experience and its forecasts will be subject to a degree of uncertainty.

What is the most appropriate amortisation method for the telephone licenses intangible asset?

Analysis
The costs of the telephone licenses should be amortised on a straight line basis over the specified license period. The economic benefits embodied in the license are expected to be consumed based on the passage of time. The price paid for the license was based on the geographic area and time period.

The unit of production method would not be appropriate as production is not related to the pattern of consumption of the economic benefits embodied in the license. The license does not refer to the number of items produced (ie telephone lines).

A revenue based method would not be appropriate as the sale of telephone services is not related to the pattern of consumption of the economic benefits embodied in the license.

Finally, Entity A is unable to forecast demand or production reliably due to its lack of previous experience in the geographical area specified in the license. Therefore, the straight line method should be used in accordance with IAS 38.97.
Example 2 – Oil and gas industry
Entity B is engaged in the exploration and development of oil and gas resources. B has recognised an intangible asset acquired in a business combination at fair value in respect of its share of the rights to extract crude oil from oilfield XYZ for a period of twenty years. The fair value of the acquired rights reflects B's share of the expected production of oil from field XYZ over the twenty year period.

What is the most appropriate amortisation method for the extractive rights intangible asset?

Analysis
The carrying amount of the extraction rights should be amortised using the units of production method. The production basis reflects the pattern of consumption of the economic benefits embodied in the extraction rights (quantities of oil included in reserves of field XYZ) and is therefore the most appropriate method.

The total share of production used for amortisation of the rights will be that expected over the twenty year term of the rights. Amortisation in each period will be calculated as the ratio of B's share of production in the period to B's share of production over the remaining term of the rights at the end of the period plus B's share of production in the period.

A straight line method of amortisation would not be appropriate as the pattern of consumption of the economic benefits embodied in the extraction rights is not based on the passage of time.

A revenue based method of consumption would not be appropriate as the future oil price is unrelated to the pattern of consumption of the economic benefits embodied in the extraction rights.

Example 3 – Film industry
Entity C produces and distributes films for both the domestic and international markets. C retains commercial ownership of the intellectual property rights relating to each film. C has recognised an intangible asset in relation to the rights to films, which it has produced or acquired.

Based on past experience C estimates that box office receipts from cinema release of a film will account for 15% of total expected revenues. Sales of DVDs and videos and licensing of TV broadcasting rights are expected to account for a further 45% and 35% of total revenues respectively. Licensing of other ancillary film rights is expected to account for the remaining 5% of total revenues. A film is estimated to have a life cycle of three years from the date of its first release.

What is the most appropriate amortisation method for the film rights intangible asset?

Analysis
The expected future revenues from the film rights intangible asset serve as a reliable 'proxy' for the economic benefits embodied in the film rights intangible asset and the pattern in which the benefits from the intangible asset are expected to be consumed. In this case, the film rights intangible asset represents several different rights (cinema, DVD, video, TV and ancillary rights), which are sold at different times. The carrying amount of the film rights should be amortised over the discrete phases of the film's life cycle using a revenue basis as this best approximates the consumption of the economic benefits embodied in the asset. The rights will be amortised 15% on cinema release, 45% on DVD and video release, 35% on licensing of TV broadcasting rights and 5% on licensing of ancillary rights.
HT 2008-18 Selected guidance on the application of the amendments to IAS 39 and IFRS 7 on Reclassification of Financial Assets

Relevant IFRS
IAS 39 Financial Instruments: Recognition and Measurement
IFRS 7 Financial Instruments: Disclosures

Project update
This Hot Topic reflects the requirements of IAS 39 Financial Instruments: Recognition and Measurement (IAS 39) and not those of IFRS 9 Financial Instruments (IFRS 9). IFRS 9 will eventually replace IAS 39 in its entirety. At this stage, IFRS 9 addresses the classification and measurement of financial assets and financial liabilities, along with derecognition. The requirements for financial liabilities and derecognition were carried forward unchanged (with the exception of some changes to the fair value option for financial liabilities to address the issue of own credit risk). Work continues on Phases 2 and 3 of the project, which address impairment and hedge accounting, respectively.

Chapters 4 and 5 of IFRS 9 specify how an entity should classify and measure financial assets. They require:

- classification based on the entity’s business model for managing the financial assets and the contractual cash flow characteristics of the financial asset
- initial measurement at fair value (plus transaction costs if not at fair value through profit or loss)
- subsequent measurement at amortised cost or fair value
- reclassification if, and only if, the reporting entity’s business model for managing its financial assets changes (which is expected to be rare).

These requirements will improve and simplify the approach for classifying and measuring financial assets.

On 28 November 2012, the Board issued an exposure draft proposing limited modifications to IFRS 9’s financial asset classification model to address application issues. IFRS 9 is effective for annual periods beginning on or after 1 January 2015 (early adoption permitted).

Issue

The Amendments were developed quickly in response to issues arising from the credit crisis. They permit the reclassification of financial instruments in certain situations. The IASB was not able to go through its usual due process and there are a number of areas where the Amendments have given rise to application questions. Since the Amendments were originally issued, the IASB has issued Reclassification of Financial Assets - Effective Date and Transition in November 2008 and Embedded Derivatives - Amendments to IFRIC 9 and IAS 39 in March 2009 to address some of these issues. This Hot Topic addresses some of the application questions relating to the Amendments, taking account of the IASB publications mentioned above where appropriate. The Hot Topic is grouped into the following broad areas:

- the effective date and transition of the Amendments
- the options in terms of transferring financial assets from one IAS 39 measurement category to another
- certain measurement issues arising when financial assets are reclassified.

The guidance takes the form of a series of questions and answers. An appendix illustrates the reclassification options under the Amendments in a matrix format.
In September 2009, the IFRS team issued the Financial Instruments on Display - Illustrative Disclosures and Guidance on IFRS 7. This guide includes illustrative disclosures of the reclassification of financial assets in accordance with the amendments made to IAS 39. This guide is available in the IFRS section of the GTInet website under 'external publications'.

Guidance

1. The effective date and transition of the Amendments

Reclassification of Financial Assets - Effective Date and Transition amended IAS 39.103H to state:

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

Before this amendment, the text in IAS 39.103H had led to a number of questions.

1.1 What is the implication of the 1 July 2008 date?

For reclassifications before 1 November 2008, the implication of the 1 July 2008 date (where applicable) is that the accounting entries necessary to give effect to the reclassification are made based on values current as of 1 July 2008 (or a later date - see 1.2 below). These amounts are used rather than amounts current as of the date of the decision to reclassify (which will of course be a later date given that the Amendments were published in October 2008). A reclassified financial asset is then reported in accordance with the requirements applicable to its new IAS 39 category from 1 July 2008 or later date.

This can be described as a partially retrospective approach.

Example

Entity A prepares its financial statements to 31 December each year. It holds a financial asset that was acquired several months ago for the purpose of being sold in the near term. It was therefore classified as held for trading (IAS 39.9). At 31 October 2008 Entity A determines that it met the conditions set out in the Amendment (IAS 39.50(c) and 50B) to reclassify this asset to loans and receivables and decided to make this reclassification as of 1 July 2008.

As a consequence, the financial asset is reclassified into loans and receivables at its fair value (IAS 39.50C). This fair value is determined as at 1 July 2008. When the entity draws up financial statements at 31 December 2008, fair value changes for this asset between its initial recognition date and 1 July 2008 are reported in profit or loss in accordance with its original held for trading reclassification. From 1 July the asset is measured at amortised cost using the effective interest method, and is subject to the applicable impairment testing requirements. The fair value at 1 July 2008 becomes its new amortised cost basis for the asset and a new effective interest rate is determined using that amount and the expected future cash flows to expected maturity.

It should be noted that any changes in the expected cash flows after 1 July 2008 should be dealt with in accordance with IAS 39.AG8, which has been revised as part of the Amendments. In summary, the revised version of AG8 will require any increase in expected future cash flows that results from an improvement in recoverability (ie in the credit-worthiness of the debtor) to be dealt with by adjusting the effective interest rate.

Note that in our view, it is not appropriate to reclassify on a retrospective basis to a date at which the entity was still actively trying to sell an investment.

1.2 Is 1 July 2008 a fixed date?

No. Paragraph 103H of Reclassification of Financial Assets - Effective Date and Transition makes it clear that a reclassification before 1 November 2008 can take effect either from 1 July 2008 or a subsequent date (note that 1 November 2008 has now passed meaning this question is now of limited relevance).
1.3 Can reclassifications be made on a retrospective basis after 1 November 2008?
No. Paragraph 103H Reclassification of Financial Assets - Effective Date and Transition makes it clear that any reclassification of a financial asset made on or after 1 November 2008 shall take effect only from the date when the reclassification is made.

1.4 IAS 39.50D and IAS 39.50E refer to a financial asset that 'would have met the definition of loans and receivables'. When does the assessment of when the financial asset would have met the definition of a loan and receivable need to be made?
Our view is that it is necessary for the asset in concern to meet the definition of loans and receivables at the date of reclassification. It is not necessary for it to have met the definition at initial recognition.

2 Reclassifications permitted by IAS 39
2.1 IAS 39.50E refers to a financial asset that 'would have met the definition of loans and receivables (if it had not been designated as available for sale)'. Is it only those available for sale financial assets that were specifically designated as available for sale upon initial recognition that can be reclassified under the Amendments?
Financial assets can be classified as available for sale on initial recognition in one of two ways - either by specific designation or by default as a result of not being classified as (a) loans and receivables (b) held-to-maturity investments or (c) financial assets at fair value through profit or loss. The words 'if it had not been designated as available for sale' in IAS 39.50E could be interpreted as implying it is only possible to reclassify those financial assets that were specifically designated as available for sale upon initial recognition.

Our view is that it is possible to reclassify any financial asset out of the available for sale category provided that it meets the definition of loans and receivables at the date of reclassification and the entity intends and has the ability to hold the financial asset for the foreseeable future or until maturity. In other words, the reason why the asset was originally included in available for sale is not relevant for this purpose.

2.2 Can assets that were classified as held for trading (at fair value through profit or loss) be reclassified to categories other than loans and receivables?
IAS 39.50D states that financial assets 'that would have met the definition of loans and receivables (if the financial asset had not been required to be classified as held for trading at initial recognition) may be reclassified out of the fair value through profit or loss category if the entity has the intention and ability to hold the financial asset for the foreseeable future or until maturity.'

The reference to the definition of loans and receivables could be interpreted as implying that reclassifications made in accordance with this paragraph can only be made to the loans and receivables category. Our view, however, is that it is also possible to reclassify to other categories (available for sale or held to maturity) if the definitions for those categories are met. The reference to the definition of loans and receivables is only relevant to determining which financial assets can be reclassified out of fair value through profit or loss under IAS 39.50D.
2.3 Can a financial asset that was classified as held for trading on the grounds that it was part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking, be reclassified under the Amendments?

IAS 39.50(a) and (b) state that it is not possible to reclassify either a derivative or a financial asset that was designated upon initial recognition as at fair value through profit or loss out of the fair value through profit or loss category. IAS 39.50(c) states that an entity may reclassify a financial asset that was classified as held for trading out of fair value through profit or loss if it is no longer held for the purpose of selling or repurchasing it in the near term*.

The question of whether it is possible to reclassify out of fair value through profit or loss a financial asset that had been classified as held for trading on the basis that it was part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking is not addressed by the Amendments.

Our view is that it is possible to reclassify such a financial asset. If the IASB did not want such instruments to be reclassified, it would have included a paragraph specifically prohibiting such transfers in the same way as it has done for derivatives and financial instruments that were designated by the entity as at fair value through profit or loss upon initial recognition.

* Note that where the financial asset would not have met the definition of loans and receivables, a reclassification will only be possible in rare circumstances.

2.4 What are rare circumstances?

The Amendments do not discuss what type of circumstances would constitute 'rare circumstances', although it is noted in the Basis of Conclusions to the Amendments, that 'rare circumstances arise from a single event that is unusual and highly unlikely to recur in the near term'.

In the IASB press release which accompanied the issue of the Amendments, it was however stated that 'the deterioration of the world's financial markets that has occurred during the third quarter of this year is a possible example of rare circumstances cited in these IFRS amendments and therefore justifies its immediate publication'.

Our view is that companies seeking to claim 'rare circumstances' will need to demonstrate that the turmoil in the world's financial markets has directly affected their intentions in relation to the investments they hold. Clearly the determination of whether or not this is the case is an exercise that requires an element of judgement.

Judgement will also be needed in deciding whether rare circumstances extend beyond the third quarter of 2008 or not. We would note though that the Amendments were developed with the intention of levelling the playing field with US GAAP, and that under US GAAP 'rare' was viewed as equating to 'almost never'.

3 Measurement issues arising from reclassifications

3.1 Does the separation of embedded derivatives need to be reassessed upon a reclassification in accordance with the Amendments?

It is not necessary to separate an embedded derivative from a host instrument when the hybrid (combined) instrument is measured at fair value with changes in fair value recognised in profit or loss (IAS 39.11(c)). If a financial asset that has been classified as held for trading is reclassified in accordance with the Amendments, then it will no longer be accounted for at fair value with changes in fair value recognised in profit or loss. Following the publication of the Amendments, the question was raised of whether any embedded derivatives need to be reassessed for separation upon reclassification of the financial asset.
In March 2009 the IASB addressed this question by publishing *Embedded Derivatives - Amendments to IFRIC 9 and IAS 39*. This states that an assessment of whether any embedded derivatives need to be separated is required upon reclassification of a financial asset out of the fair value through profit or loss category. This assessment shall be made on the basis of the circumstances that existed when the entity first became a party to the contract.

*Embedded Derivatives - Amendments to IFRIC 9 and IAS 39* is effective for annual periods ending on or after 30 June 2009. There are no stated transition provisions in it and retrospective application will therefore be required.

3.2 If assets are reclassified from available for sale, how are cumulative changes in fair value up to the date of reclassification dealt with?

IAS 39.50F states that 'for a financial asset reclassified out of the available-for-sale category in accordance with paragraph 50E, any previous gain or loss on that asset that has been recognised in other comprehensive income in accordance with paragraph 55(b) shall be accounted for in accordance with paragraph 54.'

Under IAS 39.55(b) a gain or loss on an available-for-sale financial asset is recognised directly in equity except for impairment losses and foreign exchange gains and losses.

If an available for sale financial asset is reclassified to loans and receivables under the Amendments, such that the asset is reported at amortised cost post-reclassification, the fair value of the financial asset becomes its new amortised cost. The treatment of any previous gain or loss on the asset that has been recognised directly in equity in accordance with IAS 39.55(b) depends on whether or not the financial asset has a fixed maturity.

Some loans and receivables may be perpetual, in which case IAS 39.54(b) applies. Under IAS 39.54(b) any previous gain or loss is recognised directly in equity until the financial asset is sold or disposed of. If the financial asset is subsequently impaired any previous gain or loss that has been recognised directly in equity is recognised in profit or loss.

The majority of loans and receivables, however, have a fixed maturity. In this case IAS 39.54(a) applies. Under IAS 39.54(a), any previous gain or loss is amortised to profit or loss over the asset's remaining life using the effective interest method. Any difference between the new amortised cost and maturity amount is also amortised over the remaining life of the financial asset using the effective interest method. If the financial asset is subsequently impaired, any gain or loss that has been recognised directly in equity is recognised in profit or loss in accordance with IAS 39.67.

If the fair value of an available for sale asset reclassified to loans and receivables under the Amendments has declined to less than its cost (such that a loss has been deferred with equity), consideration should be given to whether this represents an impairment at the reclassification date. Such a decline might have two causes - increases in applicable market interest rates for the instrument or a decline in the expected future cash flows relating to the asset.

If a fall in value of an available for sale asset is due to a decline in the expected future cash flows the asset has been impaired and the decline in value should be recognised in profit or loss in accordance with the rules on impairment in IAS 39.

**Project update continued**

Amortised cost and impairment of financial assets is Phase 2 of IFRS 9 *Financial Instruments* (IFRS 9), the IASB’s project to replace IAS 39 *Financial Instruments: Recognition and Measurement* (IAS 39). The current ‘incurred loss’ model is anticipated to be replaced by an ‘expected loss’ approach.
3.3 What is the effect of the changes to IAS 39.AG8 addressing revisions to expected payments or receipts?

Additional text has been added to IAS 39.AG8 to deal with situations where an entity increases its estimates of future cash receipts from an asset that has been reclassified in accordance with the Amendments. The additional text states that the effect of such an increase shall be recognised as an adjustment to the effective interest rate from the date of the change in estimate rather than as an adjustment to the carrying amount of the asset at the date of the change in estimate. There are several points to note on the effect of these changes.

Firstly, the additional text only deals with upward revisions of estimated future cash receipts. Decreases in estimated future cash receipts are therefore covered by the normal rule in IAS 39AG8, ie the carrying amount of the financial asset will be adjusted to reflect actual and revised estimated cash flows, with a resulting charge being recognised in profit or loss.

Secondly, where the estimated cash flows do not change in themselves but the timing of those cash flow does, there is no increase in estimated cash flows. Such a situation is therefore dealt with by the normal rule in IAS 39.AG8.

A third point relates to a situation where an asset is reclassified under the Amendments and the estimated future cash receipts relating to it are revised downwards after the reclassification date and then subsequently revised upwards.

In this situation, the initial downward revision after the reclassification date is dealt with by the normal rule in IAS 39.AG8. This requires that the carrying amount of the financial asset is adjusted with a resulting charge being recognised in profit or loss. In relation to the subsequent upward revision of the estimated future cash receipts, the carrying amount will be adjusted, with a corresponding credit to profit or loss, to the extent that it reverses the original decline. To the extent that the upward revision goes beyond this and results in the estimated cash flows exceeding those that were expected at the date of reclassification, however, the increase will be dealt with as an adjustment to the effective interest rate in accordance with the text that has been added to IAS 39.AG8.
## APPENDIX: Reclassification permitted or required by IAS 39 following the Amendments

<table>
<thead>
<tr>
<th>IAS 39 category of financial instruments</th>
<th>Reclassification permitted?</th>
<th>Reclassification to</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial liabilities</td>
<td>No - not permitted</td>
<td>N/A</td>
</tr>
<tr>
<td>Derivative financial assets and liabilities</td>
<td>No - not permitted</td>
<td>N/A</td>
</tr>
<tr>
<td>Financial assets designated as at fair value through profit or loss on initial recognition</td>
<td>No - not permitted</td>
<td>N/A</td>
</tr>
<tr>
<td>Held for trading assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(i) acquired or incurred principally for the purpose of selling or repurchasing it in the near term</td>
<td>Yes, permitted provided that the financial asset could either</td>
<td>Any category provided that the instrument meets the definition of that category per IAS 39.9</td>
</tr>
<tr>
<td>(ii) part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Available for sale (AFS) assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(i) that meet the definition of loans and receivables at the date of reclassification</td>
<td>Yes, provided that the entity intends and has the ability to hold the financial asset for the foreseeable future or until maturity.</td>
<td>L&amp;R</td>
</tr>
<tr>
<td>(ii) that do not meet the definition of loans and receivables at the date of reclassification</td>
<td>Yes, provided that the entity has the positive intention and ability to hold to maturity and the 'tainting' rules on classification are not effective at the date of reclassification.</td>
<td>HTM</td>
</tr>
<tr>
<td>Loans and receivables (L&amp;R)</td>
<td>Not specifically addressed by IAS 39. In our view we believe reclassification is generally not appropriate. However, if a loan or receivable becomes quoted in an active market subsequent to initial recognition a case can be made to reclassify into HTM or AFS (given that it no longer meets the L&amp;R definition).</td>
<td>HTM or AFS if applicable</td>
</tr>
<tr>
<td>Held to maturity (HTM) assets</td>
<td>Reclassification is required if, as a result of a change in intention or ability, it is no longer appropriate to use this classification (IAS 39.51)</td>
<td>AFS</td>
</tr>
</tbody>
</table>
HT 2008-19 Income from licensing intangible assets

Relevant IFRS
IAS 18 Revenue

Issue
Licensors enter into various types of licensing agreements with third parties. These licensing agreements may be:

- exclusive (where the licensee solely exploits the rights granted)
- non-exclusive (where more than one license will be granted).

Complications can arise where a combination of rights are granted or a number of different geographical territories are involved. Additionally, contracts may contain advance payment and ongoing fee arrangements for the licensee, leading to a number of options for the recognition of revenue.

Scope
The aspects of this Hot Topic dealing with motion picture films and TV programmes focuses on the issue as described above, ie the licensing of completed films. It is not aimed at accounting for revenue earned by entities that function as producers, broadcasters, retail outlets or movie theatres. Specifically, it does not deal with revenue recognition during the production phases where the film has been commissioned by a customer and is being produced to order. In such situations, the IAS 18 Revenue requirements relating to rendering of services and the percentage of completion method referred to in IAS 18.21 and set out in more detail in IAS 11 Construction Contracts should be applied in respect to the film-making service being provided.

The varied terms and conditions of these licensing arrangements result in some diversity in revenue recognition policies in practice. This Hot Topic outlines some of the factors to consider in developing an accounting policy that will recognise revenue at the appropriate time. The Hot Topic highlights the general principles applicable to identifying when revenue from licensing agreements over intangible assets can be recognised. It uses motion picture films, TV programmes and software as examples of intangible assets over which rights are commonly licensed to customers.

Project update
The IASB and FASB (the Boards) have been working together on a joint project to clarify the principles for recognising revenue and to develop a converged revenue standard. A revised exposure draft was published in November 2011. Consistent with the prior proposal, the guidance in the revised exposure draft would replace the current multiple sources of guidance on revenue with a single model; however, the earlier proposals had been amended to reduce disruption to established practices (eg the revised exposure draft includes additional “practical expedients” intended to simplify application in several areas). A final standard is now predicted in the first half of 2013. The areas that may be most affected include multiple-element arrangements, revenue subject to variable (eg performance-based) payments, contracts with significant financing and contract costs.

Guidance
Revenue arising from intangible asset licensing agreements shall be recognised on an accrual basis in accordance with the substance of the relevant license agreement when it is probable that the economic benefits associated with the transaction will flow to the entity and the amount of revenue can be measured reliably (IAS 18.29-30). The substance of the agreement might involve:

- a right of use over a specified period of time or
- a sale of the underlying rights.
When an agreement confers rights over a period of time it will often be appropriate to recognise revenue over that time period. This will be the case if the licensor retains significant risks and control over the licensed rights or has obligations to perform over the license period. In this situation the licensee is in substance paying for a right of use or for a service that is provided over time.

However, where an assignment of rights for a fixed fee or non-refundable guaranteed fee under a non-cancellable contract permits the licensee to exploit those rights freely and the licensor has no remaining obligations to perform, this is, in substance, a sale (IAS 18.IE.20). Consequently revenue should be recognised for the entire fee when the conditions for recognising the sale of goods in IAS 18.14 are met. This may be the case both for fixed duration (time-based) licenses and perpetual licenses.

In many cases, the transaction involves multiple deliverables (license; service; customer-support; upgrades; etc) over a period of time and so it may be necessary to apply the revenue recognition criteria of IAS 18 to each separately identifiable component in order to reflect the substance of the transaction (IAS 18.13).

**IAS 17 or IAS 18?**

Licensing agreements for such items as motion picture films, video recordings, plays manuscripts, patents and copyrights are excluded from the scope of IAS 17 Leases (IAS 17.2(b)). Consequently, although many licensing agreements over intangible assets have the characteristics of a lease, the scope exclusion in IAS 17 requires that such agreements be accounted for by the licensor in accordance with IAS 18 Revenue, as discussed in this Hot Topic.

**Project update**

The Boards have also been working together to develop a new single approach to lease accounting that would ensure that all leases (other than short-term leases) being recognised in the statement of financial position – ie no more operating or finance distinction. In their March 2011 meeting, the Boards tentatively decided that leases of intangibles are not required to be accounted for in accordance with the Leases Standard. Work on this project remains ongoing.

**Disclosure**

The policy adopted for recognition of revenue and the amount of revenue recognised for each significant category of revenue should be disclosed in accordance with IAS 18.35. Disclosure of the judgement involved in determining the most appropriate accounting policy to recognise revenue under film licensing agreements should be given in accordance with paragraph IAS 1.122, if significant to the results of the reporting entity.

**Discussion**

An entity may license rights over its intangible assets to customers such as manufacturers, distributors, or other licensees on either an exclusive or non-exclusive basis in a particular market or territory. The licensing agreement involves the transfer of a single right or group of rights for a single intangible asset or multiple assets. The license fee may be fixed (flat fee) or may be based on usage or on a percentage of revenue (variable fee). A variable fee arrangement may include a non-refundable guaranteed minimum (fixed) amount paid in advance or over the license period. The terms and conditions of these licenses vary significantly and may allow the licensor to continue to exercise direct control over the distribution or use of the licensed asset or may transfer control to the licensee. Similarly, the terms and conditions may impose obligations on the licensor to provide future deliverables (products or services) or to refrain from exploiting the intangible asset rights so as not to interfere with the benefits obtainable by the licensee.
The diversity of types of arrangement gives rise to questions over the timing of revenue recognition by licensors of intangible asset rights such as film and software licensors. The main policies seen are recognition on delivery of the licensed asset to the licensee (in substance a sale of goods) or recognition over the whole license period, most often on a straight-line basis (in substance a right of use or service agreement). The acceptable treatment depends on the substance of the agreement. It is also important to ensure that disclosures are sufficiently clear to enable readers of the financial statements to fully understand the accounting policy adopted and the nature of the arrangements.

When is it a sale under IAS 18?
Intangible asset licenses generally assign specific rights over the underlying asset but do not transfer ownership. Consequently they are generally regarded as arrangements to generate revenue from the use by others of an entity's asset(s) and so are accounted for in accordance with IAS 18.30(b) and 33. These paragraphs require that revenue shall be recognised on an accrual basis in accordance with the terms of the relevant agreement unless, having regard to the substance of the agreement, it is more appropriate to recognise revenue on some other systematic and rational basis. This may include recognising revenue on commencement of the licensing arrangement if the substance of the arrangement is the sale of rights over the asset, as noted in IAS 18.1E20:

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

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

Difficulties arise in practice because many licenses specify a fixed time period. Consequently, the pattern of revenue recognition frequently used for such licenses is, based on the first paragraph of this example, deferral and recognition over the term of the license, frequently on a straight-line basis.

However, the second paragraph within this same IAS 18 example goes on to use a software licensing agreement as an example of a sale of rights. This does not indicate whether the license is time-based or perpetual but focuses on the fact that the licensee can 'exploit those rights freely' and 'the licensor has no obligations subsequent to delivery'. In this case, the most appropriate accounting treatment would be to recognise the revenue when the technology or user license is granted, regardless of whether the license is time-based or perpetual.

These two approaches, when applied to the specific case of time-based licenses, highlight the need to apply judgement in determining the most appropriate treatment for these types of arrangements. It is clear from this example that any time-based element in the contract is not critical to the determination of the revenue recognition method. Other factors, in particular the licensee's exploitation rights and the licensor's risks, obligations and involvement subsequent to delivery need to be carefully analysed to determine the most appropriate timing of revenue recognition.

Where the licensing agreement is, in substance, a sale, revenue should be recognised using the criteria for recognition of revenue from sale of goods in IAS 18.14:

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

a) the entity has transferred to the buyer the significant risks and rewards of ownership of the goods;
b) the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;
c) the amount of revenue can be measured reliably;
d) it is probable that the economic benefits associated with the transaction will flow to the entity; and
e) the costs incurred or to be incurred in respect of the transaction can be measured reliably." (IAS 18.14)
Determining the substance of the licence
The contractual terms of the licensing agreement and also the economic substance of the arrangement should be considered in order to determine whether the relevant revenue relates to the use by the licensee of the entity's intangible asset or it is, in substance, a sale of rights over the asset. In some cases, the analysis will be clear. However, in many cases judgement will be required. Key considerations might include:

- to what extent the licensor is exposed to the risks and rewards of the rights assigned under the agreement, eg is the revenue a fixed fee or is it variable depending on the revenue generated by the licensee?
- what level of managerial involvement, if any, does the licensor retain in the licensee's use of the asset, eg motion picture films - is the licensee's use of the film rights variable subject to licensor approval?
- does the licensor have any ongoing obligations to provide future products or services to the licensee, eg product upgrades, marketing, technical support?
- is the licensor restricted from using or exploiting the underlying asset through the terms of the licensing contract for substantially the whole life of the asset or is the licensor still exposed to residual value risk?

If the indicators suggest the license is, in substance, a sale of rights, then the following factors should be considered to determine whether revenue from the sale can be recognised on delivery or should be delayed:

- are there restrictions on when the licensee can initiate its exploitation of the licensed rights?
- is the intangible asset covered by the licensing agreement complete and available for delivery to the licensee?
- does the licensor need to make any significant changes to the asset before the licensee can initiate its exploitation of the licensed rights?

The following sections consider some of these issues.

Fee structure
In licensing arrangements that have a variable fee structure, the licensor may be exposed to significant risks and rewards of the rights assigned under the agreement. For example, the licensor may receive royalties from the licensee's exploitation of the intangible asset. This may be based on a fixed amount per unit of usage, eg a fixed fee for each time a film is exhibited. It may be a percentage of the revenue generated by exploitation of the rights by the licensee, eg a percentage of box office takings for a film. In such cases, royalties should be accrued in accordance with the terms of the agreement.

However, if the licensee guarantees to pay the licensor a non-refundable minimum amount that is to be applied against variable fees then the overall commercial effect of the arrangement needs to be carefully reviewed. If the minimum guarantee represents a value close to the maximum revenue expected under the variable fee arrangement, it could be argued that the licensor has transferred the significant risk associated with the rights assigned and, with no further obligation and with no real expectation of further revenues, the agreement is, in substance, a sale.

Alternatively, if the non-refundable minimum amount represents an advance payment that still leaves the licensor exposed to significant risk of variability of the overall revenue receivable, it could be argued that this is merely a cash flow arrangement to accelerate some of the revenue due to the licensor. The substance of the arrangement is the granting of rights for use of the licensor’s asset and so the recognition of the advance payment would be deferred and accrued in accordance with the terms of the agreement.
Example 1 - variable fee
Entity X is a record company and owns a collection of music video recordings. It has entered into a non-exclusive licensing agreement with entity Y, a television broadcaster. The license grants entity Y the right to broadcast any of the videos from the collection an unlimited number of times over the 2-year license period. Entity Y will pay CU20 to entity X each time a video from the collection is shown.

Analysis
This is an example of a royalty agreement in which the licensor will receive royalties from the licensee's exploitation of the intangible asset (the video collection) based on a fixed amount per unit of usage, i.e., a fixed fee for each time a video is exhibited. Entity X still has control of the underlying collection and can exploit it in other ways, as the arrangement with entity Y is non-exclusive. In this case, entity X should accrue royalties as videos are broadcast, as notified by entity Y in accordance with the terms of the agreement.

Example 2 - fixed fee
Entity A owns a single film asset. The film is complete and available for immediate distribution. Entity A enters into a 15-year, non-exclusive licensing arrangement with a UK film distributor, entity B. Entity A receives a fixed fee of CU5 million. In exchange for this fee, entity A grants entity B the right to exploit freely the film during the license period but only in the UK. Exploitation includes distribution of the film for showing in cinemas, granting rights for TV broadcasts, distributing DVDs for sale and rental, and sale of film-related merchandise. Entity B is free to decide when and how it exploits the film within the geographical restriction during the period and at what price. On delivery of the film to entity B, entity A has no remaining obligations to perform. Entity A retains all other rights to the film, including the right to grant other licenses in different geographical locations over distribution and exhibition rights, merchandising rights, TV and DVD rights. Entity B expects to generate substantially all its revenue from exploiting its rights in the first few years of the license period, as the film is not expected to have long-term appeal.

Analysis
Based on the information provided, this appears in substance to be a sale of rights. Entity A should recognise the CU5 million on delivery of the film at the inception of the agreement, assuming all other revenue recognition criteria are met. This is because entity A has no continuing involvement or control over the way that entity B exhibits the film in the geographical location nor does entity A have any remaining obligations under the agreement. The fee received is fixed and so is not dependent on the successful exploitation of the film by entity B or the risks associated with the way that entity B exercises its rights under the licensing agreement. The life of the film is expected to be shorter than the license period and so entity A retains little residual value risk. Therefore, the criteria in IAS 18.14 are met.

Example 3 - non-refundable guaranteed minimum fee
Entity A enters into another 15-year, non-exclusive licensing agreement for the same film with entity C, another distributor based in the USA. The rights granted under the agreement are the same as in example 2, but cover only the geographical region of the USA. However, instead of a fixed fee, entity C agrees to pay a variable fee equal to 5% of the revenue generated by entity C under the terms of the agreement. However, entity C pays entity A CU10 million on inception of the licensing agreement as a non-refundable guaranteed minimum fee. This fee was calculated as 5% of the estimated revenue C is expected to generate from exploitation of the film rights, discounted to reflect the up-front timing of payment. Although there may be a small possibility that C will earn more income than anticipated, entity A considers it is very unlikely and so does not expect to receive any further amounts under the agreement. As in the UK (example 2 above), the useful life of the film is expected to be shorter than 15-years.

Analysis
Based on the information provided, there does not seem to be a substantive difference between this agreement and that in example 2. However, although the terms of the agreement state that the fee is variable, the risk associated with this is minimal. The guaranteed minimum amount paid of CU10 million is expected to be the maximum amount payable, as it is very unlikely that the exploitation of the film will generate any revenue above this amount. Again this appears in substance to be a sale as substantially all the risks and rewards of ownership have transferred to entity C on delivery. Entity C can exploit its rights freely for the whole of the expected useful life of the film, leaving entity A with little residual value risk. Entity A would recognise the CU10 million on delivery of the film at the inception of the agreement, as all the other revenue recognition criteria in IAS 18.14 are met.

If expectations change in the future and entity A later considers that more income will become receivable, a policy will need to be developed regarding the recognition of this additional income. Guidance provided in Hot Topic 2008-15 ‘Contracts requiring payments linked to future sales’ may be helpful in this case.
Example 4 - non-refundable up-front fee and reduced ongoing payments

Entity A enters in two agreements for the same film considered in examples 2 and 3 with entity D and entity E, who each operate a chain of cinemas in two separate European countries. These agreements provide entities D and E with exclusive rights to exhibit the film an unlimited number of times in their own and other cinemas within their respective countries for a 2-year period. They have no other exploitation rights under the agreements. During the license period, entity A is not able to exploit the film in these countries but expects to exploit it later through future TV broadcasting, DVD distribution and merchandising licenses.

The general terms of the two agreements are the same except for the payment terms. Entity D agrees to pay 5% of box office takings each time it exhibits the film. Entity E agrees to pay an up-front non-refundable fee of CU3m and then pay 1.5% of box office takings each time it exhibits the film.

Analysis

The agreement with entity D is a royalty agreement similar to that between X and Y in example 1 above. Entity A is restricted from exploiting the film for less than a major part of its useful life and retains significant residual value risk. Entity A is also exposed to the risk of variable income during the license period, as the level of revenue depends on the number of times entity D exhibits the film. Entity A should accrue royalties as the film is exhibited, as notified by entity D.

The terms and conditions of the agreement with entity E are the same except for the cash flow pattern. Although entity A has secured an amount of its expected royalties up-front, this is in exchange for a lower level of royalty going forward. Entity A is still exposed to the risk of variable income during the license period. In this situation, it would be appropriate to reflect the agreement's substance rather than its form and spread the up-front receipt over the expected number of sales to be made in the future because, in substance, the receipt is an advance royalty.

Example 5 - restricted rights

Entity R owns the rights to a popular TV drama mini-series that is expected to have a long-term appeal to a wide audience. Entity R grants a license to a TV broadcaster, entity S, to show the series up to five times under an exclusive 3-year license agreement. Entity S agrees a fixed fee of CU2m for the arrangement, payable to entity R on delivery of the mini-series. Entity S's rights are restricted to broadcasting the series and using short extracts from it to advertise the TV channel. There is no right to reimbursement of any part of the fee if entity S chooses not to broadcast the series or shows it less than the contractual maximum number of 5 times.

During the period of the license, entity R is not able to exploit the programmes, but they anticipate the series will still be popular for a much longer period after the license expires. At the end of the license period, entity R plans to exploit the mini-series further through a combination of future TV broadcasting licences, DVD distribution and retail arrangements, as well as merchandising of various products using characters, images and catch-phrases from the series.

Analysis

The agreement with entity S is, in substance the right to use entity R's asset for the 3-year fixed period of the license, which is less than a major part of the expected useful life of the series. Entity S has limited rights under the agreement and is not able to exploit freely the underlying asset. Entity R expects to receive further revenues from the asset and so is exposed to significant residual value risk.

Consequently, entity R has not transferred the significant risks and rewards of ownership of the mini-series to entity S. Entity R should recognise the CU2m fee over the license period on an accrual basis in accordance with IAS 18.30. As a practical matter, this is likely to be on a straight-line basis over the period of the arrangement, as entity R has no control over when and how often entity S will broadcast the series (subject to the maximum limit of 5 times), but another more systematic basis can be used if applicable.

Licensor's continuing managerial involvement / control

Some arrangements may restrict a licensee from freely exploiting the rights assigned to it by, for example, imposing a condition that approval is obtained from the licensor before exploitation can commence. Such restrictions may be imposed to protect the licensor's reputation or ability to exploit the underlying intangible asset. In these circumstances, the revenues generated under the licensing agreement are influenced by the licensor's continuing managerial involvement. This continuing involvement allows the licensor to retain control over exploitation of the underlying asset. Consequently, this is not, in substance, a sale but is an agreement for right of use of the asset. The licensor should, therefore, recognise revenue from the agreement over the license period on an accrual basis in accordance with IAS 18.30. As a practical matter, this is likely to be on a straight-line basis over the period of the license unless a more systematic and rational basis applies.
**Example 6 - continuing involvement**

Entity A enters into another licensing agreement with entity F for the same film considered in examples 2-4. In this case, entity A does not grant entity F the right to exhibit the film but instead grants rights to exploit film-related merchandise such as board games, computer games and other merchandising, eg posters, stickers, t-shirts, lunch-boxes, etc. for a 3-year license term. This allows exploitation worldwide except in UK and USA, where these rights have already been granted to entities B and C (see examples 2 and 3). Entity F has responsibility to design, produce and distribute the products but must obtain entity A's approval prior to production and marketing. Entity A retains the right to refuse approval if the product is considered unsuitable, eg if the quality is not acceptable or if the product is in direct competition with entity A's own exploitation of similar film-related products.

Entity A will receive 15% of the profit generated by entity F's exploitation of its rights under the agreement but entity F agrees to pay CU$5 million on inception of the licensing agreement as a non-refundable guaranteed minimum fee. Entity A is obliged to use its best efforts to grant approval to F's plans and to provide clear reasons for any refusal. The entities agree that the potential market for the relevant film-related products is so favourable that entity A expects to receive significantly more than CU$5 million over the term of the agreement but is unable to make a reliable estimate of the amount.

**Analysis**

Based on the information provided, entity F is unable to exploit freely its rights under the license because entity A has continuing managerial involvement and control over the way that entity F exploits those rights. Entity A has an obligation to provide management time and services to ensure appropriate approval of plans as they are submitted by entity F. Also, the ultimate fee receivable by entity A is dependent on the successful exploitation of the film rights by entity F and so entity A retains significant risks associated with the way that entity F exercises its rights under the licensing agreement.

In substance this is not a sale of rights but is an agreement for right of use with significant continuing managerial involvement and control. Entity A should defer recognition of the initial fee and recognise it, together with any additional revenue from the license on a systematic and rational basis over the 3-year license term. This may be to recognise the CU$5m straight-line over the 3-year license term with any additional revenue recognised as it arises. An alternative pattern may be supported by any plans or forecasts that might be available.

**Licensor's obligations regarding future deliverables**

Some agreements involve granting rights of use (a license) along with other deliverables. For example, a software license agreement may include the primary software, installation service, customer-user support (technical helpline), upgrades, etc. over the license period. In some cases, the separate deliverables are clearly identified and priced separately and so the revenue recognition criteria can be readily applied to each component. However, in many circumstances, the package is negotiated as a whole. In this situation, judgement is needed to analyse each separately identifiable component of the arrangement and allocate the total revenue appropriately to each component (IAS 18.13)

Extra care needs to be taken in analysing licences where the components are not explicitly identified but the substance of the arrangement requires the licensor to fulfil ongoing implicit obligations throughout the period of the license.
Example 7 - ongoing access obligations
Entity P grants a license to a customer to use its proprietary databases using a direct, on-line link. The license allows the customer unlimited use of the databases for a two-year period. The customer pays an up-front, non-refundable license fee of CU40,000.

Analysis
Although there may be no explicit obligation for entity P to provide ongoing services to the customer, the nature of the license requires entity P to keep access to the databases available for the two-year period. The substance of the agreement is therefore that the customer is paying for entity P to ‘stand-ready’ to enable them to access the databases, which is a service that is delivered over time. Entity P may also have a constructive obligation to incur costs to maintain the databases and keep them up-to-date. The revenue from the license fees should be accrued over the period of the agreement that reflects the provision of the service. This is likely to be on a straight-line basis unless it is anticipated that the services will be provided on a different basis.

Example 8 - time-based (fixed-period) licences
Entity Q supplies games software and grants two different types of licenses to electronic games manufacturers to use the software for a certain game. The annual license is sold for a fee of CU240,000. It allows the software to be used for one year and can be renewed annually. Entity Q has no ongoing obligations under this license.

The perpetual license is sold for a fee of CU500,000. It allows the software to be used indefinitely with the licensee entitled to any upgrades issued free of charge. The contractual terms of the license do not oblige entity Q to upgrade the software.

The game’s expected life is three years. Entity Q expects to make minor modifications/upgrades during this time but does not expect to incur significant costs in performing any upgrades.

Analysis
Under the perpetual license, there may be a constructive obligation to upgrade the software, particularly if entity Q has communicated its intentions to customers or has provided upgrades to other products under similar licenses in the past. There is some cost in satisfying this obligation. In this situation, there is a strong argument for spreading the license fee over the game’s expected life in order to match it with the costs of providing the upgrades. This is likely to be on a straight-line basis.

The annual license fee, on the other hand, does not carry any further obligations on the part of entity Q and so is, in substance, a sale. Entity Q will recognise the CU240,000 on inception of the license agreement, assuming all other revenue recognition criteria are met.

Delays to commencement of exploitation of rights
Some arrangements may restrict a licensee from initiating its exploitation of the intangible asset until some future point in time. For example, rights granted to exhibit a motion picture film on television often include a clause delaying the first showing for several months in order to protect the potential revenue stream associated with the rights to exhibit the film in cinemas and movie theatres. Revenue should not be recognised until such restrictions lapse or expire.

In some cases, the exploitation may not be possible or permitted until the licensor has satisfied further obligations under the agreement, such as customising the licensed asset specifically for the licensee, eg writing additional software to ensure the licensed software asset is compatible with the licensee’s operating system. In such cases, the licensor should consider IAS 18.13 and defer recognition of all or part of the revenue until it satisfies its obligations. Identifying what changes are considered significant requires judgement. For example, in the context of motion picture films, significant changes may be considered to be those that involve additions of new or additional content to the film, such as re-shooting a scene or adding special effects.
In some cases, the licensee can begin to exploit the film rights but may still require the licensor to make some insignificant changes to the film in order to exploit their rights fully. Insignificant changes may include minor re-editing, addition of subtitles to existing footage, reformatting of the film, and adjustments to allow for the insertions of commercials. If the substance of the licensing agreement is that of a sale, the revenue can still be recognised immediately with the cost of insignificant changes being accrued (IAS 18.19). However, the terms and conditions of the agreement need careful consideration if the technical acceptance of the product, eg film or TV programme is dependent on such changes being completed. In such circumstances, recognition of revenue may need to be deferred until the economic benefits associated with the transaction become probable, which may not happen until technical acceptance becomes probable (IAS 18.14(d)).

If the substance of the agreement is the granting of rights of use, the most appropriate treatment will require judgement depending on facts and circumstances. The delay in making the changes can be argued to be a restriction of rights and so delay the recognition of some revenue under the license.
IFRS Hot Topics 2009
HT 2009-01 Cost of an investment in a subsidiary in separate financial statements

Relevant IFRS
IFRS 3 Business Combinations
IAS 27 Separate Financial Statements

Issue
This Hot Topic provides guidance on the following issues when measuring investments in subsidiaries at cost in separate financial statements (SFS) in accordance with IAS 27:

- contingent consideration arrangements
- previously-held interests at the date of obtaining control
- acquisition-related costs.

These issues arise in part because of changes to IAS 27 that eliminated the definition of the cost method, and the revised rules for determining consideration transferred (introduced in the 2008 version of IFRS 3 – hereafter referred to as IFRS 3 (2008)).

Project updates
Consolidation package
In May 2011 the IASB issued three new standards (IFRS 10 Consolidated Financial Statements, IFRS 11 Joint Arrangements, and IFRS 12 Disclosures of Interests in Other Entities) and amended two (IAS 27 Separate Financial Statements and IAS 28 Investments in Associates and Joint Ventures) – sometimes referred to as the consolidation package. IFRS 10 redefines ‘control’ and provides extensive new guidance on applying the revised definition. The new model applies to both traditional entities and to special purpose entities (replacing IAS 27 and SIC-12 Consolidation – Special Purpose Entities). The guidance in IFRS 10 applies only to consolidated financial statements. The requirements for separate financial statements are unchanged and remain in IAS 27. The new guidance is effective for annual periods beginning on or after 1 January 2013. Cross-references to IAS 27 in this Hot Topic have been updated to reflect these changes.

IFRS 9 update
This Hot Topic reflects the requirements of IAS 39 Financial Instruments: Recognition and Measurement (IAS 39) and not those of IFRS 9 Financial Instruments (IFRS 9). IFRS 9 will eventually replace IAS 39 in its entirety. At this stage, IFRS 9 addresses the classification and measurement of financial assets and financial liabilities, along with derecognition. The requirements for financial liabilities and derecognition were carried forward unchanged (with the exception of some changes to the fair value option for financial liabilities to address the issue of own credit risk). On 28 November 2012, the Board issued an exposure draft proposing limited modifications to IFRS 9’s financial asset classification model to address application issues. IFRS 9 is effective for annual periods beginning on or after 1 January 2015 (early adoption permitted). Work continues on Phases 2 and 3 of the project, which address impairment and hedge accounting, respectively.
Did IFRS 3 (2008) change IAS 27 requirements on cost in SFS?
The January 2008 version of IFRS 3 changed the treatment of the above three items in business combination accounting (along with many other changes). Important changes were also made to IAS 27 at the same time, although those changes did not affect SFS. IFRS 3 (2008) does not apply to the measurement of investments in subsidiaries in SFS. Moreover, the revised IFRS 3 no longer refers to the 'cost of a business combination' but instead uses the term 'consideration transferred' - a different concept. Despite the absence of an explicit link, some of the IFRS 3 (2008) changes have led to questions over how to measure the cost of an investment in a subsidiary in SFS in accordance with IAS 27.

This Hot Topic discusses the accounting for these items in SFS and makes comparisons with the treatment in business combination accounting. It should however be noted that a business combination does not always involve obtaining control over a subsidiary (eg a so-called trade and asset purchase might be a business combination). Moreover, obtaining control over a subsidiary gives rise to a business combination only if the subsidiary is or contains a business as defined in IFRS 3 (2008) (IFRS 3.B7-B12).

Guidance

Cost and IAS 27
IAS 27 permits a parent to measure investments in subsidiaries in its SFS either at cost or at fair value under IAS 39 (IAS 27.10). This Hot Topic only considers the cost model, which is more commonly applied. The IFRS Glossary of Terms defines cost as: ‘the amount of cash or cash equivalents paid or the fair value of the 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 IFRSs, eg IFRS 2.’ Neither this definition nor IAS 27 provides specific guidance on the issues addressed in this Hot Topic.

As a result of the amendments in 2008, IAS 27 no longer refers to the ‘cost method’ (under which distributions paid out of pre-acquisition profits were treated as a reduction of the cost of the investment). Accordingly, cost in IAS 27 is presently defined per the definition quoted above.

Contingent consideration arrangements
In purchasing an investment in a subsidiary, a parent entity might agree to transfer additional assets or equity interests to the vendor if specified future events occur or conditions are met (or the parent might have the right to the return of amounts paid under specified conditions). These arrangements are referred to as contingent consideration in IFRS 3 (2008).

Contingent consideration in a business combination
In summary, IFRS 3 (2008)'s requirements on contingent consideration are as follows:

- contingent consideration is included in the consideration transferred at fair value at the acquisition date (unless it represents something other than consideration transferred for the acquiree) (IFRS 3.37 and 39)
- the obligation to pay contingent consideration is recorded as a financial liability or equity item in accordance with definitions in IAS 32 or other applicable IFRSs (IFRS 3.40)
- after the acquisition date a recognised financial asset or liability for contingent consideration is measured at fair value with gains or losses recognised in profit or loss. Contingent consideration classified as equity is not remeasured (IFRS 3.58(a))*.

An acquirer's contingent consideration contract is no longer scoped out of IAS 32 and IAS 39, as was the case prior to the 2008 revision. Such a contract is therefore accounted for in accordance with those Standards where applicable.

* IFRS 3.58(b)(ii) also refers to a contingent consideration asset or liability within the scope of IAS 37 or another IFRS. In practice we believe that most arrangements will be within the scope of IAS 32 or IAS 39, and that IAS 37 will apply only rarely.

IFRS 3 (2008) addresses the treatment of contingent consideration in the context of business combination accounting. There is no explicit guidance on its treatment in measuring cost in SFS. In our view:
• at the date of obtaining control, the parent should include the fair value of a contingent consideration obligation (or right) as part of the cost of its investment in a subsidiary, consistent with the IFRS 3 (2008) treatment in business combination accounting. We believe that this is consistent with the definition of cost and also reflects the fact that the contingent consideration contract will need to be included as an asset, liability or equity item in accordance with IAS 32 or IAS 39 if applicable (in both the consolidated financial statements and in the SFS)
• when the fair value of a contingent consideration contract within the scope of IAS 39 changes, our preferred view is that gains and losses are recorded in profit or loss in the SFS consistent with the approach required by IFRS 3 (2008). An alternative view is that gains or losses are treated as adjustments to the cost of investment such that the 'final' cost amount will equal the cash paid. Support for this alternative view can be drawn by analogy with the treatment of changes in a decommissioning liability that is included as part of the cost of a related asset (see IFRIC 1 Changes in Existing Decommissioning, Restoration and Similar Liabilities).

We believe that common practice before consideration of the requirements of IFRS 3 (2008) or the changes to IAS 32 and IAS 39 was to include contingent consideration as part of cost in SFS either as payments (eg of cash or shares) are made, or when they fell to be recognised as a liability under the previous version of IFRS 3. The previous version of IFRS 3 required contingent consideration (referred to as an adjustment to the cost of the combination) to be recognised when it becomes probable and is reliably measurable. Accordingly, adoption of either of the approaches above was a change in accounting policy in many cases (see later guidance on applying a change of accounting policy).

Previously-held interests at the date of obtaining control

Prior to obtaining control over an entity, a parent/investor might have held an existing (non-controlling) investment in that entity. Such an investment might have been an associate, joint venture (noting that such investments are measured at cost or in accordance with IAS 39 in SFS), or a financial asset within the scope of IAS 39. A financial asset within the scope of IAS 39 might be classified (i) as held for trading and measured at fair value through profit or loss; or (ii) as available for sale and measured at fair value with gains/losses (except impairment losses) recorded in other comprehensive income (OCI); or (iii) at cost less impairment if fair value is not reliably measurable.

IFRS 3 (2008) views previously held interests in investment assets as part of what is exchanged for a controlling interest in all of the acquiree's underlying assets and liabilities (IFRS 3.BC384). As a result, IFRS 3 requires that:

• the fair value of the previous interest is included in the determination of goodwill (IFRS 3.32)
• the remeasurement of that interest to its fair value (eg if it was measured at cost) is recognised in profit or loss
• amounts recognised in OCI (eg in relation to an available for sale financial asset) are reclassified to the income statement as if the investment had been disposed of (IFRS 3.42).

There is no explicit guidance on how to treat previously-held interests in measuring cost in SFS. In our view, IFRS 3 (2008)’s characterisation of a previously-held interest as part of what is exchanged for control of the acquiree can be extended to the measurement of cost of an investment for IAS 27 purposes. However, a more traditional view of cost as the total of the costs at each stage of the purchase is also acceptable (noting that cost in IAS 27 and consideration transferred in IFRS 3 are different concepts).

Accordingly, we believe that the parent has an accounting policy choice in its SFS to:

• apply the IFRS 3 (2008) approach described above or
• treat the total cost of the investment as the cost incurred to acquire the previous investment plus the cost of the interest that confers control. Under this approach:
  ▪ if the previous investment has been measured at cost (less impairment), the cost of the controlling interest is simply added to the carrying value of the previous (non-controlling) interest. We believe that any past impairment loss recognised should be viewed as establishing a new cost basis and should not therefore be reversed
if the previous investment has been measured at fair value (as a held for trading or available for sale financial asset), gains and losses recognised prior to obtaining control would need to be reversed in order to restate the investment to cost. We believe this restatement should be effected by adjusting the appropriate component of equity ie the component that includes the previous gain or loss (typically retained earnings in the case of a held for trading investment, or an AFS reserve in the case of an available for sale financial asset). We do not believe the restatement to cost results in gains or losses in profit or loss or OCI under this approach because it is not a gain or loss as defined in the Conceptual Framework.
Example - Previously-held available for sale investment in the SFS
Entity P is a parent entity and prepares both consolidated and separate financial statements. At 31 March X0 it holds a 10% equity interest in Entity S, which is classified as an available for sale financial asset. The original cost of the investment was CU50. At 31 March X0 the fair value and carrying value is CU70. The cumulative gain of CU20 has been recognised in OCI and is included in a separate AFS reserve in Entity P’s consolidated and separate financial statements.

At 01 April X0 Entity P acquires the other 90% of Entity S for cash consideration of CU630, with Entity S becoming a subsidiary at that date. Acquisition-related costs are not significant. Entity P’s accounting policy for investments in its subsidiaries in the separate financial statements is to use cost. How is the previous investment treated in applying this policy?

Option 1 - apply IFRS 3 approach
The fair value of the previous investment (CU70) is included as part of the cost of the total interest in Entity S, which is therefore CU680 (CU50 + CU630). The cumulative gain previously recognised within OCI is reclassified into profit and loss. The required journal entry is as follows:

<table>
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<th>Dr</th>
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<tr>
<td>Cost of investment in subsidiary</td>
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<tr>
<td>AFS investment</td>
<td>70</td>
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<tr>
<td>Cash</td>
<td>630</td>
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<tr>
<td>AFS reserve (equity)</td>
<td>20</td>
</tr>
<tr>
<td>Gain on disposal of AFS (P&amp;L)</td>
<td>20</td>
</tr>
</tbody>
</table>

Option 2 - treat cost as the cost of each stage
The original cost of the previous investment (CU50) is included as part of the cost of the total interest in Entity S, which is therefore CU680 (CU50 + CU630). The cumulative gain of CU20 previously recognised within OCI and included in the carrying amount of the AFS asset is reversed against the AFS reserve within equity. There is no effect on profit & loss or OCI for the period. The required journal entry is as follows:

<table>
<thead>
<tr>
<th>Dr</th>
<th>Cr</th>
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<tbody>
<tr>
<td>Cost of investment in subsidiary</td>
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</tr>
<tr>
<td>Cash</td>
<td>630</td>
</tr>
<tr>
<td>AFS reserve (equity)</td>
<td>20</td>
</tr>
</tbody>
</table>

Note - if the previous investment has been classified as held for trading the Option 1 approach would simply involve adding the cost of the new 90% interest to the fair value of the previous 10% interest. There would be no effect on profit or loss at the date of acquiring the 90% interest. Under the Option 2 approach, the accounting would be similar to the above journal entry but the previous fair value movement (which would have been reported in profit or loss) would be eliminated against retained earnings.

Acquisition-related costs
In obtaining control over a subsidiary, a parent entity might incur various expenses in addition to amounts payable to the vendor, such as legal, accounting and consulting fees. IFRS 3 (2008) requires that acquisition-related costs are accounted for as an expense when incurred or when services are rendered (other than costs to issue debt or equity securities, which are accounted for in accordance with IAS 32 or IAS 39 as applicable) (IFRS 3.53). However, in our view it is probably not appropriate to draw an analogy with IFRS 3 (2008) in this area. The Basis for Conclusions to IFRS 3 (2008) explains that the treatment of acquisition-related costs is a consequence of the change to the concept of consideration transferred by the acquirer to the vendor in exchange for the acquiree (IFRS 3(2008).BC365-370). We believe that ‘cost’ in IAS 27 is not the same as ’consideration transferred’. The possible differences in the treatment of costs are mentioned in IFRS 3 (2008).BC369 which states:
"... the boards accept that, at this time, accounting for most acquisition-related costs separately from the business combination, generally as an expense as incurred for services received in connection with a combination, differs from some standards or accepted practices that require or permit particular acquisition-related costs to be included in the cost of an asset acquisition..."

IAS 27 does not provide any guidance on acquisition-related costs, and practices may differ. However, our preferred view is to include directly attributable costs in the cost of investment. This approach is also consistent with the treatment of directly attributable transaction costs incurred in relation to investments measured at cost or amortised cost under IAS 39 (IAS 39.43). In its May 2009 agenda rejections, the IFRIC discussed the issue on how the initial carrying value of an equity method investment should be determined. As part of this discussion, the IFRIC noted that initial recognition of assets at cost generally includes purchase price and other costs directly attributable to the acquisition. Examples of such costs are professional fees for legal services, transfer taxes and other transactions. The IFRIC’s decision is consistent with our preferred view. However, judgement may be required in some cases to determine which costs are 'directly attributable', but providing detailed guidance on this matter is beyond the scope of this Hot Topic.

**Applying a change of accounting policy - retrospective or prospective?**

Application of the guidance provided above might involve a change of accounting policy in particular to:

- include the acquisition-date fair value of contingent consideration contracts within the cost of an investment in a subsidiary for the purpose of the SFS and/or
- apply an IFRS 3 (2008) type approach for previously-held investments in the SFS.

In our view the inclusion of contingent consideration is effectively mandated by the changes to the scope of IAS 32 and IAS 39, which take effect for years beginning on or after 1 July 2009. In other words, this is not a voluntary change of accounting policy. The *Improvements to IFRSs May 2010* confirmed that the IAS 32 and 39 changes are also to be applied prospectively. Under this approach, the cost of investments in subsidiaries acquired in annual periods that commenced before 1 July 2009, and for which part of the cost was contingent consideration, is not adjusted.

We believe that a change of accounting policy for previously-held investments in the SFS (to adopt an IFRS 3 (2008) type approach) should also be applied prospectively. This is only the case if the change of accounting policy is made as part of the overall adoption of IFRS 3 (2008) and the related changes to IAS 27. Such a policy is based on an analogy with the related requirements of IFRS 3 (2008) and the concepts underlying those requirements. We therefore believe the prospective application approach of IFRS 3 (2008) can also be extended to the SFS in this area.

It should however be noted that the transition requirements are open to interpretation for SFS. An alternative view for SFS is that changing the policy for previous interests in determining costs is a voluntary change of accounting policy. Voluntary changes of accounting policy are accounted for retrospectively subject to an impracticability constraint (IAS 8.19(b) and 23).
HT 2009-02 Acquisitions and disposals of assets held in a
corporate shell

Relevant IFRS
IAS 18 Revenue
IFRS 3 Business Combinations
IFRS 10 Consolidated Financial Statements

Issue
This Hot Topic addresses the accounting in the consolidated financial statements for the:

- acquisition of assets held in a corporate shell, in particular, how to recognise any non-controlling interests
- disposal of assets held in a corporate shell, in particular, should IAS 18 or IFRS 10 apply to the sale transaction?

Scope
This Hot Topic addresses the accounting for transactions in which assets (eg land, development properties, hotels and intangible assets) are frequently bought and sold by transferring ownership of a separate legal entity formed to hold the assets (a corporate shell) rather than by transferring title to the assets directly. A corporate shell will often be formed for legal or tax reasons. For example, a disposal of shares may be taxed at a lower rate than disposal of the underlying assets in some jurisdictions. The Hot Topic has been written with relatively straightforward transactions in mind ie those in which a controlling interest in a corporate shell is bought or sold and (i) the corporate shell has a single class of equity instruments in issue; (ii) it holds a single asset or assets that are demonstrably not a business. It is not intended to address the determination of a business, which is sometimes a complex and judgemental matter (eg for development stage entities). Additional issues also arise in transactions involving specific types of entity and more complex capital structures (eg partnerships and other entities with multiple classes of equity). These issues are also beyond the scope of this Hot Topic.

Business combination or asset purchase?
Hot Topic 2006-07 addresses whether an acquisition of an entity that holds one or more investment properties should be accounted for as a business combination or an asset purchase. That Hot Topic considers the application of the IFRS 3 definitions of a business combination and a business to the purchase of investment properties specifically. Similar issues can arise on the purchase of other assets that generate cash flows on a stand-alone basis, for example, development properties, hotels and intangible assets.

Guidance
Acquisition of assets held in a corporate shell
Assets are often held in a separate legal entity for legal or tax reasons. The acquisition of a controlling interest in such an entity may not meet the definition of a business combination. In such cases, the accounting by the acquirer will be the same as for an asset purchase. The acquisition method is not applied and no goodwill is recognised. The identifiable assets acquired are initially recognised by allocating the cost of acquiring those assets between them in proportion to their fair values. The acquirer will consolidate a 100% interest in the acquired asset(s) and recognise any non-controlling interest.
When there is a non-controlling interest, complications arise in relation to how to measure that interest and the 100% interest in the acquired asset(s). Our preferred view is:

- when the acquired asset(s) are recognised initially at cost in accordance with applicable IFRSs (eg property), recognise the non-controlling interest at its fair value at the date of the transaction and include the non-controlling interest in measuring the cost of the 100% interest in the asset(s) or
- if the acquired asset(s) are recognised initially at fair value in accordance with applicable IFRSs (eg financial assets), record the non-controlling interest at its proportionate share of that fair value.

When the acquired asset(s) are recognised initially at cost, an alternative 'gross-up' method of measuring the 100% interest in the acquired asset(s) and the non-controlling interest may be appropriate in limited circumstances. The method and these circumstances are discussed later in this Hot Topic and illustrated in Example 1.

**Disposal of assets held in a corporate shell**

Disposal of the assets by selling the shares in the separate legal entity will normally be accounted for in accordance with IFRS 10 because a parent/subsidiary relationship exists. If control is lost a net gain or loss is recognised in profit or loss calculated as the difference between the consideration received (plus any non-controlling interests and retained investment where applicable) and the carrying amount of the assets (IFRS 10.B98). Any retained investment is recognised at its fair value (IFRS 10.B98(b)(iii)).

Any change in ownership interests that does not result in a loss of control is accounted for as an equity transaction (IFRS 10.23).

However, in very rare circumstances, it may be more appropriate to recognise gross revenue and costs in accordance with IAS 18. This may be the case where the group sells such assets as part of its ordinary revenue generating activities and the normal legal form of sale is to sell them in a separate legal entity. In substance the sale will represent revenue of the group.

**Discussion**

**Acquisition of assets held in a corporate shell**

Assets that are held in a corporate shell may not meet the definition of a business (IFRS 3 Appendix A and IFRS 3.B5-B12). If the assets acquired in a corporate shell are not a business, the purchaser accounts for the transaction as an asset purchase not as a business combination (IFRS 3.3). The purchaser recognises the individual assets acquired (and liabilities assumed). The acquisition cost is allocated to the individual identifiable assets (and liabilities) on the basis of their relative fair values at the date of purchase. This type of transaction does not give rise to goodwill (IFRS 3.2(b)).

An entity that is a parent shall present consolidated financial statements with limited exceptions (IFRS 10.4). A parent must therefore consolidate an acquired corporate shell. In a 100% acquisition the accounting is straightforward. The assets acquired in the corporate shell will initially be recognised in the consolidated financial statements at the cost of acquiring those assets. Cost will include the fair value of the consideration paid or payable and any directly attributable costs.

However, where there is a non-controlling interest in the corporate shell the accounting requires further consideration. In our view the parent entity is required to consolidate a 100% interest in the asset(s) held in the corporate shell and also recognise the non-controlling interest. However, a question arises in relation to the measurement of the 100% interest in the acquired asset(s) and also the amount at which to recognise the non-controlling interest. IFRS does not include any specific guidance on these issues. Our preferred approach to this issue is to characterise the non-controlling interest as other consideration paid to acquire the asset(s) and to measure it at its fair value. The initial carrying amount of the acquired asset(s) is the sum of the acquisition cost of the controlling interest and the fair value of the non-controlling interest. Support for this approach can also be found by drawing on an analogy with IFRS 3’s requirements on measuring non-controlling interests. IFRS 3 includes two different methods of measuring the non-controlling interest, one of which is fair value (IFRS 3.19 and IFRS 3.B44-45).
IFRS 3 also allows an alternative method of measuring the non-controlling interest in a business combination - at the proportionate share of the subsidiary's identifiable net assets. However, in a business combination the identifiable net assets are mostly measured at fair value. The non-controlling interest is therefore measured primarily as a share of that fair value. In an acquisition of asset(s) in a corporate shell that is not a business, we consider that the proportionate share basis is appropriate only if the acquired asset(s) are recorded at fair value in accordance with applicable IFRSs. This would be the case, for example, with financial or biological assets.

Some commentators also argue that a simpler 'grossing-up' approach is acceptable. This involves recording the 100% interest in the acquired asset(s) at the grossed-up acquisition cost for the controlling interest. The non-controlling interest is recognised at its proportionate share of the grossed-up cost. In our view, this approach is supportable only: (i) if there are no significant 'distorting' factors that would result in a gross-up approach giving an inappropriate measure of the non-controlling interests and/or the acquired asset(s); or (ii) if adjustments are made for such factors. These distorting factors might include a control premium, transaction costs, a bargain purchase and complex capital structures.

Consider for example transaction costs. The cost of the underlying assets will include directly attributable transaction costs incurred by the group in acquiring the controlling interest. It will not be appropriate to gross up these transaction costs in determining the amount to be attributed to the non-controlling interest. Similarly, it would not be appropriate to gross up amounts attributable to a control premium or a bargain purchase. In making adjustments for these and similar factors, the objective is to attribute to the non-controlling interest their share of the fair value of the acquired asset(s), not to allocate a proportion of the parent's acquisition cost.

Judgment will be required to determine whether this approach is appropriate in the particular circumstances of the transaction (or how to make the appropriate adjustments).

The preferred approach and also the gross-up approach (with adjustments) are illustrated in the example below.
Example 1 – acquisition of assets held in a corporate shell
Entity A builds and manages hospitals. Entity B owns a single intangible asset, being a permit to build and operate a new hospital in a specific geographic location. Entity B holds no other assets and does not trade. Accordingly, Entity B does not meet the definition of a business in IFRS 3. Entity A acquires an 80% interest in Entity B from Entity C, an unrelated third party for CU400,000. Transaction costs are immaterial. The fair value of the 20% non-controlling interest in Entity B is CU80,000, determined using a valuation technique. Entity B has only one class of share capital and all shares have identical rights. The purchase consideration paid for the controlling interest was negotiated on arm’s-length terms and represents its fair value.

How should Entity A account for its controlling interest in Entity B?

In accordance with IFRS 10, Entity A must consolidate Entity B and recognise a non-controlling interest at the date of acquisition calculated in accordance with IFRS 3. IFRS 3 allows the non-controlling interest to be measured at fair value or at the non-controlling interest’s share of the acquiree’s identifiable net assets (IFRS 3.19).

**Option 1 – measure non-controlling interest at fair value**

In accordance with IFRS 3, the acquisition of an asset or group of assets that is not a business does not give rise to goodwill. The cost is allocated to the individual identifiable assets on the basis of their relative fair values at the date of purchase. Entity A will recognise 100% of the intangible asset held by Entity B and the cost of that asset will be calculated as the sum of the cost of acquiring the controlling interest and the fair value of the non-controlling interest. Entity A will record the following entries in its consolidated financial statements:

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<tr>
<td>CU480,000</td>
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**Option 2 – measure non-controlling interest at the proportion of the identifiable net assets**

If Entity A had determined or was otherwise required to determine the fair value of the permit to build and operate a hospital, the amount of the non-controlling interest could be measured at 20% of that fair value. However, Entity B consists of only a single asset which is not otherwise required to be measured at fair value; therefore, Entity A considers whether the purchase consideration paid for the 80% controlling interest would provide a reasonable basis for measuring the non-controlling interest. Entity A considers the following factors which appear to support a conclusion that purchase consideration paid could provide a reasonable basis for measuring the non-controlling interest in the asset acquired:

(i) Entity B has only one class of share capital and all shares have identical rights
(ii) Entity A acquired control of Entity B by purchasing a significant majority of Entity B’s equity shares
(iii) the purchase consideration paid for the controlling interest is the fair value of that interest
(iv) transaction costs are not material.

Entity A determines that the purchase price paid for its 80% interest included a control premium because Entity A expects that control of the acquired asset will deliver synergy benefits that the non-controlling interests will not share in. Accordingly, Entity A concludes that it would not be appropriate for the measure of the non-controlling interest in Entity B to include any portion of a control premium. As a result it would be inappropriate to measure the non-controlling interest by grossing up the unadjusted purchase consideration paid for the acquisition of the 80% controlling interest.

Entity A determines that its purchase of the controlling interest in Entity B includes a control premium of CU80,000 and that the purchase consideration paid for its 80% controlling interest, adjusted to remove the control premium (CU400,000 – CU80,000 = CU320,000), provides a reasonable basis for measuring the non-controlling interest. Therefore, Entity A will measure the non-controlling interest in the asset/entity and determine the full amount recognised for the asset/entity as follows:

(i) gross up the purchase consideration paid for the 80% controlling interest in that asset, after adjusting to remove the control premium paid (CU320,000 x 100/80)
(ii) measure the non-controlling interest as a proportionate share (20%) of the amount determined in (i)
(iii) measure the asset recognised as the sum of the purchase price paid for the controlling interest (CU400,000) and the non-controlling interests’ proportionate share of the grossed up amount (CU80,000).

Entity A will record the following entries in its consolidated financial statements:

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How should Entity A account for its controlling interest in Entity B?

In accordance with IFRS 10, Entity A must consolidate Entity B and recognise a non-controlling interest at the date of acquisition calculated in accordance with IFRS 3. IFRS 3 allows the non-controlling interest to be measured at fair value or at the non-controlling interest's share of the acquiree's identifiable net assets (IFRS 3.19).

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In accordance with IFRS 3, the acquisition of an asset or group of assets that is not a business does not give rise to goodwill. The cost is allocated to the individual identifiable assets on the basis of their relative fair values at the date of purchase. Entity A will recognise 100% of the intangible asset held by Entity B and the cost of that asset will be calculated as the sum of the cost of acquiring the controlling interest and the fair value of the non-controlling interest. Entity A will record the following entries in its consolidated financial statements:

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(i) gross up the purchase consideration paid for the 80% controlling interest in that asset, after adjusting to remove the control premium paid (CU320,000 x 100/80)
(ii) measure the non-controlling interest as a proportionate share (20%) of the amount determined in (i)
(iii) measure the asset recognised as the sum of the purchase price paid for the controlling interest (CU400,000) and the non-controlling interests’ proportionate share of the grossed up amount (CU80,000).

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Intangible asset (CU400,000 + 80,000)  |  CU  |  480,000  
Cash (includes payment of CU80,000 control premium)  |  CU  |  400,000  
Non-controlling interest (CU320,000 x 100/80 x 20%)  |  CU  |  80,000  

### Disposal of assets held in a corporate shell
Assets held in a corporate shell may be disposed of by selling the shares in that entity rather than the assets themselves. Sale of an interest in the subsidiary entity will normally be accounted for in accordance with IFRS 10. Where the parent loses control of the subsidiary, it will recognise a single net gain or loss on disposal in accordance with IFRS 10.25(c). Changes in the ownership interests in a subsidiary that do not result in loss of control (for example, disposal of a 10% interest in a wholly owned subsidiary) are accounted for as equity transactions. Any difference between the amount by which the non-controlling interest is adjusted to reflect the change in its relative interest in the subsidiary and the consideration received is recognised directly in equity (IFRS 10.23, B96).

However, IFRS requires that the financial reports represent ‘economic phenomena in words and numbers’. To be useful, the financial information must not only represent relevant phenomena, but it must also faithfully represent the phenomena that it purports to represent (Conceptual Framework QC 12). Where the assets held in the corporate shell are classified as inventory in the consolidated accounts, the sale of those assets may in substance represent revenue of the group, which should be recognised in accordance with IAS 18. This can be described as a ‘gross accounting’ approach.

### Project update
As part of its Memorandum of Understanding Agreement, the IASB and FASB undertook a project ‘Conceptual Framework’ to create a sound foundation for future accounting standards that are principles-based, internally consistent and internationally converged. On the 28 September 2010 the IASB and the FASB announced the completion of the first phase (of eight) of their joint project. The new framework builds on existing IASB and FASB frameworks. The project has since been paused until the IASB concludes its ongoing deliberations about its future work plan. This Hot Topic has been amended to reflect the fact that the Framework no longer uses the terminology ‘form over substance’ as it is deemed redundant with ‘faithful representation’.

In other cases (for example, sale of investment properties, property, plant and equipment or intangible assets), applying IFRS 10 rather than treating the transaction as an asset sale will give substantially the same answer as in both instances a (net) gain or loss would be recognised rather than gross revenue and expenses.

The determination of whether such a transaction should result in the recognition of revenue in the consolidated accounts is a matter of judgement based on the specific facts and circumstances of the business and the transaction. However, taking a gross accounting approach appears to involve overriding an explicit requirement of IFRS 10 (or arguing that IAS 18 is the more specific standard). Accordingly, such an approach should be treated with caution. Nonetheless, there may be circumstances in which recognition of revenue and cost of sales (gross accounting) better reflects the substance of the transaction and ordinary activities of the group. This will usually involve consideration of whether the group normally sells the assets concerned as part of its ordinary revenue generating activities and whether the legal form of selling such assets in the ordinary course of business in the relevant jurisdiction is to sell them in a corporate shell. Consider the following example:
Example 2 – disposal of assets held in a corporate shell

Entity D is a property developer. Its business involves acquiring land, making short-term improvements and selling the land in smaller parcels. Entity D has concluded that this land is classified as inventory rather than as investment property. It is common practice in Entity D's jurisdiction to put parcels of land into a separate legal entity and then sell the shares in that entity to customers. Entity D owns 100% of a subsidiary Entity E, which holds a parcel of land. Entity D also has other wholly owned subsidiaries E1, E2, etc. that each hold different parcels of land. Entity D proposes to sell the shares in Entity E to an unrelated third party. Similar arrangements are in place for E1, E2, etc.

Does the transaction represent the disposal of an investment in a subsidiary or the sale of an item of inventory?

Entity D is in the business of selling developed land. Selling such land is part of Entity D's ordinary revenue generating activities. Parcels of land are commonly sold in a corporate shell in Entity D's jurisdiction. Accordingly, the sale of the land held in Entity E can be argued to be within the scope of IAS 18 and to represent revenue in Entity D's consolidated financial statements.
HT 2009-03 Impairment of available-for-sale equity investments

Relevant IFRS
IAS 39 Financial Instruments: Recognition and Measurement

Project update
This Hot Topic reflects the requirements of IAS 39 Financial Instruments: Recognition and Measurement (IAS 39) and not those of IFRS 9 Financial Instruments (IFRS 9). IFRS 9 will eventually replace IAS 39 in its entirety. At this stage, IFRS 9 addresses the classification and measurement of financial assets and financial liabilities, along with derecognition. The requirements for financial liabilities and derecognition were carried forward unchanged (with the exception of some changes to the fair value option for financial liabilities to address the issue of own credit risk). At the time of writing, the current version of IFRS 9 removes any need to recognise impairment of equity investments because all such investments will be measured either at fair value through profit or loss or fair value through other comprehensive income (without ‘recycling’). On 28 November 2012, the Board issued an exposure draft proposing limited modifications to IFRS 9’s financial asset classification model to address application issues. IFRS 9 is effective for annual periods beginning on or after 1 January 2015 (early adoption permitted). Amortised cost and impairment of financial assets is Phase 2 of the project. Work also continues on Phase 3 of the project which addresses hedge accounting.

Issue
This Hot Topic provides guidance on the application of IAS 39’s impairment rules to investments in equity instruments that are classified as available-for-sale (AFS equity investments).

Guidance
Overview of accounting for AFS equity investments
Investments in equity instruments within the scope of IAS 39 do not meet the definition of held-to-maturity investments or of loans and receivables. They are therefore classified either as at fair value through profit or loss or as available-for-sale (AFS) financial assets. Under the AFS classification:

- investments are measured initially at fair value plus any directly attributable transaction costs (IAS 39.43)
- subsequently investments are measured at reporting date fair value* (without deduction for transaction costs) (IAS 39.46)
- fair value gains and losses are reported in other comprehensive income, except for impairment losses which are reported in profit or loss (IAS 39.55(b)). See IAS 39.AG83 regarding the treatment of any foreign exchange component
- gains or losses reported in other comprehensive income are reclassified to profit or loss on de-recognition (IAS 39.55(b))
- dividends are reported in profit or loss when the right to payment is established (IAS 39.55(b)).

* except for investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured. Such investments are measured at cost less impairment losses (IAS 39.46(c)).

When is an AFS equity investment impaired?
An AFS equity investment is impaired when:

- its fair value has declined to below cost and
- there is objective evidence of impairment (sometimes referred to as an impairment indicator or trigger).

Entities holding AFS equity investments (or any other financial assets that are not measured at fair value through profit or loss) are required to assess whether there is objective evidence of impairment at each statement of financial position date (IAS 39.58). The types of objective evidence that may indicate impairment of equity investments are discussed further below.
IAS 39.60 and IAS 39.IG.E4.10 make clear that a decline in fair value to less than cost is not necessarily an impairment. The key issue (which will often require the use of professional judgement) is to determine whether a decline in value below cost is accompanied by objective evidence of impairment.

Example 1 - decline in fair value but not impaired
On 15 March 20X0 Entity A acquires equity instruments in a quoted company whose shares are actively traded. Cost is CU800. The investment is classified as available-for-sale. On 31 March 20X0 (a quarterly reporting date) the quoted price indicates that the fair value has declined to CU750. Entity A's management considers whether there is any objective evidence of impairment and determines that there is not. The decline in value is believed to result from short-term profit-taking and portfolio balancing by large institutional investors.

Based on the facts and circumstances described, these equity investments are not impaired. The decline in fair value of CU50 is reported in other comprehensive income and a debit balance of the same amount is included in the available-for-sale reserve component of equity.

**Objective evidence of impairment for AFS equity investments**
Guidance on the events and circumstances that give rise to objective evidence of impairment is set out in IAS 39.59-61. IAS 39.59 sets out the main list of indicators. Although these apply to all financial assets within the scope of IAS 39's impairment rules, in practice most of IAS 39.59 is more relevant to debt-type assets than to equity investments. The most relevant guidance for equity investments is in IAS 39.61 which states:

> 'In addition to the types of events in paragraph 59, objective evidence of impairment for an investment in an equity instrument includes information about significant changes with an adverse effect that have taken place in the technological, market, economic or legal environment in which the issuer operates, and indicates that the cost of the investment in the equity instrument may not be recovered. A significant or prolonged decline in the fair value of an investment in an equity instrument below its cost is also objective evidence of impairment.'

In summary, therefore, AFS equity investments whose fair value is less than cost are impaired if:

- adverse developments affecting the investee or operating environment have occurred since acquisition that, individually or collectively, amount to objective evidence of impairment **or**
- the decline in fair value is significant or prolonged (whether or not there is other objective evidence that accompanies or explains the decline).

The reference to a 'significant or prolonged decline' is particularly important. IAS 39 effectively assumes that such a decline is attributable to events or circumstances that constitute an impairment event. It restricts the ability of the reporting entity to 'second-guess' the market's assessment of value and the prospects for recovery. This requirement can however be difficult to interpret or apply and is discussed further below.

IAS 39.59(e) and 60 both refer to the disappearance of an active market. Disappearance of an active market as a result of financial difficulties is objective evidence of impairment (eg an issuer may have its shares suspended under local stock exchange rules on announcing an adverse development in its business). Disappearance of an active market because the investments are no longer actively traded is not objective evidence of impairment (eg a decision by the issuer to de-list its shares from a stock market).
Meaning of 'significant or prolonged' decline in fair value
As noted above, a significant or prolonged decline in fair value is objective evidence of impairment. IAS 39 does not provide any further guidance or quantitative thresholds for 'significant' or 'prolonged'. In the absence of further authoritative guidance, applying these criteria is a matter for professional judgement and we do not have any formal view on how to quantify them. In assessing what is significant or prolonged, entities should consider, among other things, the normal volatility of the equity investment in question. It is also important to note that the reference is to 'significant or prolonged' (emphasis added). We believe that the term 'prolonged' should be assessed based on the period for which fair value has been less than acquisition cost, not (for example) the elapsed time since the value of the investment was at its peak.

Note: In its May 2009 agenda rejection decisions, the IFRIC discussed the issue of the recognition and measurement of financial instruments (IAS 39), specifically the meaning of 'significant or prolonged'. The IFRIC noted that the determination of what constitutes a significant or prolonged decline is a matter of fact that requires application of judgement rather than an accounting policy choice. The IFRIC also noted that IAS 39 provided certain examples that can be used in the assessment of impairment, but these are not an exhaustive list. Although the IFRIC acknowledges that guidance is necessary, this was not included in their agenda, as the IASB has accelerated its project to develop a replacement for IAS 39 and expects that a new standard will be issued in the near future. The IFRIC decision is consistent with the discussions in this Hot Topic.

Example 2 - significant but not prolonged decline in fair value
On 31 August X1 Entity B acquires equity instruments at a cost of CU1,000 and classifies them as available-for-sale. At 30 September X1 (its next reporting date) the fair value has declined to CU600. Entity B's management believes that this is explained by a change in market sentiment towards the investee's sector as a whole. Management is not aware of any other adverse factors affecting the investee or its economic environment that constitute objective evidence of impairment. Management, having regard to the normal volatility of equities in the sector and jurisdiction concerned, generally regard fair value declines as being 'significant' when they exceed 20% and 'prolonged' when they are over 6 months.

Although the fair value decline is not prolonged based on Entity B's normal criteria, it is significant. Accordingly this investment is impaired.

Some companies (although only a minority) have disclosed their own criteria for applying these terms within their accounting policies (or key judgments and estimates disclosures). In the relatively few cases identified where specific criteria have been disclosed, these criteria have fallen within the following ranges:

- 'significant' between 20% and 30%
- 'prolonged' between 9 and 12 months.

This information is included to serve as a potentially useful starting point for discussion, not to set out 'bright lines' or a formal GTI view. As noted above, we believe that application of IAS 39's criteria is a matter for professional judgement. This requires a careful analysis of the specific facts and circumstances of each case.

Accounting for impaired AFS equity investments carried at fair value
Initial impairment
When an AFS equity investment is determined to be impaired, the cumulative loss recorded in other comprehensive income is recognised in profit or loss as a reclassification adjustment. The amount of the impairment loss is the difference between the acquisition cost and the current fair value less any previous impairment losses (IAS 39.67 and 68). It follows that:

- losses (and gains) are always recognised first in other comprehensive income, and then reclassified to profit or loss when necessary, even when it is clear that the investment is impaired
- the cumulative impairment loss reclassified to profit or loss cannot exceed the decline in fair value below acquisition costs - in other words losses are not 'double-counted'
• the impairment loss is the entire decline in fair value - once the equity investment is impaired there is no basis to split that amount into an impairment loss portion and a non-reclassified portion (eg on the grounds that management believes that some of the decline will be recovered).

**Subsequent increases in fair value**
If the fair value of an impaired AFS equity investment subsequently increases (to an amount higher than the carrying value at the date of the original impairment) the carrying value of the asset is increased to its reporting date fair value in the normal way. The gain is reported in other comprehensive income. There is no reversal through profit or loss (IAS 39.69). In other words IAS 39 treats gains and losses arising on impaired AFS equity investments differently.

**Subsequent declines in fair value**
Once an AFS equity investment is impaired, any further decline in fair value below acquisition cost is also an impairment loss. This is on the grounds that, if the original impairment loss arose because a decline in fair value was viewed as significant or prolonged, any further decline in fair value is even more significant and/or more prolonged. This view is consistent with an IFRIC rejection note of June 2005 that explains:

'The IFRIC considered whether to develop guidance on how to determine whether under paragraph 61 of IAS 39 (as revised in March 2004) there has been a ‘significant or prolonged decline’ in the fair value of an equity instrument below its cost in the situation when an impairment loss has previously been recognised for an investment classified as available for sale.

'The IFRIC decided not to develop any guidance on this issue. The IFRIC noted that IAS 39 referred to original cost on initial recognition and did not regard a prior impairment as having established a new cost basis. The IFRIC also noted that IAS 39 Implementation Guidance E.4.9 states that further declines in value after an impairment loss is recognised in profit or loss are also recognised in profit or loss. Therefore, for an equity instrument for which a prior impairment loss has been recognised, ‘significant’ should be evaluated against the original cost at initial recognition and ‘prolonged’ should be evaluated against the period in which the fair value of the investment has been below original cost at initial recognition. The IFRIC was of the view that IAS 39 is clear on these points when all of the evidence in the requirements and the implementation guidance of IAS 39 are viewed together.'

As noted above the total impairment loss recognised in profit or loss does not exceed the cumulative decline in fair value (ie the reporting date fair value less acquisition cost) (IAS 39.68). Accordingly, when there is a subsequent increase in value followed by a further decrease, the decrease is recorded:

• in other comprehensive income to the extent that it offsets the post-impairment increase recorded in other comprehensive income
• in profit or loss to the extent that the fair value has fallen further below acquisition cost.

The accounting for initial impairment losses and subsequent value changes is illustrated in Example 3 below.

---

**Example 3 - impairment loss followed by subsequent changes in fair value**
Entity X reports quarterly. On 1 October 20X0 Entity X acquires an equity investment at cost and fair value of CU500. The investment is classified as available-for-sale. At the following seven quarterly reporting dates the fair value of the investment is determined to be the amount in the second column of the table below. At 30 September 20X1 the fair value has declined to CU300 and management determines that the investment is impaired. In subsequent quarters the fair value increases, but then decreases.

The table illustrates how the fair value changes and impairment are reported in other comprehensive income (OCI), profit and loss (P&L) and the AFS reserve within equity.

<table>
<thead>
<tr>
<th>Date</th>
<th>Cost/fair value</th>
<th>Quarterly change</th>
<th>Reported in OCI</th>
<th>P&amp;L</th>
<th>AFS reserve</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>CU</td>
<td>CU</td>
<td>CU</td>
<td>CU</td>
<td>CU</td>
</tr>
</tbody>
</table>

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<table>
<thead>
<tr>
<th>Date</th>
<th>Opening</th>
<th>For</th>
<th>End</th>
<th>OCI</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>01 Oct 20X0</td>
<td>500</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>31 Dec 20X0</td>
<td>550</td>
<td>50</td>
<td>50</td>
<td>-</td>
<td>50</td>
</tr>
<tr>
<td>31 Mar 20X1</td>
<td>510</td>
<td>(40)</td>
<td>(40)</td>
<td>-</td>
<td>10</td>
</tr>
<tr>
<td>30 Jun 20X1</td>
<td>480</td>
<td>(30)</td>
<td>(30)</td>
<td>-</td>
<td>(20)</td>
</tr>
<tr>
<td>30 Sep 20X1</td>
<td>300</td>
<td>(180)</td>
<td>20</td>
<td>(200)</td>
<td>-</td>
</tr>
<tr>
<td>31 Dec 20X1</td>
<td>350</td>
<td>50</td>
<td>50</td>
<td>-</td>
<td>50</td>
</tr>
<tr>
<td>31 Mar 20X2</td>
<td>320</td>
<td>(30)</td>
<td>(30)</td>
<td>-</td>
<td>20</td>
</tr>
<tr>
<td>31 Jun 20X2</td>
<td>290</td>
<td>(30)</td>
<td>(20)</td>
<td>(10)</td>
<td>-</td>
</tr>
</tbody>
</table>

**Notes**

1. The net credit of 20 in OCI comprises a loss in OCI of 180 and a reclassification adjustment of 200. The fair value movement in the quarter is first recorded in OCI (Dr OCI 180; Cr asset 180) and then the cumulative decline in fair value below cost is reclassified to P&L (Dr P&L 200; Cr OCI 200).
2. The increase in fair value in this quarter is recorded in OCI because IAS 39.69 prohibits reversals of impairment losses on equity investments through profit and loss.
3. The decline in fair value in this quarter is recorded in OCI because the cumulative decline in fair value below cost at the quarter end is less than the impairment loss previously recognised in P&L.
4. An additional impairment loss of 10 is recognised in P&L because the fair value has fallen below cost by a total of 210 and impairment losses recognised in P&L previously are 200.

**Frequency of assessment and impairment recognition**

One consequence of IAS 39’s asymmetric approach to dealing with impairments and impairment reversals is that the amount of impairment losses recognised may be affected by the frequency of reporting. IAS 39.58 is clear that the assessment of impairment is required at each statement of financial position date. In our view it is also therefore appropriate to determine the impairment losses to be reclassified from other comprehensive income to profit and loss (if any) with the same frequency. Entities could choose a more frequent assessment basis although we expect this to be rare in practice. Entities that prepare interim financial statements may therefore report higher impairment losses than those that report only on an annual basis.

IFRIC 10 confirms that impairment losses recognised in interim periods on equity investments cannot be reversed in a subsequent interim or annual period (IFRIC 10.8).

**Example 4 - quarterly, half-yearly and annual assessment**

Entity D has a 31 Dec annual reporting date and holds an AFS equity investment that originally cost CU5,000. At 31 Dec X1 the fair value has declined to CU3,000 and an impairment loss of CU2,000 is recognised in profit and loss. At 31 Mar X2 the value has declined further to CU2,500. At 30 Jun X2 the value is CU2,700. At 30 Sep X2 and 31 Dec X2 the value has recovered to CU3,000.

If Entity D reports (or assesses impairment) every quarter, it would record additional impairment losses in Q1 20X2 of CU500, which cannot be reversed through profit or loss in subsequent quarters. If it reports (or assesses impairment) half-yearly, it recognises an impairment loss in H1 20X2 of CU300. If it reports annually and assesses impairment annually, no additional impairment loss is recognised in 20X2.

**AFS equity investments carried at cost**

The previous guidance is written in the context of AFS equity investments carried at fair value. Investments in equity instruments that are not quoted in an active market and whose fair value cannot be measured reliably are carried at cost less any impairment loss (IAS 39.46(c)). However, these investments are strictly in the AFS category and IAS 39’s general principles on impairment apply to them. However, for equity investments carried at cost:
• the 'significant or prolonged decline in fair value' impairment trigger is less relevant in practice given that fair value is not readily available or reliably measurable. Instead, the investor may need to focus more on qualitative and quantitative factors such as the issuer's financial performance (including dividends), financial condition and operations, and its market and economic environment

• if there is objective evidence of impairment, the impairment loss needs to be quantified as an additional exercise (given that the investment's fair value is not routinely determined). Impairment is measured as the difference between the carrying amount of the investment and the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset (IAS 39.66)

• impairment losses are not reversed (either through profit and loss or through other comprehensive income) (IAS 39.66).
HT 2009-04 Non-controlling interests and other comprehensive income

Relevant IFRS
IAS 1 Presentation of Financial Statements
IAS 21 The Effects of Changes in Foreign Exchange Rates
IAS 27 Separate Financial Statements
IFRS 3 Business Combinations

Issue
This Hot Topic provides guidance on accounting for items of other comprehensive income (OCI) that relate to subsidiaries in the following circumstances:

- there is a non-controlling interest in the subsidiary
- the parent’s ownership interest increases or decreases (without loss of control)
- the parent loses control of the subsidiary.

Project updates
Consolidation package
In May 2010 the IASB issued three new standards (IFRS 10 Consolidated Financial Statements, IFRS 11 Joint Arrangements, and IFRS 12 Disclosures of Interests in Other Entities) and amended two (IAS 27 Separate Financial Statements and IAS 28 Investments in Associates and Joint Ventures) – sometimes referred to as the consolidation package. IFRS 10 redefines ‘control’ and provides extensive new guidance on applying the revised definition. The new model applies to both traditional entities and to special purpose entities (replacing IAS 27 and SIC-12 Consolidation – Special Purpose Entities).

Investment entities
In October 2012, the IASB issued Investment Entities (Amendments to IFRS 10, IFRS 12 and IAS 27). The amendments provide an exception to the consolidation requirements in IFRS 10 and require investment entities to measure particular subsidiaries at fair value through profit or loss, rather than consolidate them. The amendments are effective from 1 January 2014 with early adoption permitted.

IFRS 9
This Hot Topic reflects the requirements of IAS 39 Financial Instruments: Recognition and Measurement (IAS 39) and not those of IFRS 9 Financial Instruments (IFRS 9). IFRS 9 will eventually replace IAS 39 in its entirety. At this stage, IFRS 9 addresses the classification and measurement of financial assets and financial liabilities, along with derecognition. The requirements for financial liabilities and derecognition were carried forward unchanged (with the exception of some changes to the fair value option for financial liabilities to address the issue of own credit risk). On 28 November 2012, the Board issued an exposure draft proposing limited modifications to IFRS 9’s financial asset classification model to address application issues. IFRS 9 is effective for annual periods beginning on or after 1 January 2015 (early adoption permitted). Work continues on Phases 2 and 3 of the project, which address impairment and hedge accounting, respectively.
Guidance

Items recognised in other comprehensive income (OCI)
The main items that IFRS requires to be recognised in OCI are:

- revaluations of property, plant and equipment and intangible assets (IAS 16.39-40, IAS 38.85-86)
- remeasurements of defined benefit liabilities (assets) (IAS 19.57(d))
- exchange differences on translating foreign operations (IAS 21.39(c) and 44)
- fair value movements on available-for-sale financial assets except impairment losses and foreign exchange gains and losses (IAS 39.55(b))
- in cash flow (and net investment) hedge accounting, the effective portion of the gain or loss on the hedging instrument (normally a derivative) (IAS 39.95(a) and 102(a))
- current and deferred tax relating to the above items (IAS 12.61A(a))
- the investor’s share of OCI of equity accounted associates and jointly controlled entities (IAS 28.10).

Reclassification adjustments
IFRS requires some amounts recognised in OCI to be reclassified to profit or loss in specified circumstances. IAS 1.7 and 93 refer to these as ‘reclassification adjustments’. IFRS requires reclassification adjustments:

- on disposal of a foreign operation (IAS 21.48)
- on derecognition or impairment of available-for-sale financial assets (IAS 39.55(b) and 67)
- in cash flow hedge accounting, when the hedged transaction affects profit or loss and in various other circumstances (IAS 39.97-102)
- to recognise the investor’s share of reclassification adjustments of equity accounted investees (IAS 28.22(c), IAS 28.23, IAS 28.25 and IAS 31.45B)
- on loss of control of a subsidiary, as if the related assets or liabilities had been disposed of directly - see guidance below (IFRS 10.B99).

Reclassification adjustments are not permitted for revaluations of property, plant and equipment and intangible assets or for remeasurements of defined benefit plan liabilities (assets) (although transfers between components of equity are permitted on derecognition of these items) (IAS 19.BC99).

OCI when there are non-controlling interests

Items credited or charged to OCI
If items charged or credited to OCI relate to a subsidiary in which there is a non-controlling interest, the current period and cumulative balance is allocated between the parent’s ownership interest and the non-controlling interest. In practice this involves:

- recording 100% of the OCI in the single Statement of Comprehensive Income or separate Statement of Other Comprehensive Income
- disclosing the attribution of total comprehensive income between the non-controlling interest and owners of the parent (IAS 1.81(b))
- including the non-controlling interest’s share of accumulated OCI in the non-controlling interest’s component of equity.

This third requirement has the effect that the components of equity (sometimes referred to as ‘reserves’) that relate to specific types of OCI do not show 100% of the cumulative OCI in the Statement of Financial Position or in the Statement of Changes in Equity (see example below).
Example 1 - attribution of ‘revaluation surplus’
Entity P owns 90% of Entity S with the remaining 10% held by non-controlling interests. Entity P applies the IAS 16 revaluation model in its consolidated financial statements. The revaluation surplus is included as a separate component of equity (or reserve). At 31 December 20X0 Entity S’s property is revalued, and a revaluation surplus of CU100 arises in the annual period. The cumulative revaluation surplus on S’s property at this reporting date is CU500.

This has the following effects on Entity P’s consolidated financial statements (ignoring any tax effects):
- it give rise to current period OCI of CU100
- in the allocation of total comprehensive income, CU90 is attributed to the parent's owners and CU10 to the non-controlling interests
- in the Statement of Financial Position and Statement of Changes in Equity, the revaluation reserve is stated as CU450. The remaining revaluation surplus of CU50 is included in the non-controlling interest part of equity. (Total equity attributable to non-controlling interests is not typically analysed between its components in published financial statements, hence this amount of CU50 may not be visible).

The illustrative presentation included in IAS 1’s Implementation Guidance provides a more extensive example along with illustrative primary statements.

Reclassification adjustments
Reclassification adjustments arising on disposal or impairment of available-for-sale financial assets, and adjustments arising from cash flow hedge accounting, relate to 100% of the applicable amount previously recognised in OCI. The OCI reclassified into profit or loss for the period therefore includes both the amounts attributed to the parent's owners and the amounts attributed to the non-controlling interests. Consequently, the total reclassification adjustment presented in the Statement of Comprehensive Income is not the amount included in the applicable component of equity (as this is the amount attributable to the parent's owners). The amount of OCI reclassified to profit or loss that was attributed to the non-controlling interests is reallocated to those interests.

Example 2 - reclassification adjustment
Entity P owns 90% of Entity S with the remaining 10% held by non-controlling interests. At 31 June 20X1 Entity S holds an available-for-sale financial asset at its fair value of CU400. Original cost was CU300 and the cumulative gain of CU100 has been reported in OCI. Of this CU100 gain, CU90 is included in an AFS reserve within the parent's owners' equity and CU10 has been allocated to the non-controlling interest component of equity. On the same day, Entity S sells the asset for its carrying amount of CU400.

The accounting entries recorded are:

<table>
<thead>
<tr>
<th>Dr</th>
<th>Cr</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>400</td>
</tr>
<tr>
<td>AFS investment</td>
<td>400</td>
</tr>
<tr>
<td>Gain on disposal (P&amp;L)*</td>
<td>100</td>
</tr>
<tr>
<td>AFS reserve (equity)</td>
<td>90</td>
</tr>
<tr>
<td>Non-controlling interests (equity)</td>
<td>10</td>
</tr>
</tbody>
</table>

*The gain on disposal of CU100 is itself allocated between the parent's owners and the non-controlling interest as per Example 1 above. The effect on equity is: the CU90 that was in the AFS reserve becomes part of retained earnings; non-controlling interests stays the same (as the 10% share of OCI of CU10 is removed and the 10% share of the P&L gain is reallocated, the net effect on non-controlling interest is nil).

Reclassification adjustments arising on loss of control are addressed later.

OCI and changes in ownership interests
If the parent's ownership interest in a subsidiary is increased or decreased (without loss of control):
• controlling and non-controlling interests are adjusted to reflect the new relative interests (IFRS 10.23, IFRS 10.BC96). In our view, the components of equity relating to cumulative OCI (eg revaluation, currency translation and AFS reserves) should be reallocated between the amounts attributable to the parent's owners and the non-controlling interest component
• any difference between the consideration paid or received and the amount by which non-controlling interests are adjusted is recognised in equity (not in OCI), and attributed to owners of the parent (IFRS 10.B96).

As noted above, we believe that 'reallocation' is required in respect of all components of equity that relate to cumulative OCI. IAS 21.48C is explicit that this reallocation is required on a decrease in ownership interest (partial disposal) of a subsidiary that includes a foreign operation. IFRS does not provide explicit guidance on reallocation of other components of equity. In our view reallocation is the most appropriate treatment in relation to revaluation reserves, AFS reserves etc (both on an increase and a decrease in ownership). This is because reallocation results in each component of equity attributable to the controlling interest displaying the proportion of the applicable gain or loss to which the parent's owners would be entitled on realisation. We also believe this approach is consistent with IFRS 10.23 and IFRS 10.BC96.

Example 3 - change in ownership interest
Entity P owns 100% of Entity S (a foreign operation) which was acquired in a previous business combination. The consideration transferred at the acquisition date was CU3,000. At 31 March 20X1 Entity S's net assets (as reported in Entity P's consolidated financial statements) are CU5,000. The consolidated financial statements also include the following components of equity relating to S: retained earnings of CU1,000; revaluation surplus of CU1,200 and foreign currency translation reserve of CU(200). On 31 March 20X1 Entity P sells 20% of its shares in S to an unrelated third party investor for cash of CU1,100. Transaction costs are insignificant. The accounting entries recorded in the consolidated financial statements are:

<table>
<thead>
<tr>
<th></th>
<th>Dr</th>
<th>CR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1,100</td>
<td></td>
</tr>
<tr>
<td>Non-controlling interests (equity) (note 1)</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td>Revaluation surplus (equity)</td>
<td>240</td>
<td></td>
</tr>
<tr>
<td>Currency translation reserve (equity)</td>
<td></td>
<td>40</td>
</tr>
<tr>
<td>Retained earnings (equity) (note 2)</td>
<td></td>
<td>300</td>
</tr>
</tbody>
</table>

Notes
1. The change in non-controlling interests is 20% of Entity S's net assets ie CU1,000. This represents: reallocation of the revaluation surplus and currency translation reserve CU200 [20%*(1,200 - 200)]; and recognition of the proportionate share of the non-controlling interests' share of other equity of CU800 [20%*(5,000 - 1,200 + 200)].
2. The increase in retained earnings of CU300 can be rationalised as the notional 'gain' on the part disposal of CU100 [1,100 - (20%*CU5,000)] plus the 'realisation' of 20% of the revaluation surplus and currency translation reserve.

In this example Entity P owns 100% of Entity S prior to the transaction in question (ie there is no non-controlling interest). If there are pre-existing non-controlling interests that were measured at fair value (as permitted by IFRS 3.19), the total of non-controlling interests will not normally equal the proportionate interest in the subsidiary's recognised net assets. There may also be other factors affecting the recognised amount of non-controlling interests eg the existence of different classes of equity.

OCI and loss of control of subsidiary
The requirements on loss of control of subsidiaries are set out in IFRS 10.25-26 and IFRS 10B97-99. The parent entity recognises a gain or loss on when it loses control. This gain or loss is attributed to the parent's owners. It is determined as the difference after the parent:
• derecognises the assets and liabilities of the subsidiary (including goodwill) (IFRS 10.B98(a)(i))
• derecognises the non-controlling interest including any attributable components of OCI (IFRS 10.B98(a)(ii))
• recognises:
  ▪ the fair value of the consideration received (if any) (IFRS 10.B98(b)(i))
  ▪ if applicable, the distribution of shares in the subsidiary to owners (in their capacity as owners) (IFRS 10.B98(b)(ii))
  ▪ the fair value of any investment retained in the former subsidiary (IFRS 10.B98(b)(iii))
• accounts for any amounts recorded in OCI in the same way as they would be treated if the related assets and liabilities had been disposed of directly (IFRS 10.B99)
In applying this final requirement, it should be noted that IAS 21.48B sets out more specific requirements on how to deal with the currency translation reserve. It states that:

‘On disposal of a subsidiary that includes a foreign operation, the cumulative amount of the exchange differences relating to that foreign operation that have been attributed to the non-controlling interests shall be derecognised, but shall not be reclassified to profit or loss.’

In other words, only the parent's share of the currency translation reserve is reclassified to profit or loss. For other items of comprehensive income for which reclassification adjustments are required by IFRS (available-for-sale assets and cash flow hedging reserves), in our view the entire gain or loss should be reclassified. This approach is consistent with the accounting when the related assets or liabilities are disposed of directly and is therefore consistent with IFRS 10.B99. This approach affects the allocation of the total gain or loss among its components, but does not affect the net amount of gain or loss.

**Example 4 - loss of control**

Entity P owns 75% of Entity S (which includes a foreign operation). At 30 September 20X1 the amounts included in Entity P's consolidated financial statements relating to Entity S are as follows:

<table>
<thead>
<tr>
<th>Note</th>
<th>CU</th>
</tr>
</thead>
<tbody>
<tr>
<td>Available for sale (AFS) asset</td>
<td>1</td>
</tr>
<tr>
<td>Revalued property</td>
<td>2</td>
</tr>
<tr>
<td>Other assets and liabilities</td>
<td></td>
</tr>
<tr>
<td><strong>Net assets</strong></td>
<td></td>
</tr>
</tbody>
</table>

**Equity attributable to the parent**

Accumulated OCI:
- AFS reserve | 3 | 150 |
- Currency translation reserve | 3 | 75 |
- Revaluation surplus | 3 | 300 |
Other reserves | 4 | 2,475 |
**Non-controlling interests** | 5 | 1,000 |
**Total equity** | | 4,000 |

**Notes**
1. Comprising cost 1,000 and recognised fair value increase 200
2. Including revaluation surplus 400
3. Net of amounts attributed to non-controlling interests
4. P’s share of equity on acquisition 1,500 plus post acquisition retained earnings 975
5. NCI's share of: Entity S's equity at acquisition 500; post acquisition retained earnings 325; accumulated OCI 175
On 30 September 20X1 Entity P disposes of its entire interest in Entity S for cash consideration of CU3,600. The accounting entries recorded in the consolidated financial statements are:

<table>
<thead>
<tr>
<th>Dr</th>
<th>Cr</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>3,600</td>
</tr>
<tr>
<td>Net assets of S</td>
<td>4,000</td>
</tr>
<tr>
<td>Gain on disposal of AFS asset (P&amp;L) (note 1)</td>
<td>200</td>
</tr>
<tr>
<td>AFS reserve</td>
<td>150</td>
</tr>
<tr>
<td>Currency gain (P&amp;L) (note 2)</td>
<td>75</td>
</tr>
<tr>
<td>Currency translation reserve (equity)</td>
<td>75</td>
</tr>
<tr>
<td>Revaluation surplus (note 3)</td>
<td>300</td>
</tr>
<tr>
<td>Retained earnings (equity)</td>
<td>300</td>
</tr>
<tr>
<td>Non-controlling interests</td>
<td>1,000</td>
</tr>
<tr>
<td>Gain on disposal of S (P&amp;L) (note 4)</td>
<td>550</td>
</tr>
</tbody>
</table>

Notes:

1. The entire fair value increase relating to the AFS assets is reclassified to profit or loss, including the amount attributable to non-controlling interests. This is because the entire amount would have been reclassified if the AFS assets had been disposed of directly (IFRS 10.B99).
2. By contrast, with the currency translation reserve only the amount attributable to the parent's owners is reclassified in accordance with IAS 21.48B.
3. It is common practice for entities that apply IAS 16's revaluation model to reclassify the revaluation surplus to retained earnings on disposal (as a reserve transfer within equity not into profit or loss). A reclassification within equity is permitted but not required (IAS 16.41). If an entity adopts this accounting policy on a direct disposal of revalued property, the same reclassification is made on loss of control of a subsidiary in order to comply with IFRS 10.B99.
4. The gain on disposal is the balancing item as determined in accordance with IFRS 10.B98. Intuitively, the gain might be expected to be CU600 (proceeds of 3,600 less 75% of 4,000). However, the effect of recognising the entire fair value increase relating to the AFS assets is to restrict the gain on disposal of S by CU50 (the amount of the AFS gain attributable to the non-controlling interests). The transaction gives rise to an overall gain of CU825 (550+200+75). This gain can be rationalised as: the 'expected' gain of CU600 plus the parent's share of the cumulative OCI items that are reclassified to profit or loss (the AFS and currency translation reserves).

OCI and equity accounting

This Hot Topic provides guidance on accounting for OCI that relates to a subsidiary in which there is a non-controlling interest. It is not intended to provide detailed guidance on OCI that arises in the financial statements of equity accounted investments (ie most associates and joint ventures). In summary, however, it should be noted that:

- the investor recognises its share of OCI of the associate or joint venture within its own OCI (IAS 28.10)
- reclassification adjustments are made on loss of significant influence in a similar manner to loss of control of a subsidiary (ie if direct disposal of the related assets or liabilities would result in a reclassification adjustment) (IAS 28.22-25)

If the investor reduces its interest in the associate or joint venture without a loss of significant influence and it continues to apply the equity method, the entity shall reclassify to profit or loss the proportion of the gain or loss that had previously been recognised in other comprehensive income relating to that reduction in ownership interest if that gain or loss would be required to be reclassified to profit or loss on the disposal of the related assets or liabilities.
The effect of events after the reporting period on valuation, impairment and existence of financial assets

Relevant IFRS
IAS 10 Events after the Reporting Period
IAS 39 Financial Instruments: Recognition and Measurement

Project update
This Hot Topic reflects the requirements of IAS 39 Financial Instruments: Recognition and Measurement (IAS 39) and not those of IFRS 9 Financial Instruments (IFRS 9). IFRS 9 will eventually replace IAS 39 in its entirety. At this stage, IFRS 9 addresses the classification and measurement of financial assets and financial liabilities, along with derecognition. The requirements for financial liabilities and derecognition were carried forward unchanged (with the exception of some changes to the fair value option for financial liabilities to address the issue of own credit risk). On 28 November 2012, the Board issued an exposure draft proposing limited modifications to IFRS 9’s financial asset classification model to address application issues. IFRS 9 is effective for annual periods beginning on or after 1 January 2015 (early adoption permitted). Work continues on Phases 2 and 3 of the project, which address impairment and hedge accounting, respectively.

Guidance note:
The IASB issued IFRS 13 Fair Value Measurement (IFRS 13) in May 2011 which is effective for annual periods beginning on or after 1 January 2013 (early application permitted). IFRS 13 defines fair value, sets out in a single framework for measuring fair value and requires disclosures about fair value measurements. IFRS 13 does not determine when an asset, a liability or an entity’s own equity instrument is measured at fair value. Rather, the measurement and disclosure requirements of IFRS 13 apply when another IFRS requires or permits the item to be measured at fair value (with limited exceptions). This Hot Topic has been updated to reflect the guidance in IFRS 13.

Issue
After the reporting date, but before the date of authorisation of its financial statements, a reporting entity may receive information on the value, recoverability or existence of financial assets (investments) that it holds. This Hot Topic addresses the considerations for the recognition and measurement of the financial assets at the reporting date. Specifically:

- when do fair value measurements need to be adjusted?
- how is the recognition and measurement of impairment losses affected?
- where fraud is involved are there any special considerations for the recognition and measurement of the assets?
- when should financial statements of earlier periods be restated?

Guidance
Events after the reporting period
An entity adjusts amounts recognised in its financial statements to reflect adjusting events after the reporting period (IAS 10.8). Adjusting events are those that provide evidence of conditions that existed at the end of the reporting period (IAS 10.3(a)). Events that are indicative of conditions that arose after the reporting period are not adjusted for at the reporting date but should be disclosed where they are material (IAS 10.3(b), 10, 21). Professional judgement may be required to make this determination in some cases.
When events after the reporting period are non-adjusting events, the reporting entity makes the disclosures in IAS 10.21 and 22.

Impact on period end fair value and impairment

When do fair value measurements need to be adjusted?
Reporting date fair value measurements determined using quoted prices in an active market should not be adjusted to reflect changes in the quoted price after the reporting period.

When fair value is measured using a valuation technique, it is necessary to determine whether the information received after the reporting date provides evidence of conditions that existed at the reporting date (IAS 10.5(a)) and whether a knowledgeable buyer would have been aware of the information at the reporting date (IFRS 13.3). Where both these conditions are fulfilled, the valuation technique should take account of the new information.

How is the recognition and measurement of impairment losses affected?
Where the receipt of information after the reporting date provides objective evidence that a financial asset was impaired at the reporting date, appropriate adjustments should be made to the financial statements to recognise and measure the impairment loss (IAS 10.9(b)).

Where fraud is involved are there any special considerations for the recognition and measurement of the assets?
The considerations for fair value measurement and impairment are as discussed above. In rare circumstances, the effects of a fraud may be to cast doubt over the existence of the reporting entity’s financial assets at the reporting date, and/or its rights to those assets. Adjustments would be required if the assets, or the entity's rights to the assets, are determined to be non-existent or unenforceable. In these rare cases, the definition of a financial asset would not have been met at the reporting date (IAS 32.11).

When should prior years be restated?
Prior period financial statements should only be restated for prior period errors (IAS 8.42). Where the information provides evidence about conditions that existed at an earlier reporting date, the entity will need to consider whether the information could reasonably have been obtained and taken into account in preparing the accounts for that reporting period (IAS 8.5). If this is determined to be the case, the prior period should be restated in accordance with the guidance above.

Discussion

Introduction
In the current general economic downturn many companies have announced unfavourable news in respect of the current financial condition or performance of their business or lower expectations of future performance. A number of high profile and significant frauds and alleged frauds have also been reported. This type of information normally results in significant falls in the value of the issuer's equity and debt securities. We consider below the practical implications for investors with respect to the recognition and measurement of financial assets at the reporting date when such information subsequently comes to light before the financial statements are authorised for issue.

Impact on period end fair value

Fair value measurement using quoted market prices
The best evidence of fair value at the reporting date is the quoted price in an active market. When such a quoted price is available it must be used without adjustment to measure the financial asset except in limited circumstances such as when a quoted price in an active market does not represent fair value at the measurement date (IFRS 13.79(b)). A decline in the quoted price of investments between the reporting date and the date when the financial statements are authorised for issue is a non-adjusting event after the reporting date (IAS 10.11). An abnormally large change in value after the reporting date should be disclosed in the notes (IAS 10.22(g)).
Fair value measurement using a valuation technique

The objective of using a valuation technique is to establish what the transaction price would have been at the measurement date in an arm’s length exchange involving knowledgeable and willing parties and motivated by normal business considerations. The valuation should incorporate all factors that market participants would consider in setting a price (IFRS 13.3). It is implicit in a fair value measurement that information is incorporated in a valuation only if it would be available to market participants in establishing the transaction price.

The estimates and assumptions used in the valuation technique should reflect market conditions at the reporting date. Judgement may be required in some cases to determine whether a knowledgeable buyer would have been aware of the relevant information at the reporting date. This will involve consideration of the nature of ‘typical’ market participants and the normal buying process they would undertake in acquiring the financial asset in concern (including the extent of due diligence that is customary in the circumstances). For example, a venture capitalist contemplating the purchase of a substantial investment in a private entity would typically carry out extensive due diligence. By contrast a bank which routinely buys and sells loans might rely primarily on publicly available credit ratings and undertake only limited further investigation.

If a knowledgeable buyer would reasonably have been expected to obtain and consider the relevant information at the reporting date, it should be reflected in the inputs to the valuation technique (for example, by adjusting the discount rate used or estimates of future cash flows).

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Fair value using a valuation technique

Entity A holds a loan note issued by Entity B. This is classified as an available for sale financial asset. The loan note is not quoted in an active market. Entity A therefore uses a valuation technique. Entity A prepares its financial statements to 31 March each year. On 15 May 20X1, prior to the authorisation for issue of Entity A’s financial statements for 31 March 20X1, Entity B announces that it plans to withdraw from one of its key markets. The deterioration in the economy of country X has resulted in a loss of customers and future sales orders for a major product. Entity B expects to make a significant loss as a result of asset write downs, restructuring costs and the reduction in future revenues.

Should Entity A adjust the fair value of the loan at the reporting date?

Entity A determines that the announcement provides evidence of conditions that existed at the reporting date as the poor performance of the economy in country X had been evident for some time. Information about Entity B’s exposure to changes in economic conditions in country X was disclosed in publicly available information including Entity B’s latest annual and interim financial statements. Entity A therefore concludes that a knowledgeable buyer would have taken this information into account in setting a price for the loan at the reporting date. Entity A revises the discount rate (to reflect the increased credit risk of the borrower) or the estimates of future cash flows (to reflect expected recoveries) used to determine the fair value of the loan.

Impact on recognition and measurement of impairment losses

Impairment of available for sale financial assets

If a decline in the fair value of an available for sale financial asset has been recognised in other comprehensive income and there is objective evidence that the asset is impaired, the cumulative loss recognised in other comprehensive income is reclassified from equity to profit or loss as a reclassification adjustment (IAS 39.67).

The receipt of information after the reporting date indicating that an asset was impaired at the reporting date is an adjusting event after the reporting date (IAS 10.9(b)). An announcement by the investee may therefore provide qualitative evidence that an available for sale financial asset carried at fair value was impaired at the reporting date. For example, it may indicate that adverse changes had taken place at the reporting date in the technological, market, economic or legal environment in which the issuer of an equity security operates (IAS 39.61) or that the issuer of a debt security was in significant financial difficulty at the reporting date (IAS 39.59(a)).
Although the information received after the reporting date may indicate the existence of impairment, it may not affect the measurement of the impairment loss. This is because the information may not affect the period end fair value (see guidance above). For an available for sale financial asset, the impairment loss that is reclassified to profit or loss is the difference between the fair value of the financial asset at the reporting date and the acquisition cost (net of any principal repayment and amortisation) less any impairment previously recognised in profit and loss (IAS 39.68).

**Impairment of AFS financial asset**

Entity C holds quoted debt securities in Entity D which are classified as available for sale financial assets. Entity C prepares its financial statements to 31 December each year. At the reporting date, the fair value of the debt securities had declined below their cost. Entity C initially determines the decline is neither significant nor prolonged based on its normal assessment criteria. On 15 February 20X2, prior to the authorisation for issue of Entity C’s financial statements for 31 December 20X1, Entity D announces a significant loss and that it has breached some of its banking covenants at 31 December 20X1.

**Should Entity C recycle the loss recognised in other comprehensive income to profit or loss?**

The announcement provides objective evidence that the investee (Entity D) was in financial difficulty at 31 December 20X1. This is likely to be objective evidence of an impairment at the reporting date (see IAS 39.59(a)). Entity C reclassifies the loss from equity to profit or loss as a reclassification adjustment. It does not revisit the period end fair value, which is determined as quoted price in an active market. Accordingly the amount of the loss reported is not affected.

**Impairment of financial assets carried at cost or amortised cost**

If there is objective evidence that an impairment loss on loans and receivables or held to maturity investments carried at amortised cost has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (IAS 39.63). For a financial asset quoted at cost (for example, unquoted equity instruments where fair value cannot be reliably measured) the impairment loss is calculated on a similar basis except the discount rate used should equate to the current market rate of return on a similar financial asset (IAS 39.66).

As noted earlier, the receipt of information after the reporting date indicating that an asset was impaired at the reporting date is an adjusting event (IAS 10.9(b)). Judgement will be required to determine whether the information obtained provides objective evidence of impairment at the reporting date depending on the specific facts and circumstances. For example, the financial difficulties of a debtor resulting in a potential default often build up over time and significant deterioration may have occurred by the reporting date. However, in some cases the financial difficulty of the debtor may be linked to one event that occurred after the reporting date.

If there is objective evidence of impairment at the reporting date, the reporting entity is required to measure the impairment loss (IAS 39.63 and 66). For this purpose the reporting entity’s estimates of future cash flows should take account of the most up to date information available (which would include the information obtained after the reporting date) in measuring the amount of the impairment.
Impairment of loan receivable
Entity E holds a loan note in Entity F which is classified as a loan and receivable in accordance with IAS 39. Entity E prepares its financial statements to 31 December each year. On 25 March 20X3, prior to the authorisation for issue of Entity E's financial statements for 31 December 20X2, Entity F announces a significant loss for the preceding financial year, which brings into doubt Entity F’s ability to repay its borrowings. Entity F’s major customers are in the construction sector in country Y which has experienced a significant decline in activity over the past twelve months and this has resulted in a fall in demand for Entity F’s products.

Should Entity E provide for an impairment loss at the reporting date?
The announcement provides objective evidence that the loan and receivable was impaired at the reporting date. Entity F is in significant financial difficulty and this condition has built up over a period of time. Entity E calculates the impairment loss in accordance with IAS 39.63. Its estimates of future cash flows expected in relation to the loan note take account of the new information on Entity F’s financial condition.

Additional considerations when fraud is involved
Valuation and impairment
We believe the views expressed above on valuation and impairment remain applicable if the information received after the reporting date involves a fraud at the investee which was ongoing but undiscovered at the reporting date. Accordingly, if the investee entity announces a fraud event after the reporting entity's reporting date:

- a period end fair value determined as the quoted price in an active market is not adjusted for the effects of the fraud announcement
- a fair value determined using a valuation technique takes account of the fraud announcement if
  ▪ the information provides evidence of circumstances existing at the reporting date
  ▪ it is reasonable to conclude that the information would have been obtained by market participants transacting at the reporting date (this is probably a reasonable assumption only if the normal buying process would involve a due diligence process that would have a reasonable expectation of discovering the fraud)
- the fraud event may provide objective evidence of impairment at the reporting date and, if so, would be taken into account in measuring impairment losses for assets carried at cost or amortised cost.

Some confusion is caused by the example provided in IAS 10.9(e) of an adjusting event after the reporting date stating that an entity is required “…to adjust the amounts recognised in its financial statements…when the discovery of fraud or errors show that the financial statements are incorrect” (IAS 10.9(e)). Some may interpret this statement to require a reporting entity to make adjustments if the investee's financial statements have been misstated as result of fraud or error. In our view, however, IAS 10.9(e) refers to the financial statements of the reporting entity (investor). The financial statements of the investor are not 'incorrect' if they correctly report the financial assets measured in accordance with the requirements of IAS 39.

Existence
In rare circumstances the discovery of a fraud at the investee may bring into question the existence and accuracy of the description of a reporting entity's investments. It may be determined that the investment contract is fraudulent or that the underlying investments to which the reporting entity believed it has rights do not actually exist. For example, an investor may engage a custodian to acquire and hold investments (such as equity shares) on its behalf. It may then discover that the custodian has not in fact acquired the shares and has misappropriated the monies advanced by the investor. Accordingly some or all of the investments that the investor believed that it owned do not actually exist.

In such circumstances, the issue is one of existence or rights to the assets rather than valuation of those assets. Where it is determined that the assets did not exist at the reporting date, or that the entity's rights under the investment contract are unenforceable, then the investments do not meet the definition of an asset (IAS 32.11) and should not be recognised in the financial statements.
**Fraud at asset custodian**

Entity G prepares its financial statements to 31 March each year. Entity G has engaged a broker (Entity H) to acquire and hold certain investments on its behalf during the year ended 31 March 20X0. On 20 April 20X1, prior to the authorisation for issue of Entity G’s financial statements for the year ended 31 March 20X1, Entity H is charged with an alleged securities fraud perpetrated over a number of years. It is alleged that H has misappropriated some of the funds provided to it by investors and has not acquired all the assets it was engaged to hold in trust. Entity G had valued its investments at 31 March 20X1 based on information provided by Entity H and without any knowledge of the existence of the alleged fraud.

**Should Entity G adjust the carrying amount of the investments in funds at the reporting date?**

Entity G reviews its internal procedures and determines that it carried out appropriate due diligence in relation to its investments in H and had access to the same publicly available information as other market participants. Entity G therefore concludes that it would not reasonably have been expected to have knowledge of the fraud at the reporting date. However, Entity G also determines that the majority of the underlying investments it believed were held on its behalf did not actually exist at 31 March 20X1. Accordingly, Entity G adjusts the carrying amount of its investments to write off the non-existent rights.

**When should prior periods be restated?**

The entity may determine that the information received provides evidence that amounts included in prior period financial statements may have been misstated. For example, the information provides evidence that the recorded investments did not exist or that investments carried at amortised cost were impaired or that fair values (estimated using a valuation technique) were overstated in the prior period.

Prior period financial statements should only be restated for prior period errors (IAS 8.42). A prior period error is defined as an omission from or misstatements in prior period financial statements arising from a failure to use or misuse of reliable information that (a) was available when financial statement 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 (IAS 8.5). The effect of any changes in accounting estimates should be reflected in the current period financial statements (IAS 8.36).

Judgement will be required in determining whether the entity failed to obtain available information which it should reasonably have taken into account in preparing the prior period financial statements.

In the context of investments, this determination will include consideration of the nature of the investments, the reasonableness of the information obtained by the entity in relation to other available market information and the level of due diligence that would normally be expected of an investor in the circumstances. For example, an investor that holds unquoted debt securities in a listed entity, whose shares are trading freely at expected levels with normal volatility, would not be expected to obtain information that was not publicly available. In contrast, an investor that holds a material loan receivable from a private entity may be expected to obtain regular and up to date information from the borrower (for example, the borrower’s recent management accounts).
Restatement of prior periods
The facts are the same as in the previous example above. The fraud at Entity H (the broker) has been ongoing for several years. If information as to the fraud been available and properly considered, then it would have been reasonable for Entity G to conclude that the investments purportedly held on its behalf by Entity H did not exist either at 31 March 20X0 or at 31 March 20X1.

Should entity G also restate its 31 March 20X0 financial statements?
Information about the fraud was not publicly available when the 31 March 20X0 financial statements were authorised for issue. Entity G has also concluded that it performed appropriate due diligence in relation to its investments and in accordance with its own internal procedures. Accordingly, Entity G concludes that, in preparing its 31 March 20X0 financial statements, it obtained the information that it could reasonably have been expected to obtain. The new information about the fraud received in April 20X1 is not therefore considered to indicate an error in the 31 March 20X0 financial statements. Accordingly, these statements are not restated. The write-off of the non-existent assets is recorded as an expense in the year ended 31 March 20X1.
HT 2009-06 Classification of loans with covenants as current or non-current

Relevant IFRS
IAS 1 Presentation of Financial Statements
IAS 10 Events after the Reporting Period
IFRS 7 Financial Instruments: Disclosures

Issue
Loan agreements often include covenants that, if breached by the borrower, permit the lender to demand repayment before the loan’s normal maturity date. Such covenants may, for example, require the borrower to maintain one or more key financial ratios (such as interest cover or a debt to equity ratio) above or below a stated benchmark level.

This Hot Topic provides guidance on the current or non-current classification of loans payable that are subject to borrowing covenants.

Guidance
A borrower should classify a loan payable as a current liability when it does not have an unconditional right to defer settlement for at least twelve months after the reporting period (IAS 1.69(d)). The borrower should assess whether such an unconditional right exists based on the condition of the loan at the end of the reporting period (the reporting date). 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 following paragraphs provide guidance on how to apply this principle, and the specific requirements of IAS 1, when a non-current loan is subject to borrowing covenants. The guidance has been written assuming that a breach of a borrowing covenant entitles the lender to require repayment on demand.

Effect of a covenant breach on classification
Where a borrower has breached a loan covenant on or before the reporting date, it should classify the loan as current (IAS 1.74). The borrower does not have an unconditional right to defer settlement for at least twelve months after that date.

The assessment of whether or not an entity has breached its loan covenants is based on facts and circumstances at the reporting date. Accordingly:

- classification is based on whether the borrower is in breach of the covenant at the reporting period end, regardless of whether the breach has been reported to the lender at that date. For example, where a breach of a covenant is reported to the lender after the reporting period end but the assessment is based on the financial condition of the borrower at the reporting date, this will result in classification of the loan as current
- if an entity breaches a covenant after the end of its reporting period but before the date of approval of its financial statements, this is a non-adjusting event in accordance with IAS 10. This matter should be disclosed in accordance with that Standard (along with the matters referred to IAS 1.76). Information received that provides evidence of the entity's financial condition at the period end and indicates a breach of a covenant that is assessed based on period end conditions is an adjusting event
- a covenant test within the following twelve months based on the financial conditions after the end of the reporting period does not result in current classification of the loan at the reporting date. This assessment relates to the future condition of the loan. This is the case even if the borrower believes that it is likely that it will 'fail' the future covenant test
- further, a covenant test within the following twelve months based on the financial condition of the borrower at a future date does not result in current classification even if at the reporting date the borrower's financial status would result in a breach if the test were based on conditions at that date.
Covenant waivers
A lender may however grant a waiver of its right to demand repayment following a covenant breach in order to allow the borrower time to rectify the breach. The terms and conditions attached to waivers, along with their timing, should be carefully assessed to determine the effect on loan classification. For example, a waiver may:

- defer the lender's demand rights to a later date at which time the lender can decide whether to require settlement
- be an unconditional 'forgiveness' of the past breach such that the lender no longer has a right to demand repayment and will have no automatic right in future
- be conditional on future rectification actions by the lender which are in effect new or additional covenants.

Where the entity obtains a waiver in respect of the breach before the reporting date the loan is classified as non-current if the effect is to defer the lender's right to demand repayment for a period of at least 12 months from the reporting date (IAS 1.75). In other cases, a lender may agree to waive a covenant breach before the end of the reporting period, but require another test within 12 months of the reporting date. As a result of this type of waiver, the past covenant breach in effect no longer exists. As the future covenant test is based on the financial condition of the borrower at a date after the reporting period, the loan should be classified as non-current. This is consistent with our guidance above on covenant tests within twelve months.

If the lender provides a waiver after the reporting date, the borrower classifies the liability as current because at the reporting date it did not have an unconditional right to defer settlement for at least twelve months after the reporting date (IAS 1.74). The grant of the waiver is disclosed as a non-adjusting event (IAS 1.76(c)).

Uncertainty as to whether a covenant has been breached
It is not appropriate to conclude without further analysis that current classification is required simply because a covenant is expressed in qualitative terms and not (for example) as a quantified financial measure or formula. The terms of loan covenants are sometimes expressed in a way that requires interpretation or judgement. For example, a covenant may refer to 'a material adverse change in the circumstances of the borrower'. The determination of whether or not a breach has occurred at the reporting date may then require clarification from the lender or legal advice. However, the covenant does not of itself imply that the borrower does not have an unconditional right to defer settlement for at least twelve months after the reporting period.

In some cases, the terms of a covenant may suggest that the lender has absolute discretion to judge whether a breach has occurred. In this situation, the substance of the covenant is that of a demand feature with the effect that current classification is appropriate.

Guidance note:
This view was confirmed by the IFRIC in September 2010. The IFRIC received a request for views on an issue where certain term loan arrangements include a feature that allows lenders to call a loan at any time for any reason, and how such terms would impact an entity's classification of the loan as either current or noncurrent under IAS 1.

The IFRIC's view was that the determination of the loan as current or non-current should be determined based on the rights and obligations of the lender and the borrower. When a condition allows the lender to demand repayment at any time in its sole discretion, the borrower does not have the unconditional right to defer settlement for at least twelve months.

Disclosure
IFRS 7 requires the following disclosures in respect of breaches of loan covenants during the period (unless the breaches were remedied or the terms of the loan renegotiated on or before the reporting date):

- details of the breaches
- the carrying amount of the loans concerned
- whether the breach was rectified or the terms of the loan renegotiated before the financial statements were authorised for issue (IFRS 7.18-19).
Where the borrower breaches a loan covenant after the reporting period and before the date when the financial statements are authorised for issue, this will be treated as a non-adjusting event and the loan will continue to be classified as non-current. The breach would be disclosed in accordance with IAS 10.21.

Breaches of loan covenants that are not rectified prior to the date the financial statements are authorised for issue will often have implications for the appropriateness of the going concern assumption which will need to be carefully considered. A detailed discussion of going concern issues is outside the scope of this Hot Topic. However, it should be noted that:

- breach of a loan covenant is likely to be associated with wider problems in the borrower's financial performance and position
- the possible effect of the breach in accelerating the required repayment of a loan may of itself give rise to uncertainties as to the ability of the borrower to continue as a going concern, in addition to the wider problems referred to above
- if the impact of a post-reporting date covenant breach (combined with other factors as applicable) is that the going concern assumption is no longer appropriate, the effect is so pervasive that IAS 10 requires that the financial statements are prepared on a non-going concern basis (described in IAS 10.15 as 'a fundamental change in the basis of accounting, rather than an adjustment to the amounts recognized within the original basis of accounting')
- IAS 1.25 specifies disclosures concerning material uncertainties as to an entity's ability to continue as a going concern. Information received after the reporting date (including a covenant breach) is relevant in assessing whether these disclosures are required (IAS 10.16).
Examples

Example 1 - covenant test within 12 months
Entity A has a long term bank loan which is subject to certain financial covenants. The loan agreement states that these covenants will be assessed at the end of each quarter, and reported to the bank within a month of the end of each quarter. If the covenants are breached at this time, the loan will be repayable immediately. At the year end, Entity A determines that it is not in breach of the covenant.

Analysis
Entity A should classify the loan as non-current at the reporting date. The fact that Entity A must assess compliance with the covenants within the next twelve months does not change the condition of the loan at the reporting date. This assessment relates to future conditions.

Example 2 - probable future covenant breach
Facts are as in example 1 except that Entity A believes that it is likely that the loan covenants will be breached in the following quarter.

Analysis
Entity A should classify the loan as non-current at the reporting date. The fact a future breach is likely does not change the condition of the loan at the reporting date.

Example 3 - covenant breach and waiver
Facts are as in example 1. Prior to the reporting date, Entity A breaches a covenant and obtains a waiver from the bank. The terms of the waiver specify that Entity A has twelve months from the reporting date in which to rectify the breach and the bank cannot demand repayment as a result of the breach during this period. Entity A expects to rectify the covenant breach by raising additional equity capital by means of a rights issue to existing shareholders. The rights issue has been fully subscribed.

Analysis
Entity A should classify the loan as non-current at the reporting date. Entity A had obtained an appropriate waiver in respect of the breach before the reporting date and it is within its power to rectify the breach within the waiver period.

Example 4 - covenant breach and limited period waiver
Facts are as in example 3 except that the terms of the waiver specify that the bank cannot demand repayment as a result of the breach during the next three months in which period it will enter into discussions with Entity A in respect of a refinancing of the loan.

Analysis
Entity A should classify the loan as current at the reporting date. The loan was in breach at the reporting date and the waiver does not excuse the breach. The bank has deferred a decision regarding the repayment of the loan for a period of less than twelve months from the reporting date.
HT 2009-07 Unclaimed on-demand financial liabilities

Relevant IFRS
IAS 39 Financial Instruments: Recognition and Measurement

Issue
Accounting for financial liabilities with a demand feature (on-demand financial liabilities). In particular, this Hot Topic considers the accounting implications when the entity no longer expects the counter-party to demand repayment.*

On-demand financial liabilities
This Hot Topic addresses financial liabilities that are repayable at a date of the counterparty's (lender's) choosing. In our view this is what is meant in IFRS 13.47 by a 'financial liability with a demand feature’. Most liabilities, such as fixed term borrowings, become repayable at some point. However, we do not believe that a stated future repayment date is a demand feature.

Common examples of on-demand liabilities include many bank overdrafts (for the borrower) and customers' current accounts for banks. However, on-demand financial liabilities also arise in commercial arrangements outside the banking sector. A characteristic of many such transactions is that the counter-party's right to demand repayment might not be exercised for a considerable time, and sometimes not at all (for example in the case of so-called ‘dormant bank accounts').

The main accounting issue relating to on-demand financial liabilities is whether the entity can or should derecognise or reduce the liability (and recognise income) if it no longer expects the counter-party to demand repayment. A related issue is whether the entity should 'discount' an on-demand liability if it expects the counterparty to demand repayment at a future date. This Hot Topic provides guidance on these issues.

Guidance
Initial recognition
An on-demand financial liability is a liability whose contractual terms include a right of the counterparty to demand settlement at a date of its choosing.

As with all financial liabilities, IAS 39 requires that an on-demand financial liability is recognised initially at its fair value (adjusted for transaction costs if appropriate) (IAS 39.43). IAS 39 states that "the fair value of a financial liability with a demand feature… is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid" (IFRS 13.47). This precludes initial recognition at an amount less than the amount repayable on demand when settlement could be required on demand, irrespective of when the reporting entity actually expects repayment to occur.

Subsequent measurement
On-demand financial liabilities will usually be measured at amortised cost subsequent to initial recognition. Not all creditors will demand their money at the earliest opportunity however and the amounts payable may in some cases remain outstanding for long periods of time. Re-estimation of timing of future cash flows arising from a financial liability carried at amortised cost normally results in a change in carrying amount since the revised estimated cash flows are discounted at the original effective interest rate. The necessary adjustment is recognised in profit and loss (IAS 39.AG8).

* Although the Hot Topic is intended to address on-demand financial liabilities, the guidance relating to derecognition will also be relevant to other circumstances involving financial liabilities where the reporting entity no longer expects the counter-party to demand repayment. An example might be where a debtor has in the past overpaid an amount in error, and the reporting entity does not expect the overpayment to be demanded back, despite having previously notified the customer of the error.
The effective interest rate of demand financial liabilities will be 0%. This follows from the fact that the amount payable could be required to be settled immediately and is therefore the same as the initial fair value or carrying amount. Accordingly, if the entity subsequently revises its expectations about the timing of the contractual cash flows this will have no impact on amortised cost as the present value of those cash flows discounted at 0% will always equal the amount payable and initial carrying amount.

Derecognition
An on-demand financial liability is derecognised when it is extinguished. That is when the obligation specified in the contract is discharged or cancelled or expires (IAS 39.39). This condition is met when the creditor either pays the debtor or is legally released from its obligation to the debtor (IAS 39.AG57). An expectation that repayment will not be made is not in itself sufficient for derecognition to occur.

The creditor may be discharged from its obligation by process of law or by the terms of the contract. For example, where amounts due remain unclaimed after a specified period of time these may be legally extinguished or the creditor may be able to apply a management charge against the unclaimed balances progressively to settle them. In the absence of such legal or contractual provisions, the creditor will continue to recognise the unclaimed demand liabilities until they are paid. Income will only be recognised when the legal or contractual provisions enable derecognition of the unclaimed liabilities. Even then, in some cases the terms of these provisions do not enable income to be recognised.

Examples

Example 1
Entity A provides online share dealing services and has financial liabilities (customer accounts) which are non-interest bearing and where there is a contractual obligation to pay amounts in full immediately on demand. The counterparties are individuals and the accounts comprise a substantial number of individually small balances. A large number of these balances have gone unclaimed for a significant period. Past history suggests that most of these monies will remain unclaimed indefinitely as the counterparties will not access their internet accounts to action repayment.

Analysis
Entity A should initially record these accounts at the full amount repayable on demand (IFRS 13.47). Subsequently, as the effective interest rate on the demand financial liabilities is 0%, discounting will have no effect on the carrying amount if entity A revises its estimates of the timing of future cash flows (IAS 39.AG8). The financial liabilities are not derecognised until they are extinguished.

Example 2
Facts are as in Example 1 except that entity A has obtained agreement from an external regulator to apply a management charge against such balances to clear them progressively and will change the relevant contractual terms and conditions with its customers accordingly.

Analysis
As in example 1, entity A should initially record these accounts at the full amount repayable on demand (IFRS 13.47). Subsequently, as the effective interest rate on the demand financial liabilities is 0%, discounting will have no effect on the carrying amount if entity A revises its estimates of the timing of future cash flows (IAS 39.AG8). Entity A will take the contractual changes into account when they are binding and enforceable. From that date, A will derecognise the financial liabilities and recognise management fee income in accordance with the revised terms.
Example 3

Entity B carries out banking business. B has demand deposit liabilities with customers including current accounts. Current account holders can demand immediate settlement of the balance of their account. There is however normally a core of such deposits that is left outstanding for long periods of time. Entity B treats customer demand deposit accounts as dormant when there have been no deposits or withdrawals for a period of one year and B has written to the customer and no reply has been received. Where there have been no customer initiated transactions for a period of 15 years, B is statutorily discharged from its obligation to the customer on transfer of the monies to an independent unclaimed asset fund for use on community causes.

Analysis

As in examples 1 and 2, Entity B should initially record these deposit accounts at the full amount repayable on demand (IFRS 13.47). Subsequently, as the effective interest rate on the demand financial liabilities is 0%, discounting will have no effect on the carrying amount if B revises its estimates of the timing of future cash flows (IAS 39.AG8). Dormant accounts will be derecognised when the monies are transferred to the independent unclaimed asset fund and B’s obligation to the customer is extinguished by process of law.
HT 2010-01  Onerous operating leases

Relevant IFRS
IAS 17 Leases
IAS 36 Impairment of Assets
IAS 37 Provisions, Contingent Liabilities and Contingent Assets

Issue
This Hot Topic provides guidance on:

- determining when a lessee's operating lease is an onerous contract
- recording provisions for onerous operating leases, including:
  a) income available from sub-letting
  b) the distinction between onerous contracts and future operating losses
  c) the relationship between onerous contracts and asset impairment.

Lease categories and onerous contracts
This Hot Topic discusses the application of IAS 37 to onerous operating leases for the lessee. Other categories of lease may also result in non-recoverable costs or assets but IAS 37 is not applied. The relevant requirements for other lease categories are:

- finance leases - lessee: the leased asset is assessed for impairment in accordance with IAS 36
- operating leases - lessor: the lessor-owned asset is assessed for impairment in accordance with IAS 36
- finance leases - lessor: the finance lease receivable is assessed for impairment in accordance with IAS 39.

Project update
The IASB and FASB (the Boards) have been working together to develop a new single approach to lease accounting that would ensure that all leases (other than short-term leases) would be recognised in the statement of financial position – i.e. no more operating or finance distinction. A revised exposure draft is expected in Q1 2013. This Hot Topic does not consider or discuss the new proposals.

Guidance
Summary of key principles
The main accounting requirements for leases are in IAS 17. However, if a lessee's operating lease becomes an onerous contract, IAS 37 also applies. IAS 37.10 defines an onerous contract as:

"… a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it".

IAS 37 requires a provision to be made for an onerous contract. The provision is based on the unavoidable costs of meeting the entity's obligations under the contract. Unavoidable costs are stated in IAS 37.68 to:

"… reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it" [emphasis added].

These requirements must be considered along with IAS 37.63's prohibition on providing for future operating losses. It is therefore important to distinguish between unavoidable costs under an onerous lease, and (possibly related) future operating losses. Key differences are that future operating losses: (i) are not independent of the entity's future actions; and (ii) do not stem from an obligation arising from a past event (see IAS 37.19). However, the distinction is not always clear and judgement may be required. The guidance and examples below include situations where this distinction is relevant.

IAS 37.69 requires that, before providing for an onerous contract, an entity recognises any impairment loss on assets dedicated to the contract. Guidance on this is also set out below.
**Determining when a lease is onerous**

IAS 37 has no explicit requirement for entities to 'search' for onerous contracts. It is nonetheless implicit in the onerous contract principles that reasonable steps should be taken to identify them (subject to normal materiality constraints).

IAS 37 also has no detailed guidance or indicators (such as IAS 36's impairment indicators) to assist in the identification process. Accordingly, entities should apply the onerous contract definition by comparing the unavoidable costs of a lease and the expected economic benefits to be received on a case-by-case basis.

The following paragraphs consider situations that increase the likelihood that a lease is onerous.

**Leased asset is abandoned, partly-abandoned or under-utilised**

The expected economic benefits from an operating lease are of course reduced if the lessee does not use the leased asset, or uses only part of its capacity. For example, an operating lease of a property normally becomes an onerous contract when the lessee permanently vacates (i.e. abandons) the property. However, a lease can be onerous even if the underlying asset remains in use. Conversely, a lease is not necessarily onerous simply because the underlying asset is under-utilised.

It is straightforward to conclude that a lease is onerous when the leased asset is abandoned. Additional considerations apply if it is partly-abandoned. In our view it is not appropriate to divide a single lease into onerous and non-onerous portions (for example on the basis of vacant and occupied floors of a leased office building). This is because the IAS 37 onerous test is applied at the contract level. However, practice in this area is somewhat mixed. Some commentators take the view that provision should be made for an 'onerous portion' of a lease if the portion is identifiable and separable (e.g. a vacant, self-contained floor of a larger building).

**Leased asset is used in a loss-making operation**

A lease is onerous if the expected benefits (net cash inflows) from using the leased asset are less than the unavoidable costs. When the leased asset is used in a loss-making operation, deciding whether the lease is onerous requires a distinction between the net cash inflows relating to the lease and those relating to the operation as a whole. (When the leased asset has been abandoned this distinction is simple because net cash inflows from the leased asset are often zero.)

In our view, a lease is onerous only if there is a reliable basis to make this distinction. If future losses are expected, but there is no reliable basis to identify the net cash inflows relating to the lease contract, we believe these losses are future operating losses.
Example 1a - single lease with identifiable cash flows
A restaurant chain operates from several leased premises (all operating leases), and considers each to be a separate cash-generating unit (CGU) for IAS 36 purposes. For a particular site, the lease has three years to run with no break clause. Management's forecasts indicate that the net future operating cash inflows (excluding lease costs) will be only 80% of the unavoidable lease costs over that period. However, management intends to continue to operate the site because the operating cash flows contribute to the lease costs. There is no evidence that an alternative course of action (e.g., sub-letting) would generate higher net cash inflows. The CGU has been tested for impairment.

Analysis
The facts indicate that the lease is onerous. There is one leased asset associated with one CGU, so the economic benefits associated with the lease can be identified. Management has no alternative courses of action that would result in the unavoidable lease costs being more fully recoverable.

Example 1b - multiple lease premises in a single operation
A retailer operates from five leased premises in close proximity to one another and regards all five locations as one CGU. Each lease has several years to run. The CGU is loss-making and management is likely to rationalise the number of locations once a review has been completed. Management believes that it could operate profitably by abandoning two leases and downsizing to three locations. The CGU has been tested for impairment.

Analysis
At this stage it is likely that none of the leases should be considered onerous. The fact that five leases are in one CGU indicates that the cash inflows attributable to each lease are significantly interdependent. Accordingly, there appears to be no reliable basis to conclude that any one lease has unavoidable costs that exceed its expected benefits. At this stage, the CGU's expected future losses should be regarded as future operating losses.

Once management has committed (in a manner that creates valid expectations in other parties) to vacate a specific location, the future economic benefits for the lease can be distinguished. At that point an onerous contract provision is required. (Note that the closure commitment is not an 'obligating event' or 'past event' as referred to in IAS 37.17-22. The past event is signing the lease contract - see IAS 37.IE8. However, management's closure commitment results in specific leases becoming identifiable as onerous.)

Note: IFRIC agenda decision
The above analysis is consistent with an IFRIC agenda decision (in December 2003). The IFRIC considered various issues relating to onerous contract provisions. The IFRIC decided against adding the topic to its agenda but its 'rejection note' stated that: "the Board is considering additional guidance to the existing requirements to make it clear that if a contract becomes onerous as a result of an entity's own actions, no provision is recognised until that action occurs".

Rentals are above-market
In our view, a lease is not onerous solely because the rentals are higher than current market rates. IAS 37 is not a fair value-based standard. Nonetheless, an adverse change in market conditions may increase the likelihood that the lessee will be unable to recover its rental costs (either through sub-letting or operational use).

Measuring onerous lease provisions
General measurement principle
In our view, once a lease is considered onerous, the provision should be determined as the present value of the unavoidable costs, net of the expected benefits under the contract. This net approach is not explicitly stated in IAS 37 but is consistent with the definition of unavoidable costs (see above).

Example 2 - single lease with identifiable cash flows
Facts are as per example 1a, with the following additional details. For the remaining three years, the annual rental is CU1,000 and the expected annual net cash inflows from operations are CU800.

Analysis
Before taking into account the effect of discounting (which is required if material), the onerous lease provision is CU600 (CU200 for each of the three years).

Unavoidable costs
The unavoidable costs of a lease contract reflect the least net cost of exiting the contract. The provision should therefore be based on the course of action that minimises the present value of the unavoidable costs, net of future economic benefits. Depending on the facts and circumstances, this might reflect one or a combination of:
• continuing to pay the rentals until lease expiry or the next break clause
• paying a contractual break fee or penalty
• negotiating a settlement with the landlord (lessor).

Where applicable, unavoidable costs include non-rental costs payable under the lease contract such as maintenance, insurance and dilapidations.

Example 3 - vacant property with non-contractual settlement
A major nightclub operator leases several properties from a single landlord (lessor). One of those properties has been abandoned. The lease has five years to run at an annual rental of CU20,000 with no break clause. Sub-letting is not permitted. Based on past experience, given the company's business relationship with this landlord, management expects that the landlord will agree to terminate the lease for compensation of CU50,000. The discount rate is 10%.

Analysis
Based on this information the appropriate provision is CU50,000, reflecting the expected outcome of a negotiated settlement. This is less than the present value of five payments of CU20,000 discounted at 10%.

Expected economic benefits
The expected economic benefits to be received under a lease contract are normally the net cash inflows from operational use of the leased asset. The benefits are more readily determinable for an abandoned property or other asset, and are often zero (but see discussion of sub-lease income below). The determination is more difficult, and greater use of management judgement and estimates is therefore required, in situations such as:
• leased assets used in a loss-making operation (see discussion above)
• leased premises that have been vacated temporarily
• leases over corporate assets such as head office buildings
• leases that are embedded in wider contracts for goods or services.

Sub-lease income
The treatment of sub-lease income often gives rise to application questions. In our view, an onerous lease provision should be measured net of available income from sub-letting (estimated where necessary), when:
• the lease contract permits sub-letting
• the least cost strategy to exit the lease is to continue to pay the head-lease rentals and sub-let the asset.

In most cases management will pursue the exit strategy that minimises expected net exit costs. However, companies sometimes decide not to sub-let an asset even if viable, for example to prevent competitor access to a prime location. In our view, an onerous lease provision should still be measured net of available sub-lease income in these circumstances. This is because:
• this view is consistent with the unavoidable cost principle in IAS 37.68 (in other words, a portion of the head-lease rentals could be avoided even though management has decided to incur the full cost)
• the decision not to sub-let could be reversed in future. Hence the benefits foregone are future operating losses.

Available income from sub-letting is of course subject to more estimation uncertainty when no subleases are in place or being sought. However, in our view IAS 37’s principles require a best estimate to be made (subject to the overall reliable measurement threshold in IAS 37.14(c)). Accordingly, it is not appropriate to ignore sub-lease income solely on the grounds of uncertainty as to timing or amount (if sub-letting is permitted under the contract, and market conditions are such that sub-lesseors could be found).
Example 4a - vacant property with sub-lease
A services company has rationalised its head office facilities and vacated a leased office building. The lease has two years to run at a rental of CU5,000 per annum. The head-lease permits sub-letting. The company has sub-let for one year at a rental of CU3,000 per annum. Management estimates that there is a 50% probability that it will be able to extend or replace the sub-lease at the same rental for a second year. Other contractual costs are immaterial.

Analysis
Based on this information, and before discounting, management determine that an appropriate provision is CU5,500 (head-lease costs of CU10,000 for Y1 and Y2 less the expected value of sub-lease income of CU3,000 for Y1 and 50% of CU3,000 for Y2).

Example 4b - property held vacant to prevent competitor access
A grocery retailer has vacated one of its leased retail sites in a prime location after opening a new larger store in the same area. The lease has three years to run, with no break clause, at annual rental of CU100,000. The lease allows sub-letting, but the only expressions of interest are from competing grocery retailers. Available evidence indicates that these competitors would pay a rental of CU90,000 per annum. The landlord has also indicated it would accept a payment of CU40,000 to terminate the lease. However, management's current intention is to prevent competitor access to the site so it declines both opportunities.

Analysis
Based on this information, the appropriate provision is CU30,000 before discounting. The least cost exit strategy is to continue to pay the head-lease rentals and sub-let the property, at a net cost of CU10,000 for each of the three years. The provision should therefore be measured taking account of available sub-lease income even though management has decided not to sub-let.

With reference to Example 4b above, some commentators argue that the available sub-lease income should be ignored because it is not an 'expected economic benefit' based on management's intentions. Under this view, the provision would be reduced only if sub-lease income is actually expected to be received (and not merely available). However, in our view, if the lease was entered into with the intention of operational use, the 'expected economic benefits' are those from using the leased asset. Available sub-lease income reduces the unavoidable costs as defined in IAS 37.68 and should therefore be considered in estimating the least cost means of exiting the contract.

Link with impairment testing
IAS 37.69 states that:

"Before a separate provision for an onerous contract is established, an entity recognises any impairment loss that has occurred on assets dedicated to that contract (see IAS 36)"
[emphasis added].

This means that evidence that a lease or other contract is onerous also indicates impairment for IAS 36 purposes. It is then necessary to consider which assets are 'dedicated' to the lease. IASs 36 and 37 have no guidance on this and judgement may be required. In our view, the dedicated assets are assets that are closely integrated with, and whose use is dependent on, the leased asset. For example, in a property lease, leasehold improvements are normally dedicated assets.

Impairment testing is performed before recognising an onerous lease provision. Hence the carrying value of a CGU is not reduced by an onerous lease provision for the purpose of comparison with its recoverable amount. Instead, the carrying value of the CGU's assets is compared with their recoverable amount. Any excess above recoverable amount is an impairment loss. The need for an onerous contract provision is assessed as a second step.

It should also be noted that:

- it is possible that an impairment loss arises but no onerous contract provision is required
- it is also possible that an onerous contract provision is required as well as an impairment loss
- it is not appropriate to avoid an onerous contract provision when the related economic benefits are distinguishable from the CGU as a whole, on the grounds that the CGU is profitable. For example, a lease of an abandoned property is normally onerous even if management considers that lease to be part of a profitable CGU (our view is, in any case, that the lease should be removed from the CGU on abandonment).
Example 5 - onerous contracts and impairment

A leased retail site is a single CGU and is in the process of being wound down. Prior to any impairment testing, the assets dedicated to the lease and the CGU (all of which are leasehold improvements) have a net book value of CU100. The lease has one year to run with no break clause. The following table shows the required impairment write-down and onerous contract provision under two alternative scenarios for the CGU's expected cash inflows and outflows. The effect of discounting is immaterial. It is also assumed that the fair value of the leasehold improvements is negligible (and hence their recoverable amount is determined based on value-in-use).

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Scenario 1</th>
<th>Scenario 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected cash inflows</td>
<td>90</td>
<td>15</td>
</tr>
<tr>
<td>Expected cash outflows:</td>
<td>(10)</td>
<td>(10)</td>
</tr>
<tr>
<td>- lease payments</td>
<td>(20)</td>
<td>(20)</td>
</tr>
<tr>
<td>- other costs</td>
<td>(20)</td>
<td>(20)</td>
</tr>
<tr>
<td>Net cash flows</td>
<td>60</td>
<td>(15)</td>
</tr>
</tbody>
</table>

Accounting implications:
- Impairment loss (IAS 36) 40 100
- Onerous contract provision (IAS 37) NIL 10

Notes:
1. **Scenario 1**: the lease contract does not meet the onerous test even though the CGU is impaired. The CGU is written down to its recoverable amount of CU60 (a write-down of CU40).
2. **Scenario 2**: because the future net cash flows are negative the assets are written down to nil (a write-down of CU100). This write-down does not absorb the unavoidable costs of the lease, which is onerous. The onerous lease provision is CU10, being the lower of the costs of the lease (CU10) and the CGU's total net cash outflows (CU15).
IFRS Hot Topics 2012
HT 2012-01   Cash flow statements – common pitfalls and application issues

Relevant IFRS
IAS 7 Statement of Cash Flows

Introduction
Applying IAS 7 Statement of Cash Flows gives rise to a number of interpretive and application issues. Increasingly, regulators and other commentators on financial statements are highlighting errors or inconsistencies in application of the standard.

This Hot Topic provides selected guidance to identify and address some of the common pitfalls and difficult interpretative issues arising from the application of IAS 7.

Definition of cash and cash equivalents
General
The statement of cash flows reflects movements in cash and cash equivalents. The definitions of these terms are therefore central to its proper preparation.

IAS 7.6 provides the following definitions:

- **Cash** comprises cash on hand and demand deposits.

- **Cash equivalents** are short-term, highly liquid investments that are readily convertible to known amounts of cash and that are subject to an insignificant risk of changes in value.

IAS 7.7 goes on to explain that cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes.

IA 7 does not define 'short-term' but does state ‘an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three-months or less from the date of acquisition’ (IAS 7.7). Consequently, equity or other investments that do not have a maturity date are excluded from cash equivalents unless they are, in substance, cash equivalents (see 'Money market funds' below). This three-month time limit is somewhat arbitrary but is consistent with the concept of insignificant risk of changes in value and a purpose of meeting short-term cash commitments. In our view, exceptions to this three-month time limit are rare and investments with a longer maturity at inception may be included in cash equivalents only if there is strong evidence to show that they are, in substance, cash equivalents (see discussion of 'Demand deposits and other types of deposit accounts' below for examples).

Any investment or term deposit with an initial maturity of more than three months does not become a cash equivalent when the remaining maturity period reduces to less than three months.

Bank overdrafts are generally classified as borrowings but IAS 7.8 notes that if a bank overdraft is repayable on demand and forms an integral part of an entity’s cash management then it is included as a component of cash and cash equivalents. A characteristic of such a banking arrangement is that the bank balance often fluctuates from being positive to overdrawn.

Demand deposits and other types of deposit accounts
IAS 7 does not provide a definition of demand deposit. In practice, these are generally considered to be deposits with financial institutions that are repayable on demand within one working day and without penalty.
Other types of deposit accounts need to be considered carefully to assess whether they are classified as cash equivalents. Examples include:

- fixed-term deposits (ie deposits with a fixed maturity, often referred to simply as ‘term deposits’)
- open-ended or perpetual deposits requiring a period of notice for withdrawal without penalty
- longer-term deposits with early withdrawal provisions subject to some form of penalty, such as loss of interest.

Inclusion of these other deposit accounts within cash equivalents depends on both:

- the terms of the deposit or investment account (short maturity, convertible to known amounts of cash, insignificant risk of changes in value)
- the purpose for which it is held (to meet short-term cash commitments rather than for investment or other purposes).

Many open-ended or perpetual deposit accounts (ie those with no stated maturity date) offer a marginally better rate of interest than demand deposits but require some period of notice for withdrawal without penalty (ie interest is earned at the stated rate until the date of withdrawal). Entities will often use such accounts to temporarily hold cash required for working capital cash management if the withdrawal period is reasonably short. If the notice period is less than three-months, then the deposit account can be classified as a cash equivalent if the cash is intended to be used to meet short-term cash commitments.

Longer-term deposits with early withdrawal provisions subject to a penalty present particular issues. If an entity places cash in a deposit account with a stated maturity of over three months, but with early access subject to a significant penalty, it is unlikely that the intended purpose is to meet short-term cash commitments. The significant penalty also casts doubt on whether the conversion into cash is possible without a significant loss of value. The investment is unlikely to be classified as a cash equivalent for those reasons.

However, there may be limited circumstances where classification of a longer-term deposit with early withdrawal provisions subject to a penalty as a cash equivalent is appropriate. The entity may be hopeful that identified short-term cash commitments can be satisfied from its forecast or budgeted cash flows but place some cash in a term deposit with early access in case the forecast cash inflows do not materialise. In such cases, the terms and conditions of these deposits need to be carefully reviewed at the inception of the deposit to identify if it can be classified as a cash equivalent. It is critical that, at inception, the term deposit can be converted to known amounts of cash with insignificant risk of change in value. This usually means that the terms for early withdrawal are not punitive (which would in turn mean that the interest rate for the full term is less than it would be for the same term with no early access). The entity’s past practices in managing these deposits, and their role in its overall cash and treasury management strategy, are also relevant.
Example – Term deposits
Entity A recently sold surplus plant and machinery for cash proceeds of CU250,000. Management decide to deposit the funds with the bank in two term deposit accounts as follows:

a. CU175,000 into a 12-month term account, earning 4.5% interest. The cash can be withdrawn by giving 7 days’ notice but the entity will incur a penalty, being the loss of all interest earned.
b. CU75,000 into a 12-month term account earning 3.5% interest. The cash can be withdrawn by giving 7 days’ notice. Interest will be paid for the period of the deposit but only at the rate of 3%, which is equivalent to the bank’s stated rate for short-term deposits.

Management are confident that they will not need to withdraw the cash from the higher-rate deposit within the term, but want to keep easy access to the remaining CU75,000 to cover any working capital shortfalls that might arise.

Analysis
An investment in a term deposit can be classified as a cash equivalent only when it is held for the purpose of meeting short-term cash commitments and is convertible into known amounts of cash, subject to an insignificant risk of change in value:

a. although the principal will be fully recoverable with early withdrawal, the entity will lose all accumulated interest over the term, which seems to be a significant penalty. The cash is not needed to meet short-term cash commitments and so would not qualify as a cash equivalent.
b. although the deposit is stated to have a 12 month maturity period, it can be withdrawn with 7 days’ notice. Although this incurs a penalty, the reduction in the rate of interest from 3.5% to 3% is unlikely to be considered significant. The intention of management is to keep these funds available for short-term cash needs and so this deposit is likely to qualify as a cash equivalent.

Money market funds
Money market funds are investment vehicles that invest in relatively short-term (usually between one day and one year) debt instruments such as treasury bills, certificates of deposit and commercial papers. In some jurisdictions the description ‘money market fund’ can be used only by funds that meet defined criteria and are subject to specific legal and regulatory requirements. As the main purpose of the investment is usually preservation of principal with modest dividends, they are generally regarded as being at low risk of significant changes in value.

Shares or units in these funds are typically redeemable with little or no notice period, at a redemption value based on the share of net assets of the fund. Because the redemption value is based on a net asset value, rather than a fixed amount of cash, the legal form is not consistent with the definition of cash equivalents. However, in limited cases these investments are nonetheless regarded as cash equivalents in substance.

In our view it is acceptable to classify an investment in a money market fund as a cash equivalent only if there is sufficient evidence that, in substance, the definition of cash equivalents is satisfied. In particular, it is not sufficient that the investment can readily be realised in cash. The investment must be readily convertible (normally through redemption with the fund) to an amount of cash that is subject to an insignificant risk of change. The assessment of risk must be done at the time of the initial investment. This assessment would include a review of the fund’s investment rules, the nature of its underlying investments and the stability of the redemption value. Again, the entity’s past practices in managing these investments, and their role in its overall cash and treasury management strategy, are also relevant.
‘Restricted’ cash

Sometimes, cash deposits are described as 'restricted' because they are set aside for a specific purpose and are either notionally or legally 'ring-fenced'. The nature of the restriction needs to be considered to identify whether the deposit can be classified as cash or cash equivalent.

For example, a bank account may be subject to a floating charge to provide general security for a loan or loans. Such a charge is unlikely to restrict the account from being classified as cash or cash equivalent (assuming the other criteria are met), because a floating charge does not restrict the use of the account for normal trading purposes. This may be compared to a deposit account subject to a fixed charge which is held as security for a specific loan. The charge may prevent the deposit account from being used for any purpose other than providing the lender with a right of set-off to secure repayment of the loan if the borrower defaults on the scheduled payments. The restriction in this case would prevent classification as a cash equivalent because the deposit cannot be converted into cash 'on demand' and is not available to meet short-term cash needs.

Another situation is a 'client money' account used by an entity such as an insurance broker or travel agent. Before considering IAS 7 classification, an assessment should be made as to whether the client money account should be recognised as an asset by the entity in its statement of financial position (see Hot Topic 2008-06 Accounting for client money). If the entity does not recognise the client money account it does not appear in the cash flow statement.

In a group situation, there may be restrictions on the transfer of monies from a foreign subsidiary to the parent because of exchange control restrictions. This restriction would not prevent classification as cash or cash equivalent in the consolidated financial statements, provided it meets the definition as such in the subsidiary.

Where a restriction applies but does not prevent classification as cash or a cash equivalent, the nature of the restriction needs to be disclosed (IAS 7.48). If the restriction prevents classification as a cash equivalent, this may need to be shown as a separate item in the reconciliation of cash and cash equivalent balances with the appropriate line items in the statement of financial position (see 'Presentation issues' below for further details).
Example – Restricted cash: designated account
Entity A is a property company. During the year it has secured CU5m of finance, which is ring-fenced for use only for a specific development. The funds are held in a designated bank deposit account to be used only for the purposes of the specific development project, which is expected to take 3 years to complete. Withdrawals from the account can only be made with the approval of the lender when specified milestones are met. At the year end, CU1m of the fund has been used on the development and CU4m remains in the designated account.

Analysis
In this situation, the money has been obtained in order to support long-term cash needs, being the completion of the development over the three-year period. Although the designated account may not have a specified term, withdrawals can only be made to pay for actual expenditure when certain conditions are met on the specified project, which is expected to occur over the three-year lifespan of the project. Consequently, the account is not available ‘on demand’ and is not available to meet short-term cash commitments. Consequently, it will not meet the definition of cash equivalents. The balance in the designated account at the reporting date is likely to be included in the ‘cash at bank’ line item in the statement of financial position so adequate disclosure on the amount of and the reasons for the restrictions should be given in a note.

Example – Restricted cash: Government restrictions
Entity A has a wholly owned subsidiary Entity B, which holds bank accounts with domestic banks. Entity B can use the money freely within its local jurisdiction and classifies the amounts as cash and cash equivalents in accordance with IAS 7, but Government restrictions prevent it from remitting cash abroad to Entity A or to any fellow subsidiary outside the local jurisdiction.

Analysis
Entity B has appropriately classified the amounts as cash and cash equivalents in its individual financial statements and it seems likely that this is still an appropriate classification in the consolidated financial statements. However, the amounts are only available to meet the short-term cash commitments of the subsidiary, Entity B. The restriction preventing remittance to the rest of the group should be disclosed in sufficient detail to enable users to understand the impact on the group’s financial position and liquidity.

Classification of cash flow by activity (operating / investing / financing)
IAS 7 requires entities to classify and report cash flows according to the activity which gave rise to them. There are three activity classes:

Operating activities are the principal revenue-producing activities of the entity and other activities that are not investing or financing activities

Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents

Financing activities are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.

This classification by activities is designed to provide useful information about the relative importance of these activities and the inter-relationships between them to help users of the financial statements to assess the liquidity and financial adaptability of the entity. The wording of the definitions means that operating activities is the ‘default’ category for all cash flows that do not meet the definition of either investing or financing.

IAS 7 provides some examples of the cash flows expected to be classified under these headings but the limited guidance provided allows some discretion and leaves a number of questions unanswered. The following guidance is designed to highlight some of the more problematic or unclear areas but is not intended to be comprehensive. The actual classification in practice must reflect the nature of the activities of the entity and so some cash flows that may look similar may be classified differently because the nature and purpose of the business is different; for example dividends received by a venture capital company are likely to be classified as operating but a manufacturing entity is more likely to classify such income as investing.
Interest and dividends
IAS 7.31-34 allow some flexibility in the classification of cash flows from interest and dividends received and paid. Each category is however classified in a consistent manner from period to period as either operating, investing or financing activities, depending on the nature of the entity's activities.

Interest paid and interest dividends received are usually classified as operating cash flows for a financial institution because of the nature of the entity’s business. For other entities, an accounting policy choice needs to be made. Commonly, interest paid is classified as financing because it is a cost of obtaining finance. Similarly, interest and dividends received are classified as investing because they represent returns on investments.

Alternatively, IAS 7.33 permits interest paid and interest dividends received to be classified as operating cash flows "because they enter into the determination of profit or loss" (IAS 7.33).

Dividends paid are classified as financing because they are a cost of obtaining financial resources. Alternatively, they may be classified as operating to indicate the ability of the entity to pay dividends out of operating cash flows.

Example – Interest received
Entity C is a furniture retailer. It offers customers two years extended credit for sales over CU1,000. During the year, it recorded revenue for these sales of CU980,000 plus finance income of CU65,000 and received cash relating to these sales of CU360,000, of which CU40,000 related to interest.

Analysis
Entity has an accounting policy choice to classify interest received as an operating cash flow, as permitted by IAS 7.33, or as an investing cash flow on the grounds that it is a return on an investment. In this example, the interest income is primarily derived from the entity’s principal revenue-generating activity (the sale of furniture) and so entity C is more likely to classify the interest income within operating cash flows, but this is not mandatory.

In practice, a single cash flow may include both an interest element and a repayment of capital. In such cases, the two elements may need to be disaggregated if they are classified differently. Even if the two elements are included in the same category, interest paid needs to be disclosed separately (see 'Presentation issues' later in this Hot Topic).

IAS 23 Borrowing Costs requires some amounts of interest expense to be capitalised into the cost of qualifying assets in certain circumstances. IAS 7.32 and 33 seem to require that interest paid be classified as either an operating or a financing cash flow. This seems inconsistent with IAS 7.16, which might be interpreted to require that capitalised interest paid should be classified as an investing cash flow as it is part of the amount recognised for the related asset in the statement of financial position. IAS 7 does not currently deal explicitly with capitalised interest and so judgement is required to select which category to use. The classification selected should be applied consistently.

Capitalised interest
Entity A constructs a machine (that is a qualifying asset under IAS 23) and pays construction expenses of CU1,000, which includes CU50 of capitalised interest. The entity paid CU120 interest in the year, including the amount capitalised.

Analysis
Entity A normally classifies interest paid as a financing cash flow.

Entity A has an accounting policy choice:
- recognise CU950 as an investing cash flow and CU120 as financing
- recognise CU1,000 as an investing cash flow and CU70 as financing. In addition, the total amount of CU120 interest paid is disclosed in a note (see 'Presentation issues' below).
Project update

At its meeting in September 2011, the IASB tentatively decided that interest paid that is capitalized in accordance with IAS 23 should follow the classification of the underlying asset in which those payments were capitalized (ie the qualifying asset). For example, payments of interest that are capitalized as part of the cost of property, plant and equipment shall be classified as part of an entity’s investing activities, and payments of interest capitalized as part of the cost of inventories shall be classified as part of an entity’s operating activities.

An amendment to IAS 7 is proposed in the Improvements to IFRSs exposure draft, which was published on 3 May 2012. The proposed effective date would be for annual periods beginning on or after 1 January 2014 with earlier application permitted. The comment period ended on 5 September 2012 and target amendments are expected to be published in Q1 2013.

In addition, the IFRIC continues to discuss a range of clarification issues and is considering making some broader changes to clarify IAS 7’s classification principles.

Short-term loans to related parties

An entity may provide a loan or advance to another group entity or other related party, sometimes on a short-term basis, with or without charging interest. The short-term nature of such advances does not automatically result in classification as an operating activity. Unless making cash advances to other entities is part of the normal operating activities of the entity (eg trade receivables or payables), such cash flows would normally be classified as investing.

Expenditure on internally generated intangibles

Improvements to IFRSs April 2009 amended IAS 7.16 such that only expenditure that results in a recognised asset in the statement of financial position is eligible for classification as investing activities. To illustrate two applications of this requirement:

- expenditure relating to internally generated intangible assets is recognised in investing cash flows only if the capitalisation criteria in IAS 38.57 are met
- in the extractive industries, expenditure on exploration or evaluation activities is included as investing only if these costs are capitalised in accordance with IFRS 6.

Expenditure that is expensed to profit or loss as incurred, such as research costs or training expenses, is recognised in operating cash flow activities.

Cash flows relating to assets held for rental to others

For entities that routinely rent out assets in the ordinary course of business, cash flows associated with the rental assets are classified within operating activities (IAS 7.14). This includes cash payments to acquire or manufacture such assets and cash receipts from rents and the subsequent sales of the assets. This explicit requirement was introduced through Improvements to IFRSs May 2008, related to an amendment in IAS 16. This contrasts to the usual investing activity classification of cash payments made to acquire or manufacture property, plant and equipment for own use and cash receipts from the sale of such assets.

Cash flows relating to a business combination

A number of cash flow statement issues arise in relation to business combinations, including classification of different types of consideration paid. Generally, this is expected to be an investing activity because IAS 7.39 requires that aggregate cash flows arising from obtaining or losing control of a subsidiary are presented separately within investing activities. However, in more complex scenarios the guidance in IAS 7 is not always clear. This and other issues related to the acquisition and disposal of subsidiaries are considered in a separate section later in this Hot Topic.
Tax cash flows

It is usually possible to identify tax expense/income with the related transaction or event in order to recognise the tax amount in profit or loss, other comprehensive income or equity in accordance with IAS 12.57-68C. Similarly, when it is practicable to identify a tax cash flow with an individual transaction that is classified as investing or financing, the tax cash flow is also classified as investing or financing in accordance with the underlying transaction. However, IAS 7 notes that it is often impracticable to identify tax cash flows with individual transactions. Also, tax cash flows often arise in a different period from the cash flows of the underlying transactions. Accordingly, taxes paid should generally be classified as operating cash flows (IAS 7.35-36).

Total cash flows arising from taxes should be separately disclosed, either on the face of the statement or in the notes.

Presentation issues

There are a number of presentation issues that have created differences in the practical application of IAS 7. The following guidance highlights the more common issues and provides some reminders of how to address them. In some areas, an entity can choose the most appropriate method of presentation, which should then be applied consistently each period.

Cash flows from operating activities can be presented using either:

- the direct method (IAS 7.18(a)) – each major class of gross cash receipts and gross cash payments is disclosed separately, such as cash receipts from the sale of goods or services; cash payments to suppliers and cash payments to and on behalf of employees

- the indirect method (IAS 7.18(b)) – profit or loss is adjusted for items relating to investing and financing activities and for the effects of non-cash transactions, such as changes in inventories and operating receivables and payables; depreciation and amortisation; movements in provisions; deferred taxes and unrealised foreign currency gains and losses.

Gross cash flows

Major classes of investing and financing cash receipts and payments should be presented gross on the face of the statement of cash flows (IAS 7.21). Similarly, when using the direct method, major classes of operating cash receipts and payments are also presented gross (IAS 7.18). There are limited exceptions to this gross presentation where inflows and outflows can be offset and presented net (IAS 7.22). For non-financial institutions, cash receipts and payments made on behalf of customers, where these reflect the activities of the customer, can be presented net. For example, where an entity is acting as agent, cash flows should only reflect the commission received by the agent. There may also be some limited circumstances where the turnover of transactions is quick, the amounts are large and the maturities are short. For example, an entity may have a portfolio of investments that it actively manages with frequent sales and purchases.

For financial institutions, there are additional exceptions to the gross presentation requirements, allowing many transactions with customers such as making loans and collecting repayments, to be presented net (IAS 7.24).
Example – net cash flows
Entity A is a travel agent that provides travel services to its customers. Customers pay the entity and entity A then remits the cash to the travel service providers, after deducting the related agency commissions. The suppliers are responsible for providing services direct to customers and for settling any claims from customers. Entity A presents as revenue the net commissions earned in accordance with IAS 18 Revenue.

Analysis
If the direct method of presenting operating cash flows is used, entity A will present cash receipts from customers and cash payments to suppliers on a net basis. This reflects the substance of the transactions with customers and suppliers, consistently with the statement of comprehensive income presentation of net revenue. If the indirect method of presenting operating cash flows is used, this net presentation is automatically reflected.

Starting point for the indirect method
Using the indirect method, an entity determines its cash flows from operating activities by adjusting profit or loss for various items (IAS 7.18(b)). This raises the question as to which profit or loss figure should be used. The illustrative example in Appendix A to IAS 7 starts with 'profit before tax' and so may be considered the preferred treatment but others are acceptable. Alternatives commonly seen in practice are:

- start with operating profit (this term is not defined in IFRS and so management judgement is needed to identify an appropriate sub-total for this item)
- start with the final profit or loss figure at the foot of the income statement (or the sub-total used immediately before the section presenting other comprehensive income if a single statement format is used).

IFRS 5 requires the results of any discontinued operation to be presented separately from those of continuing operations on the face of the statement of comprehensive income. Consequently, the 'profit before tax' figure relates only to continuing operations and so will need to be adjusted for relevant operating cash flows relating to the discontinued operation if profit before tax is used as the starting point in the statement of cash flows. If the entity chooses to use the 'bottom line' profit or loss for the period amount, then this will include both continuing and discontinued operations and so no adjustment is needed.

In either case, the taxation paid figure should include the total from both continuing and discontinued operations.

Presentation of adjustments to profit or loss using the indirect method
IAS 7 is not explicit as to whether the adjustments to profit or loss should be presented on the face of the statement of cash flows or in the notes. The Illustrative Example in Appendix A to IAS 7 shows them in the statement itself and is a widely-used presentation. Presentation in the notes is also used but placement varies in practice (either among the other notes to the financial statements or immediately following the statement of cash flows).

Reconciliation of cash and cash equivalent balances
IAS 7 requires that the components making up the total opening and closing balances of cash and cash equivalents in the statement of cash flows should be disclosed. These totals should be reconciled to the appropriate line items in the statement of financial position (IAS 7.45). For example, some term deposits or restricted cash deposits may be included in the line item 'cash at bank' in the statement of financial position, but are excluded from the balance of cash and cash equivalents (see 'Definition of cash and cash equivalents' section above).

Where the reporting entity holds foreign currency cash and cash equivalent balances, these are monetary items that will be retranslated at the reporting date in accordance with IAS 21. Any exchange differences arising on retranslation will increase or decrease these balances but do not give rise to cash flows. The effect of these exchange differences is presented at the foot of the statement of cash flows in order to reconcile cash and cash equivalents at the beginning and end of the period (IAS 7.28).

The treatment of foreign exchange differences in the statement of cash flows is discussed later in this Hot Topic.
Example – foreign exchange differences
Extract from statement of cash flows

<table>
<thead>
<tr>
<th></th>
<th>20X1</th>
<th>20X0</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net change in cash and</td>
<td>CU000</td>
<td>CU000</td>
</tr>
<tr>
<td>cash equivalents</td>
<td>23,469</td>
<td>1,165</td>
</tr>
<tr>
<td>Cash and cash</td>
<td></td>
<td></td>
</tr>
<tr>
<td>equivalents, beginning</td>
<td>11,259</td>
<td>10,029</td>
</tr>
<tr>
<td>of year</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exchange differences</td>
<td>61</td>
<td>43</td>
</tr>
<tr>
<td>on cash and</td>
<td></td>
<td></td>
</tr>
<tr>
<td>cash equivalents</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash and cash</td>
<td></td>
<td></td>
</tr>
<tr>
<td>equivalents, end of</td>
<td>34,789</td>
<td>11,237</td>
</tr>
<tr>
<td>year</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Extract from notes to the financial statements - Cash and cash equivalents

<table>
<thead>
<tr>
<th></th>
<th>20X1</th>
<th>20X0</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash and cash</td>
<td></td>
<td></td>
</tr>
<tr>
<td>equivalents</td>
<td></td>
<td></td>
</tr>
<tr>
<td>consist of the following:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash at bank and in</td>
<td>CU000</td>
<td>CU000</td>
</tr>
<tr>
<td>hand:</td>
<td>24,352</td>
<td>7,867</td>
</tr>
<tr>
<td>GBP</td>
<td>2,087</td>
<td>674</td>
</tr>
<tr>
<td>USD</td>
<td>1,392</td>
<td>449</td>
</tr>
<tr>
<td>Short-term deposits</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(CU)</td>
<td>6,958</td>
<td>2,247</td>
</tr>
<tr>
<td></td>
<td>34,789</td>
<td>11,237</td>
</tr>
</tbody>
</table>

Non-cash transactions

IAS 7.43 requires that investing and financing transactions that do not involve an inflow or outflow of cash or cash equivalents are excluded from the statement of cash flows. Examples of such transactions include the issuance of shares in exchange for shares in another entity and the acquisition of property, plant or equipment under a finance lease.

Such transactions require specific disclosure to give the user of the financial statements relevant information about the transaction. For example, when equipment is acquired under a finance lease, it is necessary to eliminate this item from the total amount of tangible asset additions to identify the appropriate investing cash outflow. The non-cash transaction note can be used to reconcile the tangible asset additions figure, distinguishing cash additions from leased additions. Similarly, the creation of the finance lease liability does not involve any cash inflow so again the non-cash transaction note can be used to reconcile the movement in the liability. Any payments of principal are reported as financing cash outflows (IAS 7.17(e)), with any interest element reported as financing or operating, depending on the entity's accounting policy.

Example – non-cash transactions

Entity B is a manufacturing company. It obtains a new machine to use within its manufacturing plant under a 5-year finance lease agreement. Entity B recognises the machine within property, plant and equipment at an amount of CU400,000 and recognises a finance lease liability for CU400,000. By the end of the reporting period, B has paid scheduled repayments of CU35,000, of which CU2,900 was recognised as a finance cost in profit or loss. Entity B has a policy of recognising interest paid within financing activities.

Analysis

The addition to property, plant and equipment of CU400,000 will be shown as a non-cash transaction in the notes to the financial statements (IAS 7.43) because there is no immediate cash flow involved at the inception of the lease. The creation of the CU400,000 lease liability is not shown as a financing inflow but is instead disclosed in the non-cash transactions note.

The CU2,900 interest element of the lease rentals is included in the total of interest paid within financing activities in accordance with the entity's accounting policy and the CU32,100 (CU35,000 – CU2,900) capital element of the lease rentals paid will be classified as a financing outflow in accordance with IAS 7.17(e).

Central banking function

In some cases, the reporting entity may have no cash in its own name. For example, the cash operations of a subsidiary may be administered by the parent company which effectively acts as a bank. All suppliers and employees are paid by the parent company and receipts from customers are received into the parent company's bank account. As the subsidiary has no direct cash transactions, a question arises as to whether a statement of cash flows is required.
IAS 7.43 requires an entity to disclose its non-cash investing and financing transactions, suggesting that the subsidiary's transactions that are channelled through the parent should be disclosed. This does not, however, explicitly require disclosure of non-cash transactions relating to operating activities. On this basis, some may argue that there is no need to provide any such disclosure for a subsidiary that has no bank account. In our view, however, this view is hard to reconcile with IAS 7's overall objectives. The fact that they channel these cash flows through another entity for administrative purposes should not detract from the need to present relevant information to users of the financial statements. In such situations, the subsidiary is effectively using the parent entity as its 'bank' and the intra-group account is, in substance, the subsidiary's 'bank account'.

In our view, the cash flow information described above is best presented as a primary statement of cash flows, clearly annotated to confirm that all cash flows are directed through another entity and by recognising a zero balance in cash and cash equivalents at the beginning and end of the reporting period. The net impact of these centrally managed cash flows will be reflected in the intercompany balances between the parent and subsidiary. The net movement should be shown as an investing or financing activity as appropriate. This approach is consistent with the requirements in IAS 7 that all entities should prepare a statement of cash flows that forms an integral part of the financial statements.

**Disclosure of total interest paid**

IAS 7.31 requires that cash flows arising from interest and dividends received and paid be classified separately under the activity appropriate to their nature (see above). In addition, IAS 7.32 requires that the total amount of interest paid during a period be disclosed in the statement of cash flows. The amount included in this total includes all interest paid in the period, irrespective of whether it has been recognised as an expense in profit or loss or capitalised in accordance with IAS 23. If all interest paid falls to be classified under a single activity, our preferred view is to show the total under the appropriate heading on the face of the statement of cash flows but presentation in a note to the financial statements is also acceptable. Some entities disclose this information immediately after the statement of cash flows.

**Example - Capitalised interest**

As in a previous example, entity A constructs a machine (that is a qualifying asset under IAS 23) and pays construction expenses of CU1,000, which includes CU50 of capitalised interest. The entity paid CU120 interest in the year, including the amount capitalised.

**Analysis**

Entity A has an accounting policy choice relating to the classification of capitalised interest:

- recognise CU950 as an investing cash flow and CU120 as financing. In this case, the inclusion of a separate line item 'interest paid CU120' in financing activities is sufficient to satisfy the IAS 7.32 disclosure requirement
- recognise CU1,000 as an investing cash flow and CU70 as financing. If this option is selected, entity A would also need to disclose the total amount of CU120 interest paid, either at the foot of the statement of cash flows or in a note to the financial statements.

**Cash flow per share**

Some entities may wish to disclose a 'cash flow per share' amount. This is not specifically addressed in IFRS and so judgement is needed to determine the appropriate accounting policy.

Relevant guidance may be found in IAS 33 *Earnings Per Share*, which envisages that an entity may choose to disclose an amount per share that is based on a different amount than the earnings figure required by IAS 33. In such cases, IAS 33.73 requires specific disclosure, including details of how the numerator is calculated, together with a reconciliation to a related line item in the statement of comprehensive income. Although some entities wishing to disclose cash flow per share may not be included within the scope of IAS 33, the guidance for developing accounting policies given in IAS 8.10-11 would require that it be considered.
Measurement issues
There is little guidance within IAS 7 relating to the measurement of items to be included within the statement of cash flows because the measurement of gross cash flows usually requires little judgement or estimation. However, when the indirect method for the presentation of operational cash flows is used, there are some reconciliations that can cause problems in practice. The following guidance provides some reminders of how to address the most common issues.

Foreign currency exchange differences
As previously noted, when the reporting entity holds foreign currency cash and cash equivalents, these are monetary items that will be retranslated at the reporting date in accordance with IAS 21. Any exchange differences arising on this retranslation will have increased or decreased these cash and cash equivalent balances. As these exchange differences do not give rise to any cash flows, they should not be reported as any part of the cash flow activities presented in the statement of cash flows. (Their net impact should be disclosed as a reconciling item between opening and closing balances of cash and cash equivalents at the foot of the statement of cash flows, as noted earlier.)

The non-cash impact of the exchange differences needs to be eliminated from the operating, financing and investing cash flows. The method of doing this within the statement of cash flows depends on a number of factors, including whether:

- the exchange difference has been recognised in profit and loss or in other comprehensive income (OCI)
- the related transaction is settled or unsettled
- the related transaction relates to operating, investing or financing activities
- the entity applies the direct or indirect method.

Individual entities
Exchange differences that have been recognised in profit or loss on settled transactions classified as operating activities do not cause any difficulties in the statement of cash flows as they will automatically have been reflected either through the direct cash flows or in the reconciliation from profit to operating cash flows using the indirect method. However, where a settled transaction does not relate to operating activities and the exchange gain or loss is included in profit or loss, it should be removed in the reconciliation required under the indirect method as it will in effect be included as part of the cash flows arising from the settlement disclosed under financing or investing activities.
Example - Foreign currency cash flows

Entity A (whose functional currency is CU) had a balance of cash and cash equivalents of CU10,000, but no trade receivables or trade payables on 1 Jan 20X2. During 20X2, the entity entered into the following foreign currency transactions:

- Entity A purchased goods for resale from Europe for €200,000 when the exchange rate was CU1=€1.5. This balance is still unpaid at 31 Dec 20X2 when the exchange rate is CU1=€1.6. An exchange gain on retranslation of the trade payable of CU8,333 is recorded in profit or loss [€200,000@1.5 = CU133,333; €200,000@1.6 = CU125,000]
- Entity A sold the goods to an American client for $280,000 when the exchange rate was CU1=$2. This amount was settled when the exchange rate was CU1=$1.96. A further exchange gain of CU2,857 regarding the trade receivable is recorded in profit or loss [$280,000@2 = CU140,000; $280,000@1.96 = CU142,857]
- Entity A also borrowed €100,000 under a long-term loan agreement when the exchange rate was CU1=€1.54 and immediately converted it to CU64,935. The loan was retranslated at 31 Dec 20X2 @1.6 = CU62,500, with a further exchange gain of CU2,435 recorded in profit or loss.
- Entity A therefore records a cumulative exchange gain of CU13,625 (8,333 + 2,857 + 2,435) in arriving at its profit for the year.

In addition, Entity A records a gross profit of CU6,667 (CU140,000 – CU133,333) on the sale of the goods.

Analysis

Entity A includes the following amounts in its statement of cash flows using the indirect method of reporting operating activities.

<table>
<thead>
<tr>
<th>Description</th>
<th>CU</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit (13,625 + 6,667)</td>
<td>20,292</td>
</tr>
<tr>
<td>Adjustment for:</td>
<td></td>
</tr>
<tr>
<td>Foreign exchange gain on financing item</td>
<td>(2,435)</td>
</tr>
<tr>
<td>Increase in trade payables</td>
<td>125,000</td>
</tr>
<tr>
<td><strong>Net cash inflow from operating activities</strong></td>
<td>142,857</td>
</tr>
<tr>
<td>Cash inflow from financing activity</td>
<td>64,935</td>
</tr>
<tr>
<td><strong>Net increase in cash and cash equivalents</strong></td>
<td>207,792</td>
</tr>
<tr>
<td>Cash and cash equivalents at beginning of period</td>
<td>10,000</td>
</tr>
<tr>
<td><strong>Cash and cash equivalents at end of period</strong></td>
<td>217,792</td>
</tr>
</tbody>
</table>

Foreign operations

In a group situation, a foreign operation may be included in the consolidated financial statements. IAS 21 requires that the foreign operation's assets and liabilities be retranslated at the closing rate of exchange and income and expenditure items are translated at their actual exchange rate (or an average rate if appropriate). In this case, all exchange differences are recorded in other comprehensive income (OCI), until disposal of the foreign operation when they are reclassified into profit or loss. IAS 7 requires the foreign operation's cash flows to be translated at the actual exchange rate or an average rate, if appropriate (IAS 7.26-27).

Care is needed when applying the indirect method in the consolidated statement of cash flows that includes a foreign operation. If translated financial statements of the foreign operation are used, exchange differences will be included in the movements between opening and closing balances of assets and liabilities. For example, an increase in inventories held by a foreign subsidiary from $240 to $270 during the year will be reported as an unchanged amount of CU150 if the opening rate of CU1=$1.60 becomes CU1=$1.80 by the reporting date. It is therefore advisable to take the functional currency statement of cash flows of the foreign subsidiary as the starting point. The $30 increase in inventories can then be translated at the average exchange rate (assuming this is an appropriate approximation) to achieve the required cash flow amount in the consolidated statement of cash flows. Otherwise, an adjustment is needed to not only account for the exchange difference related to the opening balance but also to reflect the difference between the closing rate used for the closing balance and the average rate used for the recognition of inventory used in profit or loss.
Example - Cash flows of foreign operations (extract)
Entity A (whose functional currency is CU) has a foreign subsidiary entity B, based in the USA. Entity B has an opening balance of inventory of $240 and a closing balance of $270. At the start of the year, the exchange rate is CU1 = $1.60, the closing rate is CU1 = $1.80 and the average rate for the year is CU1 = $1.65.

Analysis
IAS 7.26 requires that the cash flows of the foreign subsidiary are translated at the actual exchange rate at the time of the transaction, or at an average exchange rate if that is a suitable approximation (IAS 7.27).

The simplest way of presenting the change in inventory of the foreign subsidiary is to identify the change in the subsidiary’s functional currency and translate that at the average rate, ie $30 (270-240) @1.65 = CU18.18. This amount is included in the changes in working capital presented in the reconciliation of net cash flows from operating activities using the indirect method.

This can be reconciled as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventories at end of year</td>
<td>($270 @ 1.8)</td>
</tr>
<tr>
<td>Inventories at beginning of year</td>
<td>($240 @ 1.6)</td>
</tr>
<tr>
<td>Change in inventory</td>
<td>$30</td>
</tr>
<tr>
<td>Exchange difference:</td>
<td></td>
</tr>
<tr>
<td>Retranslation of opening balance at closing rate</td>
<td>($240 @1.8 - $240 @ 1.6)</td>
</tr>
<tr>
<td>Retranslation of movement included in profit or loss</td>
<td>($30 @ 1.8 - $30 @ 1.65)</td>
</tr>
<tr>
<td>Increase in inventories reported in the statement of cash flows</td>
<td>18.18</td>
</tr>
</tbody>
</table>

Cash flows relating to business combinations and disposals
A number of cash flows can arise relating to the acquisition of a business by an entity. Generally, these are expected to be recognised as investing activities because IAS 7.39 requires that aggregate cash flows arising from obtaining or losing control of a subsidiary are presented separately within investing activities. However, other requirements in IAS 7 create apparent contradictions that have led to inconsistencies in practice.

Consideration transferred in a business combination
Deferred consideration
Normally, cash consideration paid at the time of a business combination will be classified as an investing activity (IAS 7.39). The acquiring entity will record the fair value of the deferred consideration as a liability at the acquisition date (IFRS 3.37). This liability will increase as the discount reflecting the time value of money unwinds and is reflected as a finance charge in profit or loss. When the liability is settled at a later date, the payment will reflect both the amount initially recognised as consideration plus the interest element (ie the unwinding of the discount). IAS 7 does not deal directly with how this payment should be classified and so in practice the following alternatives may be observed:

- classify the entire payment as an investing cash flow on the grounds that it is part of the aggregate cash flows arising from obtaining control of the subsidiary (IAS 7.39)
- classify the entire payment as a financing cash flow on the grounds that the payment of deferred items represent a reduction of a liability; this is consistent with the required treatment of a payment made by a lessee to reduce the outstanding liability relating to a finance lease (IAS 7.17(e))
- disaggregate the payment into
  a) the amount initially recognised as consideration (and treat as investing or financing as above) and
  b) the interest element resulting from the unwinding of the discount, which should be treated as a financing or operating cash flow according to the entity's policy choice (see 'Interest and dividends' above).

This disaggregation approach is consistent with IAS 7.12, which notes that a single payment may include cash flows that are classified differently and gives the repayment of a loan as an example.

Our preferred view is to disaggregate the payment into the consideration and interest components in accordance with the third approach described above.
Future developments
The IFRIC has debated the treatment of both deferred and contingent (see below) consideration in a business combination at its meetings in September 2011, November 2011 and March 2012. No firm decisions were made at these meetings but the supporting Agenda Papers suggest that our preferred views are currently better supported than the alternatives. However, these discussions are not final and so cannot be considered as interpretive guidance from the IFRIC. Consequently, judgement is required to select an accounting policy choice until such time as IAS 7 is amended to address this lack of clarity.

Contingent consideration
Similar decisions need to be made for contingent consideration as for deferred consideration (see above) but with an added complication. As with deferred consideration, the amount initially recognised as a liability is the fair value of the contingent consideration (IFRS 3.39). Changes to this fair value that relate to conditions and events after the acquisition date are recognised in profit or loss and do not affect the consideration transferred in exchange for the acquiree (and, consequently, do not affect goodwill (IFRS 3.58)). In addition, the fair value initially recognised will be adjusted to reflect the passage of time and related unwinding of the discount. Again, inconsistency is observed in practice and the subsequent payment of the contingent consideration may be recognised as follows:

- classify the entire payment as an investing cash flow on the grounds that it is part of the aggregate cash flows arising from obtaining control of the subsidiary (IAS 7.39)
- classify the entire payment as a financing cash flow on the grounds that the payment of contingent consideration recognised as a liability represents a reduction of that liability; consistent with the required treatment of a payment made by a lessee to reduce the outstanding liability relating to a finance lease (IAS 7.17(e))
- disaggregate the payment in accordance with IAS 7.12 into:
  - the principal amount of contingent consideration, including any changes to the amount initially recognised to reflect any changes in the expected outcome of the contingency (classify this principal amount as investing or financing as above) and
  - the interest element resulting from the unwinding of the discount which should be treated as a financing or operating cash flow according to the entity's policy choice (see 'Interest and dividends' above)
- disaggregate the payment in accordance with IAS 7.12 into:
  - the amount initially recognised as consideration (and treat as investing or financing as above)
  - the amount of any excess over the amount initially recognised as consideration that reflects conditions and events after the acquisition date and are recognised in profit or loss. Classify this element of the payment as an operating cash flow on the grounds that it does not result in a recognised asset in the statement of financial position (IAS 7.16)
  - the interest element resulting from the unwinding of the discount, which should be treated as a financing or operating cash flow according to the entity's policy choice (see 'Interest and dividends' above).

Although technical arguments can be made to support the fourth approach (disaggregation into three components), this can be challenging to apply in practice, especially if the amount actually paid is lower than the original estimated amount of contingent consideration. Therefore, our preferred view is to disaggregate at least the interest component in accordance with the third approach.

Cash and cash equivalents acquired
Any cash and cash equivalents acquired in a business combination must be netted against the amount of consideration paid and disclosed under investing activities (IAS 7.42).
Transaction costs
There is no specific guidance in IAS 7 regarding transaction costs relating to the acquisition of a subsidiary and some inconsistency is seen in practice. IAS 7.39 states that the aggregate cash flows arising from obtaining or losing control of a subsidiary shall be presented separately and classified as investing. However, Improvements to IFRSs April 2009 amended IAS 7.16 such that only expenditure that results in a recognised asset in the statement of financial position is eligible for classification as investing activities. This seems to contradict IAS 7.39 because these transaction costs are expensed to profit or loss in accordance with IFRS 3.53. In our view, classification as operating is preferred but classification as investing is considered acceptable. In either case, clear disclosure will be required.

Example – Acquisition of subsidiary
Entity D acquired a subsidiary on 1 October 20X1. Consideration of CU1,000,000 recognised at the date of acquisition consisted of:
- cash - CU450,000
- present value of deferred consideration payable in 6 months - CU225,000
- fair value of contingent consideration - CU325,000. The actual amount payable depends on whether certain revenue and profit targets are met over the following year.

In addition, entity D paid CU25,000 acquisition costs. The identifiable net assets of the newly acquired subsidiary included cash and cash equivalents of CU140,000.

How is this acquisition reflected in the statement of cash flows for the year ended 31 December 20X1?

Analysis
- within investing activities, a cash outflow of CU310,000 is reported, being the cash consideration paid of CU450,000 less the cash and cash equivalents acquired of CU140,000
- the deferred and contingent consideration amounts of CU225,000 and CU325,000 are non-cash transactions, as no cash has yet been paid (see below). These amounts are excluded from the statement of cash flows but will be reported as part of the total consideration disclosure required by IAS 7.40
- our preferred approach is to include the transaction costs of CU25,000 within operating cash flows

Example – Acquisition of subsidiary continued
During 20X2, Entity D
- paid the deferred consideration CU225,000, plus interest of CU5,000
- paid contingent consideration of CU375,000. This was a higher amount than recognised as consideration because the subsidiary’s results exceeded expectations and included interest of CU15,000.

How are these payments reflected in the statement of cash flows for the year ended 31 December 20X2?

Analysis
Entity D has to make an accounting policy choice for the classification of each of these payments. If the disaggregation into three components approach is chosen:
- the deferred payment of CU225,000 is classified as investing
- the contingent consideration payment of CU375,000 is broken down into its component parts as follows:
  - CU325,000 initially recognised as consideration is classified as investing
  - CU15,000 interest is classified as below (either operating or financing)
  - the remaining CU35,000 relates to changes in circumstances since acquisition and is classified as operating
- the total interest payment of CU20,000 (5,000+15,000) is classified as either operating or financing in accordance with the entity’s normal policy choice.

Changes in non-controlling interests
Changes in ownership interests in a subsidiary that do not result in a loss of control are treated as equity transactions in accordance with IAS 27 and the cash flows arising from such changes are included within financing activities in accordance with IAS 7.42A.
Acquisitions and disposals of subsidiaries

When a subsidiary joins or leaves the group, its cash flows should be included in the consolidated statement of cash flows for the same period as the results are reported in the consolidated statement of comprehensive income. As noted previously, an entity presents separately within investing activities the aggregate cash flow arising from obtaining or losing control of a subsidiary (IAS 7.39). This aggregate cash flow includes any cash consideration paid or received and the amount of cash and cash equivalents in the subsidiary over which control is obtained or lost. IAS 7.42 requires the net of these two amounts to be included in investing activities.

Recording the cash consideration or proceeds net of any cash and cash equivalent balances transferred means that any property, plant and equipment, intangible assets and working capital (excluding cash and cash equivalents) of the subsidiary at the acquisition or disposal date would need to be eliminated from other cash flow headings so as to avoid double counting because the related amounts are already included within the investing activities figure. For example, when using the indirect method, the adjustments for changes in working capital between the opening and closing consolidated position are adjusted to eliminate the assets and liabilities acquired or disposed of. Any additions to property, plant and equipment and goodwill will not be separately reported within the statement of cash flows.

An example using the indirect method is set out overleaf. This example is intended to demonstrate the mechanics of dealing with an acquisition or disposal of a subsidiary during the year in the statement of cash flows. A number of disclosure requirements have not been dealt with here but examples can be seen in the publication Reporting under IFRS: Example consolidated financial statements. For full details, refer to IAS 7, IFRS 3 and IFRS 5.

Example – Subsidiary acquired in the year

Entity A acquires a subsidiary, entity B, during the year. Summarised information from the consolidated statements of comprehensive income and financial position is provided, together with some supplementary information, to demonstrate how the statement of cash flows under the indirect method is derived. Entity A has chosen to classify interest paid as a financing activity.

<table>
<thead>
<tr>
<th>20X2</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Consolidated statement of comprehensive income (extract)</strong></td>
<td>CU</td>
</tr>
<tr>
<td>Revenue</td>
<td>1,900</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>1,100</td>
</tr>
<tr>
<td>Gross profit</td>
<td>800</td>
</tr>
<tr>
<td>Depreciation</td>
<td>(150)</td>
</tr>
<tr>
<td>Other operating expenses</td>
<td>(280)</td>
</tr>
<tr>
<td>Interest cost</td>
<td>(20)</td>
</tr>
<tr>
<td><strong>Profit before taxation</strong></td>
<td>350</td>
</tr>
<tr>
<td>Taxation</td>
<td>(75)</td>
</tr>
<tr>
<td><strong>Profit after taxation</strong></td>
<td>275</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>20X2</th>
<th>20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Consolidated statement of financial position (extract)</strong></td>
<td></td>
</tr>
<tr>
<td>Assets</td>
<td>CU</td>
</tr>
<tr>
<td>Cash and cash equivalents</td>
<td>40</td>
</tr>
<tr>
<td>Trade receivables</td>
<td>270</td>
</tr>
<tr>
<td>Inventories</td>
<td>150</td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td>800</td>
</tr>
<tr>
<td>Goodwill</td>
<td>90</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>1,350</td>
</tr>
<tr>
<td>Liabilities</td>
<td>CU</td>
</tr>
<tr>
<td>Trade payables</td>
<td>340</td>
</tr>
<tr>
<td>Income tax payable</td>
<td>60</td>
</tr>
<tr>
<td>Long term debt</td>
<td>500</td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
<td>900</td>
</tr>
<tr>
<td><strong>Net assets</strong></td>
<td>450</td>
</tr>
</tbody>
</table>
### Other information

All of the shares of entity B were acquired for CU370 cash. The fair values of assets acquired and liabilities assumed were:

<table>
<thead>
<tr>
<th>Description</th>
<th>CU</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventories</td>
<td>20</td>
</tr>
<tr>
<td>Trade receivables</td>
<td>40</td>
</tr>
<tr>
<td>Cash</td>
<td>10</td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td>550</td>
</tr>
<tr>
<td>Trade payables</td>
<td>(160)</td>
</tr>
<tr>
<td>Long term debt</td>
<td>(180)</td>
</tr>
<tr>
<td>Goodwill</td>
<td>90</td>
</tr>
<tr>
<td><strong>Cash consideration paid</strong></td>
<td><strong>370</strong></td>
</tr>
</tbody>
</table>

### Analysis

This information will be incorporated into the statement of cash flows as follows:

#### Statement of cash flows for 20X2 (extract)

<table>
<thead>
<tr>
<th>Description</th>
<th>CU</th>
<th>CU</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit before taxation</td>
<td>350</td>
<td></td>
</tr>
<tr>
<td><strong>Adjustments for non-cash items</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td>150</td>
<td></td>
</tr>
<tr>
<td>Decrease in inventories (150-175-20)</td>
<td>45</td>
<td></td>
</tr>
<tr>
<td>Decrease in trade receivables (270-250-40)</td>
<td>20</td>
<td></td>
</tr>
<tr>
<td>Decrease in trade payables (340-300-160)</td>
<td>(120)</td>
<td></td>
</tr>
<tr>
<td>Interest paid included in financing activities</td>
<td>20</td>
<td>115</td>
</tr>
<tr>
<td>Taxation (60-55-75)</td>
<td>(70 )</td>
<td></td>
</tr>
<tr>
<td><strong>Net cash inflow from operating activities</strong></td>
<td>395</td>
<td></td>
</tr>
<tr>
<td>Interest paid</td>
<td>(20)</td>
<td></td>
</tr>
<tr>
<td><strong>Net cash outflow from financing activities</strong></td>
<td>(20)</td>
<td></td>
</tr>
<tr>
<td>Cash paid to acquire subsidiary (370-10)</td>
<td>(360)</td>
<td></td>
</tr>
<tr>
<td><strong>Net cash outflow from investing activities</strong></td>
<td>(360)</td>
<td></td>
</tr>
<tr>
<td>Increase in cash and cash equivalents</td>
<td>15</td>
<td></td>
</tr>
<tr>
<td>Cash and cash equivalents, beginning of year</td>
<td>25</td>
<td></td>
</tr>
<tr>
<td><strong>Cash and cash equivalents, end of year</strong></td>
<td>40</td>
<td></td>
</tr>
</tbody>
</table>
### Appendix A - List of amended Hot Topics

<table>
<thead>
<tr>
<th>Hot Topic No.</th>
<th>Description</th>
<th>Nature of changes made</th>
</tr>
</thead>
<tbody>
<tr>
<td>HT 2005-01</td>
<td>Equity transactions of an associate (now Share-based payments of an associate)</td>
<td>Modified example to consider the expense previously recognised by the investor related to the stock options; changed title to ‘Share-based payments of an associate’ as better reflects substance of the Hot Topic</td>
</tr>
<tr>
<td>HT 2006-05</td>
<td>Additional investments in associates and joint ventures</td>
<td>Updated view to reflect that the subsequent share of the associate’s profits/losses should be determined by taking into account the fair values of the assets and liabilities at the date each tranche was acquired (eg on a mixed measurement basis), with certain limited exceptions</td>
</tr>
<tr>
<td>HT 2006-23</td>
<td>Debt modifications</td>
<td>Updated view to reflect that the preferred approach is that a non-substantial modification should be accounted for as an adjustment to the existing liability (removing wording indicating that there was an option to treat the non-substantial modification as an extinguishment). Further, updated view to indicate that in circumstances where the quantitative analysis indicates a less than 10% cash flow change, consideration should still be given to whether there have been qualitative changes to the terms of the instrument that indicate there has been a substantial change</td>
</tr>
</tbody>
</table>
| HT 2007-24    | Convertible debt and the effect of the changes to the conversion ratio on equity or liability classification | Modified two views in Appendix A regarding if particular instruments meet equity classification criteria or not (do they meet the fixed-for-fixed test) to align with current thinking including the following:  
• for conversion feature whereby the conversion ratio changes upon a dividend payment  
• for a standalone option or warrant whereby the option entitles the holder to acquire a fixed percentage of share capital at a fixed price per share |
| HT 2008-11    | IAS 1 and the requirement for a third statement of financial position (balance sheet) | Updated for Improvements to IFRS issued in May 2012 which clarifies when a third Statement of Financial Position is necessary |
## Appendix B - List of withdrawn Hot Topics

<table>
<thead>
<tr>
<th>Hot Topic No.</th>
<th>Description</th>
<th>Reason for withdrawal</th>
</tr>
</thead>
<tbody>
<tr>
<td>HT 2005-05</td>
<td>Control under IAS 27 Consolidated and Separate Financial Statements</td>
<td>Superseded by IFRS 10</td>
</tr>
</tbody>
</table>
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