Executive guide to IFRS

Topic summaries 2010

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Introduction

This executive guide to IFRS is a compendium of PricewaterhouseCoopers' topic summaries. Executives, accountants, legal practitioners, company administrators, financial advisers, auditors and academics may find this guide a valuable reference tool.

The summaries include key information on each of the major accounting topic areas – presented in alphabetical order. They explain the financial reporting requirements on a topic-by-topic basis.

They comprise: an overview (a very brief explanation of the topic) and a summary of key requirements (2-4 pages explaining the current IFRS requirements). They also include a list of resources available on each topic, including the text of standards, interpretations, exposure drafts, etc; and PricewaterhouseCoopers' guidance and interpretations, tools, practice aids and publications that relate to the topic. All of these resources are available on PwC inform (the firm's accounting and auditing web site pwcinform.com – some of the content referred to is only available to subscribers).

The on-line version of these topic summaries is continually being updated as the topics develop. You can access the latest up-to-date topic summaries free by visiting:

- www.pwc.com/ifrs – click on 'Topic summaries' in the left-hand navigator; and
- www.pwcinform.com – click on 'Topic summaries' in the 'Accounting and corporate reporting' box.

Details of other information available on PwC inform can be found on the inside back cover of this publication.

Accounting policies, accounting estimates and errors

Overview

The accounting policies that an entity follows are often those required by IFRS that are relevant to the particular circumstances of the entity. However, for some situations, standards are either silent or offer a choice. In any event, management should select appropriate accounting policies.

Management uses its judgement in developing and applying an accounting policy that results in information that meets the qualitative characteristics of relevance and reliability, including faithful representation, substance over form, neutrality, prudence and completeness. If there is no IFRS standard or interpretation that is specifically applicable, management should consider the applicability of the requirements in IFRS on similar and related issues, and then the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the Framework. Management may also consider the most recent pronouncements of other standard-setting bodies, other accounting literature and accepted industry practices, where these do not conflict with IFRS.

Accounting policies should be applied consistently to similar transactions and events.

Changes in accounting policies

Changes in accounting policies made on adoption of a new standard are accounted for in accordance with the transition provisions (if any) contained within that standard. If specific transition provisions do not exist, a change in policy (whether required or voluntary) is accounted for retrospectively (that is, by restating all comparative figures presented) unless this is impracticable.

Issue of new/revised standards not yet effective

Standards are normally published in advance of the required implementation date. In the intervening period, where a new/revised standard that is relevant to an entity has been issued but is not yet effective, the entity discloses this fact. It also provides the known or reasonably estimable information relevant to assessing the impact that the application of the standard might have on the entity's financial statements in the period of initial recognition.

Changes in accounting estimates

An entity recognises prospectively the changes in accounting estimates by including the effects in profit or loss in the period that is affected (the period of the change and future periods), except if the change in estimate gives rise to changes in assets, liabilities or equity. In this case, it is recognised by adjusting the carrying amount of the related asset, liability or equity in the period of the change.

Errors

Errors may arise from mistakes and oversights or misinterpretation of information.

Errors that are discovered in a subsequent period are prior period errors. Material prior-period errors are adjusted retrospectively (that is, by restating comparative figures) unless this is impracticable.

Resources

Standards and interpretations
- IAS 8, Accounting policies, changes in accounting estimates and errors

Exposure drafts and discussion papers

PwC guidance
- International Manual of Accounting chapter 5, Accounting policies, accounting estimates and errors

Tools practice aids and publications
- IFRS extracts from from accounts

Summary of key requirements

Objective and scope

1 IAS 8, 'Accounting policies, changes in accounting estimates and errors', prescribes criteria for selecting and applying accounting policies. It also deals with the accounting treatment and disclosure requirements of changes in accounting policies, accounting estimates and corrections of prior period errors. [IAS 8 paras 1, 3].

Selecting and applying accounting policies

2 Accounting policies are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial information. Accounting policies need not be applied where the effect of applying them is immaterial, but it is inappropriate to make or leave uncorrected immaterial departures from accounting standards to achieve a particular presentation of an entity's financial position, financial performance or cash flows. [IAS 8 paras 5, 8].

3 Where an accounting standard specifically applies, the accounting policy for a particular transaction or other event or condition should be determined by reference to that standard. Where no accounting standard applies

specifically, management should develop a policy that gives information that is:

- relevant to the needs of users when making economic decisions; and
- reliable, so that the financial statements:
  - faithfully represent the financial position, performance and cash flows of the entity;
  - reflect the substance of transactions, other events and conditions and not just the legal form; and
  - are free from bias (that is, neutral), prudent and, in all material respects, complete.
  [IAS 8 paras 7, 10].

4 When developing accounting policies, management should take account of existing sources in the following order:

- Requirements in standards and interpretations that deal with similar and related matters. The standard notes that IFRSs are sometimes accompanied by guidance notes that assist entities in applying their requirements. Each guidance note states whether or not it is an integral part of the IFRS. A guidance note that is an integral part of the IFRS is mandatory; a guidance note that is not an integral part of the IFRS is not mandatory but may be useful when applying the IFRS.
- The definitions, recognition criteria and measurement principles for assets, liabilities, income and expense set out in the Framework. [IAS 8 para 11].

5 Management may also take into account the most recent pronouncements of other standard-setters that use an accounting framework similar to that of the IASB, other accounting literature and accepted industry practices, to the extent that these do not conflict with the sources listed above. [IAS 8 para 12].

6 Accounting policies should be applied consistently, unless an accounting standard or interpretation requires or permits different accounting policies to be applied to different categories of items. Where a standard or interpretation allows or requires different policies for different categories, an accounting policy for each such category should be selected and applied consistently. [IAS 8 para 13].

Changes in accounting policies

General rules

7 An accounting policy is only changed when the change is either required by a standard or interpretation or when it results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, performance or cash flows. [IAS 8 para 14].

8 When an entity applies an accounting standard or interpretation for the first time it applies the specific transitional provisions, if any, of that standard or interpretation. For example, a new standard may specify that it should only be applied prospectively and, if so, the entity does not make prior period adjustments for the effect of the change. [IAS 8 para 19(a)].

9 When an entity applies a standard or interpretation for the first time and that standard or interpretation contains no specific transitional provisions, or when an entity changes a policy voluntarily, it applies the changes retrospectively, that is, it makes prior period adjustments for the effects of the change. This rule applies unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change in policy (see below). [IAS 8 paras 19(b), 23].

Applying changes in accounting policy

10 Where a change in accounting policy is applied retrospectively, an entity adjusts the opening balance of each component of equity that is affected for the earliest prior period presented in the financial statements. It also adjusts the other comparative amounts (that is, amounts in the statement of comprehensive income (and, if presented separately, income statement), balance sheet, cash flow statement, statement of changes in equity and related notes) disclosed for each prior period presented as if the new policy had always applied. This rule applies except where it is impracticable to determine either the period-specific effects of the change or the cumulative effects of the change. [IAS 8 paras 22, 23].

11 Except where driven by a change in circumstances, a change in the classification of an item within the balance sheet or income statement may represent a change in accounting policy. When the presentation or classification of items is changed, IAS 1 (revised), 'Presentation of financial statements', requires comparative figures to be restated (unless it is impracticable, see below) and sets out disclosure requirements. [IAS 1 (revised) paras 41, 42].

Disclosure of changes in accounting policy

12 IAS 8 sets out disclosure requirements for situations where a change in policy (i) has an effect on the current period or any prior period, (ii) would have such an effect except that it is impracticable to determine the amount of the adjustment, or (iii) might have an effect on future periods. [IAS 8 paras 28, 29]. In addition, when an entity applies a change in accounting policy retrospectively, the entity presents an additional balance sheet as of the beginning of the earliest comparative period. [IAS 1 (revised) para 10(f)]. However, in our view, entities may choose to omit the additional balance sheet if there is no impact on that balance sheet and this fact is disclosed.

Standards issued but not yet effective

13 Where a new or revised standard or interpretation that is relevant to an entity has been issued, but is not yet effective and an entity has not voluntarily adopted the standard or interpretation, the entity discloses this fact. It also gives information about the likely effects on the financial statements of adopting the new standard or interpretation, so far as the effects are known or can reasonably be estimated. [IAS 8 para 30].

Changes in accounting estimates

General rules

14 A change in accounting estimate is defined as *''...an adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of errors''.* [IAS 8 para 5].

15 Changes in accounting estimates are *not* applied retrospectively and accordingly, financial information presented for prior periods is not restated. Instead, the effect of a change in an accounting estimate is recognised prospectively (that is, from the date of change) as follows:

- by including it in profit or loss:
  - in the period of change, if the change affects only that period;
  - in the period of change and future periods, where the change also affects future periods; or
- to the extent that a change in an accounting estimate gives rise to changes in assets and liabilities, or relates to an item of equity, adjusting the carrying amount of the related asset, liability or equity item in the period of the change.
  [IAS 8 paras 36, 37].

16 Sometimes it is difficult to distinguish a change in accounting estimate from a change in accounting policy. In such cases, the change is treated as a change in accounting estimate, with appropriate disclosure. [IAS 8 para 35].

Disclosure of changes in accounting estimates

17 For a change in accounting estimates, an entity discloses the nature and amount of the change that affects the current period or that is expected to have an effect in future periods. The only exception is where it is impracticable to estimate the effect on future periods. Where the effect on future periods is not disclosed because it is impracticable, that fact is disclosed. [IAS 8 paras 39, 40].

18 There is an additional disclosure requirement in respect of changes in estimates in IAS 34, 'Interim financial reporting'. When an estimate of an amount reported in an interim period is changed significantly during the final interim period of the financial year, but a separate financial report is not published for that final interim period, the nature and amount of that change in estimate is disclosed in a note to the annual financial statements for that financial year. [IAS 34 para 26].

Prior period errors

19 Financial statements do not comply with IFRSs if they contain either material errors or immaterial errors (because of the quantum of error) made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows. IAS 8 defines prior period errors and 'material' in the context of such errors. Material prior period errors are corrected retrospectively in the first financial statements issued after their discovery.

20 Retrospective correction is effected by:

- restating the comparative figures for the prior period or periods presented in which the error occurred; or
- if the error occurred before the earliest period presented in the financial statements, restating the opening balances of assets, liabilities and equity for the earliest period presented.

This rule applies unless it is impracticable to determine either the period-specific effects of the error or the cumulative effect of the error. [IAS 8 paras 5, 42, 43].

21 Generally, where a prior period error impacts any component of the financial statement being presented, the reporting entity evaluates whether the error is material and warrants adjusting the financial statements retrospectively. Materiality should not be assessed solely against a single measure such as the profit for the year or retained earnings, but rather against the financial statements as a whole. The error should be corrected, in accordance with paragraph 42 of IAS 8 by retrospectively adjusting the prior period financial statements. SEC registrants reporting under IFRS also need to be aware of the requirements of Staff Accounting Bulletin 108 ('SAB 108'), 'Considering the effects of prior year misstatements when quantifying misstatements in current year financial statements'.

22 The correction of prior period errors is different from a change in accounting estimate. Accounting estimates are approximations that may need revision as additional information becomes known. Errors do not relate to accounting estimates, but rather to the intentional or unintentional misuse or disregard of information that was

available at the time the financial statements were authorised for issue or that should have been available. [IAS 8 paras 5, 48].

23 IAS 8 sets out disclosure requirements for material prior period errors, including the disclosures in situations where it is impracticable to determine the effect on one or more prior periods. [IAS 8 para 49]. In addition, when an entity makes a retrospective restatement of items in its financial statements, it presents an additional balance sheet as of the beginning of the earliest comparative period. [IAS 1 (revised) para 10(f)]. However, in our view, entities may choose to omit the additional balance sheet if there is no impact on that balance sheet and this fact is disclosed.

Impracticability of retrospective application or restatement

24 The standard includes a definition of 'impracticable' and guidance for determining circumstances in which it is impracticable to apply a new policy retrospectively or to restate retrospectively for the correction of errors. IAS 8 does not permit the use of hindsight when retrospectively applying an accounting policy or correcting prior period errors.

25 Where it is impracticable to determine the period-specific effects of the change on comparative information for one or more prior periods presented, the retrospective application or restatement is applied retrospectively only to the extent that it is practicable. The retrospective application or restatement is applied to adjust assets and liabilities as at the beginning of the earliest period presented for which retrospective application is practicable and a corresponding adjustment is made to the opening balance of each affected component of equity for that period. In simple terms the entity should go back as far as it can. [IAS 8 paras 24, 26].

26 Where it is impracticable to determine the cumulative effect, at the beginning of the current period, of the retrospective application or restatement, the entity adjusts the comparative information to apply the retrospective application or restatement prospectively from the earliest date possible. [IAS 8 paras 25, 27].

Accounting principles and applicability of IFRS

Overview

The IASB has the authority to set IFRS and to approve interpretations of those standards.

IFRSs are intended to be applied by profit-orientated entities. These entities' financial statements give information about performance, position and cash flow that is useful to a range of users in making financial decisions. These users include shareholders, creditors, employees and the general public. A complete set of financial statements includes a:

- Balance sheet.
- Statement of comprehensive income.
- Cash flow statement.
- Statement of changes in equity.
- Description of accounting policies.
- Notes to the financial statements.

The concepts underlying accounting practices under IFRS are set out in the IASB's 'Framework for the preparation and presentation of financial statements'.

Resources

Standards and interpretations

- Framework for the preparation and presentation of financial statements

Exposure drafts and discussion papers

- Exposure draft on improved conceptual framework phase A
- Exposure draft on improved conceptual framework phase D – the reporting entity

PwC guidance

- International Manual of Accounting chapter 2, Accounting principles and applicability of IFRS

Summary of key requirements

1 The current international reporting structure is headed by the International Accounting Standards Committee Foundation, which oversees the International Accounting Standards Board (IASB).

IASB

2 The IASB has authority to set IFRS and to approve Interpretations. [Constitution para 32]. It is also responsible for ensuring that due process is in place for international accounting standard-setting. The due process is set out in brief in the Constitution and is expressed more fully in the IASB's 'Preface to International Financial Reporting Standards' (the Preface).

The process for setting an international standard is as follows:

- Identifying and reviewing the issues related to the topic and considering the application of the Framework.
- Studying national accounting requirements and practice and exchanging views with national standard-setters.
- Consulting the Standards Advisory Council (see below) about the advisability of adding the topic to the IASB's agenda.*
- Forming an advisory group to give advice to the IASB on the project.
- Publishing for public comment a discussion document.
- Publishing for public comment an exposure draft approved by at least nine votes of the IASB, including any dissenting opinions held by IASB members (*) and a basis for conclusions.
- Publishing within an exposure draft a basis for conclusions.
- Considering all comments received within the comment period on discussion documents and exposure drafts.*
- Considering the desirability of holding a public hearing or conducting field tests.
- Approving a standard by at least nine votes of the IASB and including in the published standard any dissenting opinions (*) and a basis for conclusions explaining the steps in the IASB's due process and how the IASB dealt with public comments on the exposure draft.
- Publishing within a standard a basis for conclusions explaining, among other things, the steps in the IASB's due process and how the IASB dealt with public comments on the exposure draft.

[Preface para 18].

IFRIC

3 The International Financial Reporting Issues Committee (IFRIC) works on emerging issues that require attention before an international standard can be amended or issued. The IFRIC is a committee of the IASB. The IFRIC's duties include the interpretation of international accounting standards where conflicting or unsatisfactory interpretations have emerged and to give timely guidance on issues that have not yet been addressed by international standards. The role of IFRIC is not to issue standalone accounting standards. Interpretations are, however, authoritative.

Standards Advisory Council

4 The Standards Advisory Council (SAC) was set up to provide a formal forum for participation by those with wider accountancy interests that may not be represented on the Board. The SAC's role is to provide broad strategic

* Mandated by the Constitution.

advice on the IASB's agenda priorities and insight into the possible benefits and costs of particular projects. The SAC must be consulted on any major projects that the IASB undertakes and on any changes to the Constitution.

Objectives

5 The IASB's objectives are fourfold:

- To develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the various capital markets of the world and other users of the information to make economic decisions.
- To promote the use and rigorous application of those standards.
- In fulfilling the objectives above, to take account of, as appropriate, the special needs of small and medium-sized entities and emerging economies.
- To work actively with national standard-setters to bring about convergence of national accounting standards and IFRSs to high quality solutions.

[Preface para 6].

Purpose of IFRS

6 IFRSs are designed with the general purpose financial statements of profit-orientated entities in mind. IFRSs may, however, also be useful for non-profit orientated entities. General purpose financial statements give information about financial performance, position and cash flow that is useful for making economic decisions by a range of users, including shareholders, creditors, employees and the general public.

7 A complete set of financial statements includes a balance sheet, a statement of comprehensive income, a statement of changes in equity, a cash flow statement, a list of accounting policies and notes to the financial statements. [Preface paras 9 to 11]. The scope of individual IFRSs is set out in the particular standards. [Preface para 17].

Framework

8 IFRS operates under the IASB's Framework for the preparation and presentation of financial statements. The main headings of the IASB's Framework are:

- Preface, including a decision usefulness stance.
- Introduction, including comments on the purpose of the Framework and the needs of users (who are assumed to be investors or those with similar needs to investors).
- Objectives of financial statements, including a concentration on assessment of future cash flows.
- Underlying assumptions, including the accrual basis and the going concern convention.
- Qualitative characteristics, including understandability, relevance, reliability, comparability and fairness.
- Elements of financial statements, including financial position (assets, liabilities and equity) and performance (income and expenses).
- Recognition of elements, including probability of future benefit, reliability of measurement and recognition of assets, liabilities, income and expenses.
- Measurement of elements.
- Concepts of capital and its maintenance.

Objectives of financial statements

9 The IASB identifies the objective of financial statements as being the provision of *"information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions".* [Framework para 12].

Underlying assumptions

10 There are two assumptions underlying financial statements, accruals and going concern.

Qualitative characteristics

11 The four main characteristics are understandability, relevance, reliability and comparability. Understandability allows for reasonable expertise on the part of the users. Conversely, information about complex issues should not be excluded, because it might be considered too difficult for users. [Framework para 25].

12 Relevance suggests the ability to influence users' economic decisions by helping or confirming the evaluation of events of the past, present or future. [Framework para 26]. Materiality is a subsidiary concept of relevance.

13 Reliability is required before information can be useful. This, in turn, requires information to be *"free from material error and bias".* It is also necessary for the information to faithfully represent the transactions or other events it purports to represent. [Framework para 31]. This requires presentation in accordance with substance not legal form.

14 The fourth characteristic is comparability, over time and from one company to another. This clearly requires consistency and the disclosure of accounting policies and any changes in them. It also requires disclosure of corresponding figures for previous periods. [Framework paras 39 to 42].

Elements of financial statements

15 There are two main groups of elements of financial statements. The first is associated with measuring an entity's financial position: assets, liabilities and equity. The second is those elements that relate to measuring an entity's performance: income and expenses. Within these main categories there are sub-classifications, for example, expenses by function or nature, assets and liabilities by degree of liquidity.

Recognition

16 The IASB's Framework calls for recognition of elements when:

- it is probable that any future economic benefit associated with the item will flow to or from the entity; and
- the item has a cost or value that can be measured with reliability.

[Framework para 83].

17 The Framework takes an asset and liability approach rather than focusing on matching of income and expenses. This is borne out by the recognition criterion for income and expenses: *"Income is recognised in the income statement when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. This means, in effect, that recognition of income occurs simultaneously with the recognition of increases in assets or decreases in liabilities...".* [Framework para 92].

Measurement

18 The Framework is entirely non-prescriptive when it comes to measurement. It notes that a number of different measurement bases are used in practice, including historical cost, current cost, realisable value and present value.

19 The Framework notes that it is a financial concept of capital maintenance (see below) that is adopted by most entities.

Accounting conventions

20 All accounting systems depend on the capital maintenance concept adopted, the basis used to value assets and the unit of measurement used. Capital maintenance concepts, asset valuation bases and the units of measurement used can be combined in different ways to create different accounting conventions. The more common conventions are historical cost, modified historical cost, fair value convention, current purchasing power and current cost.

Capital maintenance

21 There are at least two different concepts of capital maintenance: operating capital maintenance and financial capital maintenance. Operating capital maintenance, although it can be measured in a variety of different ways, generally seeks to ensure that the business' physical operating capacity is preserved. Financial capital maintenance attempts to conserve the value of the funds that shareholders have invested in the business. Financial capital maintained can either be the monetary value of capital attributable to shareholders or a value adjusted by a general purchasing power index to maintain capital as a fund of real purchasing power.

Valuation basis

22 The measurement of profit is also affected by the valuation basis chosen. There are a variety of valuation bases, including historical cost, current cost and market value or fair value.

Unit of measurement

23 The unit of measurement chosen affects how profit is determined. Reporting can be in nominal currency or in units of constant purchasing power.

Agriculture

Overview

Agricultural activity is defined as the managed biological transformation and harvest of biological assets (living animals and plants) for sale or for conversion into agricultural produce (harvested product of biological assets) or into additional biological assets.

All biological assets are measured at fair value less estimated costs to sell, with the change in the carrying amount reported as part of profit or loss from operating activities. Agricultural produce harvested from an entity's biological assets is measured at fair value less estimated costs to sell at the point of harvest.

Costs to sell include commissions to brokers and dealers, levies by regulatory agencies and commodity exchanges and transfer taxes and duties. Costs to sell exclude transport and other costs necessary to get assets to market.

The fair value is measured using an appropriate quoted price where available. However, if an active market does not exist for biological assets or harvested agricultural produce, the following may be used in determining fair value: the most recent transaction price (provided that there has not been a significant change in economic circumstances between the date of that transaction and the balance sheet date); market prices for similar assets, with adjustments to reflect differences; and sector benchmarks, such as the value of an orchard expressed per export tray, bushel or hectare and the value of cattle expressed per kilogram of meat. When any of this information is not available, the entity uses the present value of the expected net cash flows from the asset discounted at a current market-determined rate.

Resources

Standards and interpretations
- IAS 41, 'Agriculture'

PwC guidance
- International Manual of Accounting chapter 32, Agriculture

Tools practice aids and publications
- IFRS extracts from accounts

Summary of key requirements

Objective and scope

1 The objective of IAS 41, 'Agriculture', is to prescribe the accounting treatment and disclosures related to agricultural activity. IAS 41 introduced a fair value measurement model for agricultural activity. IAS 41 prescribes, among other things, the accounting treatment for biological assets during the period of growth, degeneration, production, procreation, and for the initial measurement of agricultural produce at the point of harvest.

2 IAS 41 applies to agricultural activity, which is defined as *''the management by an entity of the biological transformation and harvest of biological assets for sale or for conversion into agricultural produce, or into additional biological assets''.* There are several key terms in this definition that distinguish agricultural activity from other activity, namely 'biological assets', 'agricultural produce', 'biological transformation' and 'management'. These terms are summarised below.

- Biological assets are living plants or animals, such as forests or cattle.
- Agricultural produce is the harvested product of an entity's biological assets, such as wool, milk or beef.
- Biological transformation is the processes of growth, degeneration, production and procreation that cause qualitative or quantitative changes in a biological asset. For example, calves are born (procreation), they grow into mature cattle (growth) then they yield milk or beef (production).
- Management of biological transformation normally takes the form of activity to enhance, or at least stabilise, the conditions necessary for the process to take place. For example, management of the cattle discussed above would involve housing and feeding them as well as maintaining their health. Harvesting from unmanaged sources (such as sea fishing) is not agricultural activity.

[IAS 41 paras 5-7].

Initial recognition

3 The initial recognition of biological assets or agricultural produce is subject to the general recognition criteria for assets set out in the Framework and IFRS. The entity must demonstrate control over the asset that will generate future benefits that can be measured reliably. [IAS 41 para 10]. Control over biological assets would usually be evidenced by legal ownership, and for example the branding or marking of cattle on acquisition or birth. [IAS 41 para 11].

4 Initial recognition will occur at the point of purchase, or when biological assets are generated from existing assets, such as calves from livestock. Agricultural produce that is attached to a biological asset, such as wool to sheep and grapes to the vine, is not recognised separately.

Initial and subsequent measurement

5 IAS 41 includes a presumption that an entity can establish a fair value for biological assets. [IAS 41 para 30].

On initial recognition, and at each subsequent balance sheet date an entity measures biological assets at fair value less estimated costs to sell. [IAS 41 para 12]. An entity may rebut this presumption in rare circumstances where a market-determined price is not available, or the entity cannot make a reliable estimate of fair value. In such a situation the entity recognises the biological assets at cost less depreciation and impairment. [IAS 41 para 30].

6 Agricultural produce harvested from an entity's biological assets is measured at fair value less costs to sell at the point of harvest. [IAS 41 para 13].

7 Costs to sell include commissions to brokers and dealers, levies by regulatory agencies and commodity exchanges, and transfer taxes and duties. Costs to sell exclude transport and other costs necessary to get assets to market. These costs are already taken into account in determining fair value. [IAS 41 para 9].

Fair value

8 Where available, fair value should be based on appropriate market prices. [IAS 41 para 17]. In the absence of appropriate market prices, one or more of the following methods should be used to estimate fair value, if such data is available:

- The most recent market transaction price, provided that prices are fairly stable.
- Market prices for similar assets with adjustment to reflect differences.
- Sector benchmarks, such as the value of an orchard expressed per export tray, bushel or per hectare or the value of cattle per kilogram of meat.

[IAS 41 para 18].

9 These prices may not however reflect the value of a biological asset in its current condition. For example, fruit trees may not be of a size that they can be traded. In such a situation an entity may derive a fair value from the present value of expected cash flows discounted at a market-determined rate. [IAS 41 para 20]. Either a pre or post-tax discount rate can be used depending on the valuation methodology applied. In determining the present value of the expected net cash flows, an entity includes the net cash flows that market participants would expect the asset to generate in its most relevant market, taking into account factors such as expected future increases in yield. [IAS 41 paras 20, 21].

10 Biological assets may be physically attached to land, for example fruit trees, vines and sugar cane. While a market may not exist for the biological asset as such there may be an active market for the combined asset. The entity may use the market price of the combined asset to determine the fair value of the biological asset, for example by deducting the fair value of raw land and land improvements from the fair value of the combined asset. [IAS 41 para 25].

11 If a biological asset's fair value cannot be measured reliably by any of the methods described above, it should be measured at cost less accumulated depreciation and impairment losses, if any. [IAS 41 para 30].

Gains and losses

12 Gains or losses arising on initial recognition of biological assets or agricultural produce at fair value less costs to sell and on re-measuring fair value of biological assets are recognised in profit or loss in the period in which they arise. [IAS 41 paras 26, 28].

Government grants

13 Although there is a standard that deals with the accounting for government grants (namely IAS 20, 'Accounting for government grants and disclosure of government assistance'), IAS 41 provides a different rule where a grant is receivable in respect of biological assets measured at fair value less estimated costs to sell. An unconditional grant is recognised as income when it is receivable. A conditional grant, on the other hand, should be recognised as income only when the conditions are satisfied. [IAS 41 paras 34, 35].

Presentation and disclosure

14 IAS 1 (revised), 'Presentation of financial statements', requires that biological assets are presented separately on the face of the balance sheet. [IAS 1 (revised) para 54(f)]. The disclosures required by IAS 41 comprise both financial and non-financial information.

15 Financial information includes:

- gain or loss on initial recognition and from changes in fair value;
- valuation methods used;
- fair value of agricultural produce harvested in the period;
- restricted assets and assets pledged as security;
- commitments; and
- a reconciliation of changes in the carrying amount of biological assets in the period.

Where assets are carried at cost because no fair value is available there are additional disclosures including: a description of the assets; reasons why fair value cannot be determined; a range of estimates of fair value if possible; useful lives or depreciation rates; and the gross carrying amount and accumulated depreciation at the beginning and end of the period with details of changes in the period. If fair values become available, disclosure is required of the assets concerned, the reasons why fair value is now determinable and the effect. [IAS 41 paras 40, 47-56].

16 Non-financial information required includes:

- A description of the entity's agricultural activity and its biological assets.
- Measures of the physical quantities of the entity's biological assets and its output during the period.
- An explanation of the entity's financial risk management strategies related to agricultural activity.

[IAS 41 paras 46, 49].

17 An entity also discloses information in relation to government grants including:

- The nature and extent of grants recognised.
- Unfulfilled conditions and other contingencies related to grants.
- Significant decreases expected in grants.

[IAS 41 para 57].

Associates

Overview

An associate is an entity in which the investor has significant influence, but which is neither a subsidiary nor a joint venture of the investor. Significant influence is the power to participate in the financial and operating policy decisions of the investee, but not to control those policies. It is presumed to exist when the investor holds at least 20 per cent of the investee's voting power. It is presumed not to exist when less than 20 per cent is held. These presumptions may be rebutted.

Associates are accounted for using the equity method unless they meet the criteria to be classified as 'held for sale' under IFRS 5, 'Non-current assets held for sale and discontinued operations'. Under the equity method, the investment in the associate is initially carried at cost. It is increased or decreased to recognise the investor's share of the profit or loss of the associate after the date of acquisition.

Investments in associates are classified as non-current assets and presented as one line item in the balance sheet (inclusive of notional goodwill arising on acquisition). Investments in associates are tested for impairment in accordance with IAS 36, 'Impairment of assets', as single assets if there are impairment indicators under IAS 39, 'Financial instruments: Recognition and measurement'.

If an investor's share of its associate's losses exceeds the carrying amount of the investment, the carrying amount of the investment is reduced to nil. Recognition of further losses are discontinued, unless the investor has an obligation to fund the associate or the investor has guaranteed to support the associate.

In the separate (non-consolidated) financial statements of the investor, the investments in associates are carried at cost or as financial assets in accordance with IAS 39.

Resources

Standards and interpretations
- IAS 28, 'Investments in associates'

Exposure drafts and discussion papers

PwC guidance
- Manual of Accounting chapter 27, Associates

Tools practice aids and publications
- IFRS extracts from accounts

Summary of key requirements

Objective and scope

1 IAS 28, 'Investments in associates', sets out the accounting treatment for associates and the related disclosure requirements. It deals with the classification, accounting and disclosure for associates.

2 All investments in associates fall within the standard's scope, except for investments in associates held by venture capital organisations, mutual funds, unit trusts and similar entities, including investment-linked insurance funds. The exemption is available if the investments are designated as at fair value through profit and loss or are classified as held for trading and are accounted for in accordance with IAS 39, 'Financial instruments: Recognition and measurement'. Such investments are measured at fair value with changes in fair value recognised in profit or loss. [IAS 28 para 1].

Classification

3 An associate is an entity, including an unincorporated entity, over which the investor has significant influence and that is neither a subsidiary nor an interest in a joint venture. Significant influence is the power to participate in the investee's financial and operating policy decisions, but is not control or joint control over those policies. The existence and effect of potential voting rights that are currently exercisable or convertible are considered when assessing whether an entity has significant influence. [IAS 28 paras 2, 8].

4 It is presumed that where an investor holds, directly or indirectly 20 per cent or more of the voting power of an entity, it has significant influence over that entity. Conversely, it is presumed that where an investor holds, directly or indirectly less than 20 per cent of the voting power of an entity, it does not have significant influence over that entity. However, despite the investor's interest, both these presumptions can be rebutted where an investor can demonstrate that it has or does not have significant influence. [IAS 28 para 6].

5 The standard gives examples of how an investor could demonstrate that it has significant influence. [IAS 28 para 7].

6 Significant influence is usually demonstrated through the investor's participation in establishing the entity's financial and operating policies. [IAS 28 paras 2, 6]. The investor might show its significant influence through any of the following:
- Representation on the entity's board or equivalent governing body. [IAS 28 para 7(a)].

- Participation in policy-making processes such as strategic decisions and decisions about dividends or other distributions. [IAS 28 para 7(b)].
- Material transactions between the investor and the entity. [IAS 28 para 7(c)].
- Interchange of managerial personnel. [IAS 28 para 7(d)].
- Provision of essential technical information. [IAS 28 para 7(e)].

Use of the equity method

7 IAS 28 specifies that an investor must use the equity method to account for its associates. [IAS 28 para 13]. An entity with subsidiaries and associates, therefore, prepares consolidated financial statements that include its associates using the equity method.

8 The requirement to use the equity method to account for associates also applies to investors that do not have subsidiaries, but do have investments in associates. The financial statements prepared by these investors are known as 'economic interest', financial statements. 'Economic interest' financial statements differ from 'separate' financial statements in which investments in associates are measured at cost or in accordance with IAS 39, 'Financial instruments: Recognition and measurement', (see 'Separate financial statements' below).

Exceptions to the equity method

9 There are certain exceptions to the application of the equity method. The first concerns associates classified as held for sale in accordance with IFRS 5, 'Non-current assets held for sale and discontinued operations'. The second is in respect of investors that are exempt under IAS 27 from the requirement to prepare consolidated financial statements (see below). The third is in respect of entities that are exempt under IAS 28 from the requirement to prepare economic interest financial statements (see below). [IAS 28 paras 2, 5, 11, 13].

10 IAS 27, 'Consolidated and separate financial statements', exempts certain parents, that are wholly or partially owned by another entity and that have both investments in subsidiaries and associates, from the requirement to prepare consolidated financial statements and, therefore, to consolidate and equity account respectively those subsidiaries and associates, provided that certain specified conditions apply. IAS 28 additionally exempts investors, that are wholly or partially owned by another entity and that only have investments in associates (and that, therefore, do not prepare consolidated financial statements), from the requirement to equity account those associates in their economic interest financial statements if similar conditions apply. Such entities may present separate financial statements as their only financial statements. [IAS 27 para 10; IAS 27 (revised) para 10; IAS 28 paras 5, 13].

Application of the equity method

11 The equity method is a method of accounting whereby the investment is initially recognised at cost and is increased or decreased to recognise the investor's share of the profit or loss of the associate after the date of acquisition. Hence, the profit or loss of the investor includes the investor's share of the profit or loss of the investee.

12 Many of the procedures appropriate for the application of the equity method are similar to those that apply in the consolidation of subsidiaries and in this respect the standard cross-refers to IAS 27.

Accounting policies

13 The standard states that in arriving at the amounts to be included by the equity method of accounting, the same accounting policies as those of the investor should be applied. [IAS 28 para 26].

Losses

14 Where an investor's share of an associate's losses equals or exceeds its interest in the associate, the investing group should discontinue recognising its share of further losses. The amount to be reduced to nil includes not only the carrying amount of the associate under the equity method, but also other long-term interests that in substance form part of the investor's net investment in the associate. Additional losses are provided for only to the extent that the investor has incurred legal or constructive obligations or made payments on behalf of the associate. [IAS 28 paras 29, 30].

Impairment losses

15 The entire carrying amount of the investment in associate, which includes goodwill, is tested for impairment in accordance with IAS 36; 'Impairment of assets', as a single asset. Its recoverable amount, being the higher of value in use and fair value less costs to sell, is compared with its carrying amount, whenever the impairment indicators in IAS 39, 'Financial instruments; Recognition and measurement' point towards the investment being impaired. An impairment loss recognised in those circumstances is deducted from the investment and is not allocated specifically to any asset, including goodwill. Any reversal of that impairment loss is recognised in accordance with IAS 36. [IAS 28 para 33].

Transactions with associates

16 The standard states that profits and losses resulting from 'upstream' and 'downstream' transactions between an investor (including its consolidated subsidiaries) and an associate are recognised only to the extent of the unrelated investors' interests in the associate. Upstream transactions, for example, are sales of assets from an associate to the investor and downstream transactions are, for example, sales of assets by the investor to the associate. [IAS 28 para 22].

Year ends

17 The financial statements used for the purpose of including the results of associates should be either co-terminous with those of the group or, where this is not practicable, made up to a date that is not more than three months from the investing group's period end. Where the associate's reporting date does not coincide with that of the investing undertaking, and significant transactions or events have occurred since the associate's reporting date, it will be necessary to make adjustments to the results and net assets of the associate before they are equity accounted by the investor. [IAS 28 paras 24, 25].

Presentation

18 Investments in associates are classified as non-current assets. The investor's share of profit or loss of associates and the carrying amount of those investments should be separately disclosed. The investor's share of the associate's discontinued operations is also disclosed separately. Under IAS 1 (revised), 'Presentation of financial statements', the share of the associate's profits or losses (after tax and minority interests) is presented after the line item for finance costs, but before the line item for tax expense. [IAS 28 para 38; IAS 1 (revised) paras 81, 82].

19 The investor's share of changes recognised in other comprehensive income should be recognised by the investor in other comprehensive income. Under IAS 1 (revised), this amount is presented before total comprehensive income. [IAS 28 para 39; IAS 1 (revised) para 82].

Acquisitions

20 The standard requires that when an entity acquires an associate, fair values should be attributed to the investee's underlying assets and liabilities. The fair value of assets provides the basis for subsequent depreciation that is reflected in the investor's share of the results. The standard also requires that goodwill relating to an associate is included in the carrying amount of the investment in the associate. Amortisation of that goodwill is not permitted. [IAS 28 para 23].

Loss of significant influence

21 Prior to implementing IAS 27 (revised), an investor discontinues equity accounting from the date that it ceases to have significant influence over an associate. The retained investment is accounted for in accordance with IAS 39, 'Financial instruments; Recognition and measurement' from that date. The carrying amount of the investment at the date that it ceases to be an associate is measured at cost on initial recognition as a financial asset in accordance with IAS 39 from that date. [IAS 28 paras 18,19].

22 IAS 27 (revised) is applied to accounting periods beginning on or after 1 July 2009. The revised standard amended paragraphs 18 and 19 of IAS 27 and inserted paragraph 19A. Under IAS 27 (revised) an investor discontinues equity accounting from the date that it ceases to have significant influence over an associate and accounts for the investment in accordance with IAS 39 from that date. On the loss of significant influence, the investor measures at fair value any investment the investor retains in the former associate. The investor recognises in profit or loss any difference between:

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

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

[IAS 28 (amended) para 18].

23 When an investment ceases to be an associate and is accounted for in accordance with IAS 39, the fair value of the investment at the date when it ceases to be an associate is regarded as its fair value on initial recognition as a financial asset in accordance with IAS 39. [IAS 28 (amended) para 19].

24 If an investor loses significant influence over an associate, the investor accounts for all amounts recognised in other comprehensive income in relation to that entity on the same basis as if the associate had directly disposed of the related assets or liabilities. Hence, if a gain or loss previously recognised in other comprehensive income would be reclassified to profit or loss on the disposal of the related assets or liabilities, the investor reclassifies the gain or loss from equity to profit or loss (as a reclassification adjustment). If an investor's ownership interest in an associate is reduced, but the investment continues to be an associate, the investor reclassifies to profit or loss only a proportionate amount of the gain or loss previously recognised in other comprehensive income. [IAS 28 (amended) para 19A].

Separate financial statements

25 IAS 28 cross-refers to IAS 27 as that standard specifies the accounting and disclosures required for investments in associates in an investor's separate financial statements. IAS 27 requires that such investments should be accounted for either at cost or in accordance with IAS 39. [IAS 28 para 35; IAS 27 para 37; IAS 27 (revised) para 38].

26 Separate financial statements are defined in IAS 28 as the investor's own financial statements in which investments are accounted at cost or in accordance with IAS 39. Associates are not equity accounted in separate statements. Separate financial statements are presented in addition to consolidated financial statements. [IAS 28 paras 2 to 4].

27 IAS 27 and IAS 28 do not mandate which entities produce separate financial statements. An entity may voluntarily elect, or be required by local regulations, to present separate financial statements.

28 Investors that are exempt from the requirement to consolidate or equity account their investments may present separate financial statements as their only financial statements (see para 2.10 above). [IAS 28 para 5].

Disclosure

29 IAS 28 sets out a number of detailed disclosures including the fair value of investments in associates for which there are public price quotations and summarised financial information of associates, including the aggregated amounts of assets, liabilities, revenues and profit and loss. [IAS 28 para 37(a)(b)]. Disclosure is also required of reasons for rebutting the presumption that significant influence exists where 20 per cent or more of the voting power of an entity is held and the presumption that such influence does not exist where less than 20 per cent is held. [IAS 28 paras 37(c)(d)].

30 Other disclosures include the reporting date of an associate if different from that of the investor and reasons for using the different date; restrictions on remittances from the associate; any unrecognised share of losses of an associate; and the fact that an associate is not equity accounted where any of the exemptions apply, with summarised financial information for such associates. [IAS 28 para 37(e)(f)(g)(h)(i)]. Finally the investor is required to disclose its share of contingent liabilities of an associate incurred jointly with other investors and those contingencies arising because the investor is severally liable for all or part of the associate's liabilities. [IAS 28 para 40].

Business combinations

Overview

IFRS 3, 'Business combinations', was revised and issued in January 2008. The revised standard is effective for annual periods beginning on or after 1 July 2009. The previous version of IFRS 3 is addressed in a separate topic summary, which is available at www.pwcinform.com (see 'Accounting & corporate reporting' – 'Topic summaries').

A business combination is a transaction or event in which an acquirer obtains control of one or more businesses ('acquiree(s)'). Control is defined as the power to govern the financial and operating policies of an entity or business so as to obtain benefits from its activities. A number of factors may influence which entity has control, including: equity shareholding, control of the board and control agreements. There is a presumption of control if an entity owns more than 50 per cent of the equity shareholding in another entity.

Business combinations occur in a variety of structures. IFRS focuses on the substance of the transaction, rather than the legal form. The overall result of a series of transactions is considered if there are a number of transactions among the parties involved. For example, any transaction contingent on the completion of another transaction may be considered linked. Judgement is required to determine when transactions should be linked.

All business combinations are accounted for using the acquisition method. The acquisition method can be summarised in the following steps:

- Identify the acquirer.
- Determine the acquisition date.
- Recognise and measure the identifiable assets acquired, liabilities assumed and any non-controlling interest in the acquiree.
- Recognise and measure the consideration transferred for the acquiree.
- Recognise and measure goodwill or a gain from a bargain purchase.

The acquisition method looks at a business combination from the perspective of the acquirer – that is, the entity that obtains control over another business. It first involves identifying the acquirer. The acquirer measures the consideration, fair value of assets and liabilities acquired, goodwill and any non-controlling interests as of the acquisition date (the date on which it obtains control over the net assets of the acquiree).

The acquiree's identifiable assets (including intangible assets not previously recognised), liabilities and contingent liabilities are generally recognised at their fair value. Fair value is determined by reference to an arm's length transaction; the intention of the acquirer is not relevant. If the acquisition is for less than 100 per cent of the acquiree, there is a non-controlling interest. The non-controlling interest represents the equity in a subsidiary that is not attributable, directly or indirectly to the parent. The parent can elect to measure the non-controlling interest at its fair value or at its proportionate share of the identifiable net assets.

The consideration of the combination includes cash and cash equivalents and the fair value of any non-cash consideration given. Any shares issued as part of the consideration are fair valued. If any of the consideration is deferred, it is discounted to reflect its present value at the acquisition date, if the effect of discounting is material.

A portion of the consideration may be contingent on the outcome of future events or the acquired entity's performance ('contingent consideration'). Contingent consideration is also recognised at its fair value at the date of acquisition. The accounting for contingent consideration after the date of acquisition depends on whether it is classified as a liability (to be re-measured to fair value each reporting period through profit and loss) or equity (no re-measurement), using the guidance in IAS 32.

Goodwill is recognised for the future economic benefits arising from assets acquired that are not individually identified and separately recognised. If the non-controlling interest is measured at its fair value, goodwill includes amounts attributable to the non-controlling interest. If the non-controlling interest is measured at its proportionate share of identifiable net assets, goodwill includes only amounts attributable to the controlling interest – that is the parent.

Goodwill is recognised as an asset and tested annually for impairment, or more frequently if there is an indication of impairment.

In rare situations – for example, a bargain purchase as a result of a distressed sale – it is possible that no goodwill will result from the transaction. Rather, a gain will be recognised.

Resources

Standards and interpretations

- IFRS 3 (revised), 'Business combinations'
- Improvements to IFRSs 2010
- IAS 27 (revised), 'Consolidated and separate financial statements'

Exposure drafts and discussion papers

- Exposure draft on consolidated financial statements

PwC guidance

- Manual of Accounting chapter 25A, Business combinations under IFRS 3 (revised)

Tools practice aids and publications
- IFRS extracts from accounts
- Publication IFRS 3 (revised) – Impact on earnings, the essential questions and answers for decision-makers
- Global guide to accounting for business combinations and non-controlling interests
- A pocket guide – New IFRS for Acquisitions (M&A)

Summary of key requirements

Objective and scope

1 IFRS 3 (revised), 'Business combinations', was published in January 2008 and establishes principles for how an acquirer:
- Recognises and measures the identifiable assets acquired, liabilities assumed and non-controlling interests.
- Recognises and measures goodwill acquired in a business combination or a gain from a bargain purchase.
- Determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination.

[IFRS 3 (revised) para 1].

IFRS 3 (revised) should be applied prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 July 2009. [IFRS 3 (revised) para 64].

2 A business combination is a transaction or event in which an acquirer obtains control of one or more businesses. [IFRS 3 (revised) App B]. A business is 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 (revised) App A]. It may be structured in a variety of ways. IFRS 3 (revised) applies to all business combinations, except:
- The formation of a joint venture.
- The acquisition of an asset or group of assets that does not constitute a business (in which case, the identifiable assets acquired and the liabilities assumed are recognised by the acquirer by allocating the cost among them based on their relative fair values at the date of purchase and no goodwill is recognised).
- A combination of entities or businesses under common control.

[IFRS 3 (revised) para 2].

Method of accounting

3 All business combinations in the scope of IFRS 3 (revised) should be accounted for using the acquisition method of accounting ('acquisition method'). [IFRS 3 (revised) para 4]. The acquisition method views a business combination from the perspective of the acquirer. At the acquisition date, the acquirer recognises, separately from goodwill, the identifiable assets acquired, the liabilities assumed (including contingent liabilities) and any non-controlling interest in the acquiree. [IFRS 3 (revised) para 10].

4 The acquisition method can be summarised in the following steps:
- Identify the acquirer.
- Determine the acquisition date.
- Recognise and measure the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree
- Recognise and measure the consideration transferred for the acquiree.
- Recognise and measure goodwill or a gain from a bargain purchase.

[IFRS 3 (revised) para 5].

Identify the acquirer

5 The acquisition method of accounting requires identification of an acquirer for every business combination. The acquirer is the entity that obtains control over one or more other entities or businesses (the 'acquiree(s)'). Control is defined as the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. [IAS 27 (revised) para 4]. A number of factors may influence control including: equity shareholding, control of the board, control agreements and potential voting rights. If an entity owns more than 50 per cent of the equity shareholding in another entity, there is a presumption of control.

6 Where a new company is created to acquire two or more pre-existing companies, one of the pre-existing companies must be designated as the acquirer. [IFRS 3 (revised) para B18]. This type of business combination is accounted for as a reverse acquisition. A reverse acquisition occurs when the entity that issues the securities (the legal acquirer) is identified as the acquiree for accounting purposes. [IFRS 3 (revised) para B19]. The accounting acquiree must meet the definition of a business for the transaction to be accounted for as a reverse acquisition.

Determine the acquisition date

7 The acquisition date is the date on which the acquirer obtains control over the acquiree, which is generally the

closing date. However, the acquirer might obtain control on a date that is either earlier or later than the closing date. An acquirer should consider all pertinent facts and circumstances in identifying the acquisition date. [IFRS 3 (revised) paras 8-9].

Recognise and measure identifiable assets and liabilities and non-controlling interests

8 At the acquisition date, the acquirer should recognise, separately from goodwill, the acquiree's identifiable assets, liabilities and contingent liabilities (generally at fair value) and any non-controlling interest. [IFRS 3 (revised) para 10]. The assets and liabilities identified may include some that have not been previously recognised by the acquiree.

9 The general principle is that the assets, liabilities and contingent liabilities are recognised at fair value. Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. [IFRS 3 (revised) App A]. However, there are some exceptions for items such as: income taxes, indemnification assets, reacquired rights, share-based payment awards, assets held for sale and employee benefits. [IFRS 3 (revised) paras 24-31].

10 The seller in a business combination may contractually indemnify the acquirer for the outcome of a contingency or uncertainty related to all or part of a specific asset or liability. For example, the seller may indemnify the acquirer against losses above a specific amount that arise from a particular tax or environmental contingency. As a result, the acquirer obtains an indemnification asset. The acquirer can recognise this indemnification asset at the same time and on the same basis as the indemnified item is recognised as a liability (subject to the asset's recoverability). [IFRS 3 (revised) para 27]. Indemnification assets continue to be measured on the same basis as the related indemnified liability in the post-acquisition period. [IFRS 3 (revised) para 57].

11 The identifiable assets acquired and liabilities assumed must meet the definition of assets and liabilities in the 'Framework for the preparation and presentation of financial statements' to qualify for recognition. For example, costs that the acquirer expects, but is not obliged, to incur to effect its plan to exit an activity of the acquiree or terminate employment of the acquiree's employees are not liabilities at the acquisition date. [IFRS 3 (revised) para 11] Additionally, contingent assets do not meet the definition of an asset and are not recognised in a business combination.

12 The identifiable assets must be part of what the acquirer and the acquiree exchanged in the business combination transaction, rather than the result of a separate transaction. [IFRS 3 (revised) para 12]. Additionally, with the exception of leases and insurance contracts, the acquirer must classify and designate the identifiable assets and liabilities based on the contractual terms, economic conditions, its operating or accounting policies and other pertinent conditions as they exist at the acquisition date. [IFRS 3 (revised) para 15].

13 The acquiree's contingent liabilities should be recognised at fair value, if this can be measured reliably. Subsequently, contingent liabilities should be measured at the higher of the amount that would be recognised under IAS 37, 'Provisions, contingent liabilities, and contingent assets', and the amount initially recognised (less, when appropriate, cumulative amortisation recognised in accordance with IAS 18, 'Revenue'). [IFRS 3 (revised) paras 23, 56].

14 Any non-controlling interest in the acquiree is stated at either the non-controlling interest's proportionate share of the acquiree's identifiable net assets or at its fair value. [IFRS 3 (revised) para 19]. This election can be made on a business combination by business combination basis and will also impact the amount of goodwill recognised.

15 The acquirer can account for the business combination using provisional values for items for which the accounting (and determination of fair value) is incomplete. The acquirer should retrospectively adjust the provisional values within 12 months of the acquisition date, with a corresponding adjustment to goodwill, to reflect new information obtained about facts and circumstances that existed at the acquisition date. [IFRS 3 (revised) para 45]. Adjustments to deferred taxes are subject to the same measurement period requirements.

Recognise and measure consideration transferred for the acquiree

16 The consideration transferred in a business combination is measured at its fair value, which is calculated as the sum of the acquisition date fair values of the assets transferred by the acquirer, the liabilities incurred by the acquirer to the former owners of the acquiree and the equity interests issued by the acquirer. [IFRS 3 (revised) para 37]. Consideration that will be paid at a later date is recorded at its fair value, discounted to its present value at the acquisition date if the effect of discounting is material.

17 Consideration may include assets or liabilities of the acquirer that have a carrying amount that differs from their fair value at the acquisition date. Such amounts are remeasured to their fair value through profit and loss at the acquisition date, unless such assets and liabilities remain under the control of the acquirer subsequent to the acquisition date. [IFRS 3 (revised) para 38].

18 Adjustments to the business combination's cost that are contingent on future events or conditions ('contingent consideration') should also be recognised as consideration at fair value at the acquisition date. If the contingent consideration meets the definition of a liability in accordance with IAS 32, 'Financial instruments: Disclosure and presentation', it is remeasured to its fair value through profit and loss each subsequent reporting period. If the contingent consideration is classified as equity in accordance with IAS 32, it is not remeasured. [IFRS 3 (revised) paras 39-40, 58].

19 Costs directly attributable to the acquisition are expensed as incurred. These costs may include, for example, finder's fees; advisory, legal, accounting, valuation and other professional service fees; general administrative costs; and internal acquisition department costs. An exception to this requirement relates to costs to issue debt or equity securities that are recognised in accordance with IAS 32, 'Financial instruments: disclosure and presentation', and IAS 39, 'Financial instruments: Recognition and measurement'. [IFRS 3 (revised) para 53].

20 Consideration only includes the amounts that the acquirer paid the acquiree to obtain control of the business. Other amounts paid must be identified and accounted for in accordance with the relevant IFRSs. Examples of items that are accounted for separately from the business combination may include: settlement of a pre-existing relationship between the acquirer and acquiree (that is, off-market contract, lawsuit), compensation to former owners of the acquiree for future services, or reimbursement of the acquiree or its owners for paying the acquirer's acquisition-related costs. [IFRS 3 (revised) para 52].

Recognise and measure goodwill or gain from a bargain purchase

21 The value attributed to goodwill represents the future economic benefits arising from assets that are not capable of being individually identified and separately recognised. Goodwill is measured as the excess of:

- the fair value of consideration as of the acquisition date;
- the amount of the non-controlling interest measured at fair value or the proportionate share of identifiable net assets; and
- the acquisition-date fair value of any previously held non-controlling interest over 100 per cent of the identifiable net assets, measured in accordance with IFRS 3 (revised).

[IFRS 3 (revised) para 32].

22 The amount of goodwill will vary depending on how the non-controlling interest is valued. If the non-controlling interest is measured at its full fair value, the goodwill will include amounts attributed to the non-controlling interest. If the non-controlling interest is measured at its proportionate share of identifiable net assets, goodwill will be attributable only to the controlling interest.

23 Goodwill is not amortised. Instead, it is subject to annual impairment tests, or more frequently if there is an indication of impairment.

24 If the value of identifiable net assets exceeds the total of consideration, fair value of previously held interest and the non-controlling interest, the acquirer would recognise a gain in the profit or loss on the acquisition date. Such situations would be rare. An example, may be a forced sale in which the seller is acting under compulsion from a regulator. [IFRS 3 (revised) paras 34-35].

Business combination achieved in stages

25 When a business combination is achieved in stages, the acquirer should remeasure its previously held interest in the acquiree at its fair value at the date control is obtained, recognising a resulting gain or loss in profit or loss. [IFRS 3 (revised) para 42]. The prior interest held is deemed to be part of the consideration paid in exchange for the controlling interest.

Disclosure

26 IFRS 3 (revised) requires extensive disclosures that enable users to evaluate the nature and financial effect of business combinations that occur during the reporting period or after the reporting period but before the financial statements are issued. [IFRS 3 (revised) para 59]. The disclosures include, among other items:

- The amounts recognised at the acquisition date for each class of the acquiree's assets.
- Liabilities and contingent liabilities.
- The fair value of total consideration by class.
- The amount of any non-controlling interest.
- A reconciliation of goodwill from the beginning to end of the period.
- A description of any transactions that are recognised separately from the business combination.
- Gain or loss recognised as a result of remeasuring, previously held interest to fair value.

[IFRS 3 (revised) para B64].

27 Similarly, IFRS 3 (revised) requires disclosure of the acquiree's revenue and profit or loss since the acquisition date that is included in the acquirer's profit or loss for the period and (on a *pro forma* basis) of the combined entity's revenue and profit or loss for the period as though the acquisition date for all business combinations in the period had been the beginning of that period. [IFRS 3 (revised) para B64].

Applying IFRS 3 (revised) to transactions excluded from the scope

28 An entity might choose to apply IFRS 3 (revised) to a business combination that is excluded from the scope of IFRS 3 (revised). For example, an entity must have an accounting policy for business combinations involving entities under common control. The formation of new holding companies and group reorganisations are frequent activities that might be treated as business combinations involving entities under common control. For common control transactions that fall outside the scope of IFRS 3 (revised), entities have a policy choice of either using the purchase accounting method outlined in IFRS 3 (revised), or using predecessor accounting by applying for example, the pooling of interests or merger accounting. This policy election must be made and followed based on the guidance in IAS 8, ‘Accounting policies, changes in accounting estimates and errors’.

Cash flow statements

Overview

The cash flow statement is one of the primary statements in financial reporting (along with the statement of comprehensive income and the balance sheet). It presents the generation and use of 'cash and cash equivalents' by category (operating, investing and finance) over a specific period of time. It provides users with a basis to assess the entity's ability to generate and utilise its cash.

Operating activities are the entity's revenue-producing activities. Investing activities are the acquisition and disposal of long-term assets (including business combinations) and investments that are not cash equivalents. Financing activities are changes in equity and borrowings.

Management may present operating cash flows by using either the direct method (gross cash receipts/payments) or the indirect method (adjusting net profit or loss for non-operating and non-cash transactions, and for changes in working capital).

Cash flows from investing and financing activities are reported separately gross (that is, gross cash receipts and gross cash payments) unless they meet certain specified criteria.

The cash flows arising from dividends and interest receipts and payments are classified on a consistent basis and are separately disclosed under the activity appropriate to their nature. Cash flows relating to taxation on income are classified and separately disclosed under operating activities unless they can be specifically attributed to investing or financing activities.

The total that summarises the effect of the operating, investing and financing cash flows is the movement in the balance of cash and cash equivalents for the period.

Separate disclosure is made of significant non-cash transactions (such as the issue of equity for the acquisition of a subsidiary or the acquisition of an asset through a finance lease). Non-cash transactions include impairment losses/reversals; depreciation; amortisation; fair value gains/losses; and income statement charges for provisions.

Resources

Standards and interpretations

- IAS 7, 'Statement of cash flows'

PwC guidance

- Manual of Accounting chapter 30, Cash flow statements

Tools, practice aids and publications

- IFRS extracts from accounts

Summary of key requirements

1 IAS 7, 'Statement of cash flows', requires the reporting of movements of cash and cash equivalents, classified as arising from three main activities – operating, investing and financing. [IAS 7 Objective].

2 All entities must include a cash flow statement as part of their financial statements. There are no exemptions available from this requirement. [IAS 7 para 1].

3 Where a parent prepares consolidated financial statements, it should prepare a consolidated cash flow statement as if the group were a single entity, with intra-group cash flows eliminated. The cash flows of entities accounted for under the equity method should be included only to the extent that they reflect cash movements between those entities and the group. The cash flows of those entities that are accounted for on a proportional consolidation basis should be included in the cash flow statement to the extent of the group's proportional share of those cash flows. [IAS 7 paras 37, 38].

Format of cash flow statement

4 No specific format is prescribed by the standard. It requires the presentation of cash flows under the three main classifications of operating, investing and financing activities. However, it does not set out a sequence to be followed. Instead, it allows cash flows to be reported in the manner most appropriate to the entity. [IAS 7 paras 10, 11]. In practice, the significant majority of entities reporting under IFRS keep to the order of operating, investing and financing activities.

Operating cash flows

5 Operating cash flows comprise all cash flows during the period that do not qualify as either investing cash flows or financing cash flows. [IAS 7 para 6].

6 Operating cash flows may be prepared from the entity's accounting records under the direct method, which shows the gross cash receipts/payments from operations. Alternatively, the entity can calculate the cash flows indirectly by adjusting net profit or loss for non-operating and non-cash transactions; and for changes in working capital. [IAS 7 para 18]. Where the indirect method is used, a reconciliation between profit or loss and the net cash flow from operating activities has to be presented.

7 Entities are encouraged to report cash flows from operating activities using the direct method, because the information provided is more useful. [IAS 7 para 19].

Investing cash flows

8 Investing activities include cash payments to acquire property, plant and equipment and other long-term assets, unless these are part of an entity's operating activities. IAS 7 was amended to clarify that cash payments to manufacture or acquire assets held for rental to others and subsequently held for sale as described in paragraph 68A of IAS 16 (which applies to assets that are held for rental and routinely sold) are cash flows from operating activities. The cash receipts from rents and subsequent sales of such assets are also cash flows from operating activities.

9 Investing activities also include cash payments and cash receipts relating to acquisition and disposal of debt and equity interests in other entities and interests in joint ventures (except for these relating to dealing or trading activity). [IAS 7 para 16(c)]. Loans or advances made to other parties are classified as investing activities. [IAS 7 para 16(f)].

9.1 The IASB has clarified that only expenditures that result in a recognised asset in the balance sheet are eligible for classification as cash flows from investing activities. This is applicable for accounting periods beginning on or after 1 January 2010. This may impact the classification of expenditure such as that on exploration activities or internal research activities where this cannot be capitalised as an intangible asset. For accounting periods beginning before 1 January 2010 there is an accounting policy choice of the entity as to whether to classify the cash flows as operating or investing.

Financing cash flows

10 Financing cash flows include cash flows relating to obtaining, servicing and redeeming sources of finance. Those sources of finance can include loans, debentures and share capital [IAS 7 para 17(a)-(e)].

Cash and cash equivalents

11 The resulting cash flow total for the period is the movement in the balance of cash and cash equivalents from the start of the period to the end. If the total for cash and cash equivalents presented cannot be traced directly to the balance sheet, a reconciliation is presented in the notes to the financial statements disclosing the components of cash and cash equivalents used for the cash flow statement and how these reconcile back to the balance sheet. [IAS 7 para 45].

12 Cash equivalents are defined as ''*short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value*''. Short-term is viewed by IAS 7 as normally meaning investments with an original maturity of three months or less. [IAS 7 paras 6, 7].

13 A bank overdraft may be used as part of an entity's day-to-day cash management tools rather than as financing arrangements. Normally, such overdraft accounts will regularly fluctuate between a positive and a negative balance. The overdraft balance should be included in the balance of cash and cash equivalents where overdrafts are used for such cash management purposes. [IAS 7 para 8]. In all other circumstances, an overdraft balance is treated as part of the entity's financing.

Acquisitions and disposals of subsidiary undertakings

14 Where a group acquires or disposes of a subsidiary, the amounts of cash and cash equivalents paid or received in respect of the consideration should be reported in the cash flow statement, net of any cash and cash equivalent balances transferred as part of the purchase or sale. IAS 7 also requires disclosure in the notes to the cash flow statement of the full purchase or disposal consideration, detailing any cash and cash equivalents element and the separate disclosure of the amounts of cash and cash equivalents transferred as part of the subsidiary's net assets in relation to the purchase or sale. Additionally, IAS 7 requires the amount of assets and liabilities acquired or disposed of, by each major category, to be disclosed. [IAS 7 paras 39 to 40].

15 If an entity has early adopted IAS 27 (revised), 'Consolidated and separate financial statements' (effective for periods beginning on or after 1 July 2009) consequential amendments to IAS 7 are applicable. The main change is to require cash flows arising from changes in ownership interests in subsidiaries that do not result in a loss of control to be classified as cash flows from financing activities.

Foreign currency transactions or operations

16 Entities with foreign currency transactions or foreign operations should present the functional currency equivalent of foreign currency cash flows, using the exchange rate ruling at the date of the cash flow or an exchange rate that approximates to the actual rate (for example, the average rate for the period). [IAS 7 paras 25 to 27].

17 Foreign currency movements on cash and cash equivalents should be reported separately in the cash flow statement to allow the reconciliation of the opening and closing balances of cash and cash equivalents. [IAS 7 para 28].

Cash flows from hedging activities

18 Cash flows that result from derivative transactions undertaken to hedge another transaction should be classified under the same activity as cash flows from the transaction that is subject to the hedge. [IAS 7 para 16].

Tax cash flows

19 Tax cash flows are normally classified as operating cash flows. However, where specific cash flows can be identified with either investing activities or financing activities, then it is appropriate to classify that element of the tax cash flows as investing or financing respectively. [IAS 7 para 10]. Where the tax cash flows are included in investing or financing categories, disclosure of the total tax cash flows should also be given. [IAS 7 para 36].

Interest and dividend cash flows

20 The cash flows arising from dividends and interest receipts and payments should be classified in the cash flow statement, in a consistent manner from period to period, under the activity appropriate to their nature. These items are required to be disclosed separately on the face of the cash flow statement. [IAS 7 para 31]. IAS 7 does not dictate how dividends and interest cash flows should be classified, but rather allows an entity to determine the classification appropriate to its business.

21 It is generally accepted that dividends received and interest paid or received in respect of the cash flows of a financial institution will be classified as operating activities. For other types of entities, interest and dividends received may be classified in either operating or investing activities. Interest and dividends paid may be classified as either operating or financing activities. [IAS 7 paras 33, 34].

Netting cash flows

22 Generally cash flows should be shown gross. The primary exceptions are when:

- cash receipts and payments are made on behalf of a customer and, therefore, represent the customer's transactions and not the reporting entity's; or
- cash receipts and payments are in respect of items for which the turnover is quick, the amounts are large and the maturities are short.

[IAS 7 para 22].

23 The derivation of operating cash flows by use of the indirect method also results in some netting of cash flows.

Other requirements

24 The net cash flows relating to discontinued operations should be disclosed. The cash flows should be classified between operating, investing and financing. This information can either be presented on the face of the cash flow statement or in the notes. [IFRS 5 para 33(c)].

25 Significant non-cash transactions (such as the issue of equity for the acquisition of a subsidiary) should be disclosed in a note to the cash flow statement. Non-cash transactions include impairment losses/reversals; depreciation; amortisation; fair value gains/losses; and income statement charges for provisions. [IAS 7 para 43].

26 Restricted cash balances should be disclosed in a note to the cash flow statement, including a narrative explanation of any restriction. [IAS 7 para 48].

27 Entities are encouraged, but not required, to give a summary analysis of cash flows by segment. This would be at the level of operating, investing and financing cash flows. [IAS 7 para 52].

Consolidated and separate financial statements

Overview

IAS 27, 'Consolidated and separate financial statements', was revised and issued in January 2008. The revised standard is effective for annual periods beginning on or after 1 July 2009. The previous version of IAS 27 is addressed in a separate topic summary, which is available at www.pwcinform.com (see 'Accounting & corporate reporting' – 'Topic summaries').

IAS 27 (revised) requires consolidated financial statements to be prepared in respect of a group, subject to certain exceptions. All subsidiaries should be consolidated. A subsidiary is an entity that is controlled by the parent. Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. It is presumed to exist when the investor directly or indirectly holds more than 50 per cent of the investee's voting power; this presumption may be rebutted if there is clear evidence to the contrary. Control may also exist where less than 50 per cent of the investee's voting power is held and the parent has the power to control through for example control of the board of directors.

Consolidation of a subsidiary takes place from the date of acquisition, which is the date on which control of the net assets and operations of the acquiree is effectively transferred to the acquirer. Consolidated financial statements are prepared to show the effect as if the parent and all the subsidiaries were one entity. Transactions within the group (for example, sales from one subsidiary to another) are eliminated.

An entity with one or more subsidiaries (a parent) presents consolidated financial statements, unless all the following conditions are met:

- It is itself a subsidiary (subject to no objection from any shareholder).
- Its debt or equity are not publicly traded.
- It is not in the process of issuing securities to the public.
- The ultimate or intermediate parent of the entity publishes IFRS consolidated financial statements.

There are no exemptions if the group is small or if certain subsidiaries are in a different line of business.

From the date of acquisition, the parent (the acquirer) incorporates into the consolidated statement of comprehensive income the financial performance of the acquiree and recognises in the consolidated balance sheet the acquired assets and liabilities (at fair value), including any goodwill arising on the acquisition (see chapter 25A of the Manual of Accounting for further guidance in determining goodwill).

A subsidiary held exclusively for disposal that meets the definition of an asset held-for-sale is not excluded from consolidation, however, it is measured and accounted for under IFRS 5, 'Non-current assets held for sale and discontinued operations', at fair value less costs to sell.

In the separate (non-consolidated) financial statements of a parent entity, the investments in subsidiaries should be carried at cost or as financial assets in accordance with IAS 39.

Previously under the cost method, parents had to recognise dividends from pre-acquisition earnings as a reduction in the cost of investment. This method was replaced by an amendment to IAS 27 to present dividends as income in the separate financial statements of the investor when the parent company has a right to receive the dividend. The investment then has to be tested for impairment as a consequence of an amendment to IAS 36, 'Impairment of assets'.

The amendment to IAS 27 also specifies the measurement of cost by a new company where the new company is established as either a new parent or new intermediate parent in a group reorganisation. If certain criteria are met, the new company measures cost at its share of the equity items in the separate financial statements of its subsidiary.

Consolidation of special purpose entities

A special purpose entity (SPE) is an entity created to accomplish a narrow, well defined objective. It may operate in a pre-determined way so that no other party has explicit decision-making authority over its activities after formation. An entity should consolidate an SPE when the substance of the relationship between the entity and the SPE indicates that the SPE is controlled by the entity.

Control may arise at the outset through the pre-determination of the activities of the SPE or otherwise. An entity may be deemed to control an SPE if it is exposed to the majority of risks and rewards incidental to its activities or its assets.

Resources

Standards and interpretations

- IAS 27, 'Consolidated and separate financial statements'
- Improvements to IFRSs 2010
- Amendment to IFRS 1, 'First-time adoption of IFRS', and IAS 27, 'Consolidated and separate financial statements'

Exposure drafts and discussion papers

- ED 10, 'Consolidated financial statements'

PwC views

- PwC comment letter to the IASB on ED10 on consolidated financial statements

PwC guidance

- Manual of Accounting chapter 24A, Consolidated and separate financial statements

Tools, practice aids and publications

- IFRS extracts from accounts

Summary of key requirements

1 IAS 27 (revised), 'Consolidated and separate financial statements', sets out the requirements for preparing and presenting consolidated financial statements for a group of entities under the control of a parent. It also deals with the accounting for investments in subsidiaries, jointly controlled entities and associates when an entity elects, or is required by local regulations, to present separate financial statements. [IAS 27 (revised) paras 1, 3].

Consolidated, 'economic interest' and separate financial statements

2 IAS 27 (revised), IAS 28, 'Investments in associates', and IAS 31, 'Interests in joint ventures', cover the accounting for three forms of financial statements: 'consolidated' financial statements, 'economic interest' financial statements and 'separate' financial statements.

- IAS 27 determines the content of 'consolidated' financial statements, which are prepared by investors that have subsidiaries and present the group as a single economic entity. [IAS 27 (revised) para 4].
- IAS 28 and IAS 31 determine the content of an investor's 'economic interest' financial statements, which are those prepared by investors that do not have subsidiaries, but do have investments in jointly controlled entities or associates. An investor's 'economic interest' financial statements are required by IAS 28 and IAS 31 to include investments in jointly controlled entities by proportionately consolidating or by equity accounting and investments in associates by equity accounting. [IAS 28 paras 2 to 4; IAS 31 paras 3 to 5].
- 'Separate' financial statements have in the past been referred to as 'entity' or 'stand-alone' financial statements. They are defined in IAS 27 (revised) as a parent's, venturer's or investor's own financial statements and are those in which investments are accounted for on the basis of the direct equity interest (rather than on the basis of the reported results and net assets of the investees). IAS 27 (revised) does not mandate which entities should produce separate financial statements, but specifies the accounting required when an entity elects, or is required by local regulations, to present separate financial statements. In separate financial statements, investments in subsidiaries, jointly controlled entities and associates are accounted for either at cost or in accordance with IAS 39, 'Financial instruments: Recognition and measurement', that is, af fair value. [IAS 27 (revised) paras 4, 38]

3 A parent may elect, or be required by local regulations to present, separate financial statements *in addition* to the consolidated financial statements.

Requirement to prepare consolidated financial statements

4 IAS 27 (revised) requires a parent to present consolidated financial statements in which it consolidates its investments in subsidiaries. But a parent need not prepare consolidated financial statements if it meets all of the following conditions:

- The parent is a wholly-owned subsidiary, or a partially-owned subsidiary of another entity and its other owners have been informed about, and do not object to, the parent not presenting consolidated financial statements.
- The parent's debt or equity instruments are not traded in a public market.
- The parent did not file, nor is it in the process of issuing any class of instruments, in a public market.
- The ultimate or any intermediate parent produces consolidated financial statements available for public use that comply with IFRS.

[IAS 27 (revised) para 10].

Scope of consolidated financial statements

5 Consolidated financial statements include all subsidiaries of the parent. A subsidiary is an entity, including an unincorporated entity, such as a partnership, that is controlled by another entity (known as the parent). [IAS 27 (revised) paras 12, 4]. The consolidated financial statements also include the parent's investments in associates, accounted for under the equity method and joint ventures, accounted for under either the equity method or proportionate consolidation (see separate topic summaries for associates and joint ventures).

Control

6 Control is defined in IAS 27 (revised) as the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. [IAS 27 (revised) para 4].

7 Control is presumed to exist when the parent owns, directly or indirectly, more than half of the entity's voting power, unless in exceptional circumstances it can be clearly demonstrated that such ownership does not constitute control. The standard also sets out the following circumstances where control exists when the parent owns

half or less of the entity's voting power. These circumstances are where it has:

- Power over more than half of the voting rights by virtue of an agreement with other investors.
- Power to govern the entity's financial and operating policies under a statute or an agreement.
- Power to appoint or remove the majority of the members of the board of directors or equivalent governing body and control of the entity is by that board or body.
- Power to cast the majority of votes at meetings of the board of directors or equivalent governing body and control of the entity is by that board or body.

[IAS 27 (revised) para 13].

8 An entity may own share warrants, call options, convertible debt instruments or other similar instruments that, if exercised or converted, give the entity voting power (potential voting rights). The existence and effect of potential voting rights that are *currently* exercisable or convertible should be taken into account when assessing whether control exists. [IAS 27 (revised) paras 14, 15].

Subsidiaries held for sale

9 IFRS 5 deals with the situation where a subsidiary is acquired and held exclusively with a view to sale within 12 months from acquisition. Such entities are treated as a disposal group, with their results being consolidated in one line in the income statement within discontinued operations. The assets of a disposal group are shown in aggregate and separately from the aggregate of the disposal group's liabilities as a 'non-current asset held for sale' or a 'non-current liability held for sale'. [IFRS 5 para 38].

Venture capital organisations, severe long-term restrictions, dissimilar activities

10 There is no exclusion from consolidation for subsidiaries held by venture capital organisations, mutual funds, unit trusts and similar entities. Similarly, it is not possible to exclude subsidiaries because of severe long-term restrictions, which significantly impair the entity's ability to transfer funds to the parent. It is also not possible to exclude a subsidiary where its activities are dissimilar to those of its parent or group. [IAS 27 (revised) paras 16, 17].

Special purpose entities (SPEs)

11 SIC 12 requires an SPE to be consolidated when the substance of the relationship between an entity and the SPE indicates that the SPE is controlled by that entity. Very often with an SPE, control arises because its activities are pre-determined (that is, it operates on 'autopilot'). [SIC 12 paras 1, 2, 8]. The standard identifies the following types of situations where control might arise. These are situations where in substance:

- The SPE's activities are being conducted on behalf of the entity according to its specific business needs so that the entity obtains benefits from the SPE's operations.
- The entity has the decision-making powers to obtain the majority of the SPE's benefits from its activities or, by setting up an 'autopilot' mechanism, the entity has in effect delegated these decision-making powers.
- The entity has rights to obtain the majority of the SPE's benefits and, therefore, may be exposed to risks attaching to the SPE's activities.
- The entity retains the majority of the SPE's residual, or ownership, risks or assets in order to obtain benefits from its activities.

[SIC 12 App].

Consolidation procedures

12 Consolidated financial statements are prepared by combining the financial statements of the parent and its subsidiaries on a line by line basis, adding together those items of assets, liabilities, equity, income and expenses that are alike. To present the group as a single economic unit, the following procedures are applied:

- The carrying amount of the parent's investment and the parent's share of equity in each subsidiary are eliminated.
- Non-controlling interests are not income or expense. IAS 1 (revised) requires non-controlling interests share of profit or loss and total comprehensive income for the period to be allocated and separately disclosed on the face of the income statement between the parent's equity holders and non-controlling interests.
- Non-controlling interests in consolidated subsidiaries' net assets are identified and presented in the consolidated balance sheet within equity, separately from the parent shareholders' equity.
- The proportions of profit and loss, total comprehensive income and changes in equity allocated to the parent and non-controlling interests are based on present ownership interests.
- All intra-group balances, transactions, income and expenses are eliminated in full. Intra-group losses may indicate impairment.
- For the purpose of consolidating a subsidiary's results, the difference between the reporting dates of the subsidiary and the parent can be no more than three months. Where there is a difference in reporting dates adjustments are required to be made for the effect of significant transactions or events that occur between these dates.
- The consolidated financial statements are prepared using uniform accounting policies.

- The subsidiary's income and expenses are included in the consolidated financial statements from the date of acquisition to the date on which the parent ceases to have control.

[IAS 27 (revised) paras 18 to 28; IAS 1 (revised) para 83].

Loss of control

13 Loss of control can occur with or without a change in absolute or relative ownership levels, for example, as a result of a contractual arrangement or when a subsidiary becomes subject to the control of a government, court, administrator or regulator. Further, a parent might lose control in multiple arrangements. Circumstances and the economic effect of these arrangements may indicate that the multiple arrangements should be accounted for as a single arrangement. The parent should account for the multiple arrangements as a single arrangement if one or more of the following exist:

- Each arrangement was entered into at the same time or in contemplation of each other.
- They form a single transaction designed to achieve an overall commercial effect.
- The occurrence of one arrangement is dependent on the occurrence of at least one of the other arrangements.
- One arrangement on its own is not considered to be economically justified, but collectively they are economically justified.

[IAS 27 (revised) paras 32, 33].

14 If a parent loses control of a subsidiary, then at the date when control is lost it:

- Derecognises the assets, any goodwill and liabilities of the subsidiary at their carrying amounts.
- Derecognises the carrying amount of any non-controlling interests.
- Recognises the fair value of the consideration received and recognises any distribution of shares of the subsidiary to owners in their capacity as owners if required.
- Recognises the retained investment, if any, at its fair value.
- Reclassifies gains or losses previously recognised in other comprehensive income (for example, revaluations of available-for-sale financial assets) to profit or loss, and gains or losses previously recognised in other comprehensive income directly to retained earnings, for example, revaluation reserve as required by the applicable IFRSs.
- Recognises any resulting difference as a gain or loss in profit or loss attributable to the parent.

[IAS 27 (revised) paras 34, 35, 37]

15 Changes in a parent's ownership interest that do not result in a loss of control are accounted for as equity transactions, that is transactions with owners in their capacity as owners. Any difference between the amount of consideration paid or received and the amount by which the non-controlling interest is adjusted is recognised directly in equity and attributed to the owners of the parent. [IAS 27 (revised) paras 30, 31].

Presentation and disclosure

16 A parent entity may present all consolidated income and expense in a period either in a single statement of comprehensive income or in two statements: a statement presenting profit and loss items titled 'Income statement' and a second statement beginning with profit or loss and then presenting other comprehensive income titled 'Statement of comprehensive income' (see separate topic summary IAS 1 (revised), 'Presentation of financial statements').

17 IAS 27 (revised) sets out a number of detailed disclosure requirements including:

- Details of the circumstances where the standard's presumptions in respect of whether a parent has control are rebutted when an entity holds more than half of the voting (or potential voting) power of the investee.
- Details of the nature of the relationship between the parent and the subsidiary, where the parent does not own more than half of the voting power.
- The nature and extent of any significant restrictions on the ability of subsidiaries to transfer funds to the parent.
- The reporting date of a subsidiary when not co-terminous with that of the parent with reasons for using a different date; and a schedule that shows the effects of changes in a parent's ownership interest in a subsidiary that does not result in a loss of control.

[IAS 27 (revised) para 41(a) to 41(e)].

18 IAS 27 (revised) requires that if control of a subsidiary has been lost, the parent discloses the gain or loss attributable to recognising the retained investment at its fair value, and if the total gain or loss is not separately disclosed in the income statement, then the parent discloses the line item that includes this amount. [IAS 27 (revised) para 41(f)].

19 Where a parent is exempt from preparing consolidated financial statements it states:

- The fact that they are separate financial statements,
- The fact the exemption from consolidation has been used, and gives details of the parent that produces consolidated financial statements and the address from which such financial statements can be obtained.
- Details of significant investments in subsidiaries, jointly controlled entities and associates.
- The method used to account for these investments.

[IAS 27 (revised) para 42].

20 Furthermore, when a parent or venturer with an interest in jointly controlled entity or an investor in associate prepares separate financial statements, then IAS 27 (revised) requires that:

- The accounts disclose the fact that they are separate financial statements.
- The reasons for their preparation if not required by law.
- Details of significant investments in subsidiaries, jointly controlled entities and associates.
- The method used to account for these investments.

[IAS 27 (revised) para 43].

Disposal of subsidiaries, businesses and non-current assets

Overview

IFRS 5, 'Non-current assets held-for-sale and discontinued operations', is relevant when any disposal occurs or is planned. The held-for-sale criteria in IFRS 5 apply to non-current assets (or disposal groups) whose value will be recovered principally through sale rather than through continuing use. The criteria do not apply to assets that are being scrapped, wound down or abandoned.

IFRS 5 defines a disposal group as a group of assets to be disposed of, by sale or otherwise, together as a group in a single transaction, and liabilities directly associated with those assets that will be transferred in the transaction.

The non-current asset (or disposal group) is classified as 'held-for-sale' if it is available for its immediate sale in its present condition and its sale is highly probable. A sale is 'highly probable' where: there is evidence of management commitment; there is an active programme to locate a buyer and complete the plan; the asset is actively marketed for sale at a reasonable price compared to its fair value; the sale is expected to be completed within 12 months from the date of classification; and actions required to complete the plan indicate that it is unlikely that there will be significant changes to the plan or that it will be withdrawn.

Non-current assets (or disposal groups) classified as held for sale are:
- Carried at the lower of the carrying amount and fair value less costs to sell.
- Not depreciated or amortised.
- Presented separately on the face of the balance sheet (assets and liabilities should not be offset).

A discontinued operation is a component of an entity that can be distinguished operationally and financially for financial reporting purposes from the rest of the entity and:
- Represents a separate major line of business or major geographical area of operation.
- Is part of a single co-ordinated plan to dispose of a separate major line of business of geographical area of operation.
- Is a subsidiary acquired exclusively with a view for resale.

An operation is classified as discontinued only at the date on which the operation meets the criteria to be classified as held for sale or when the entity has disposed of the operation. There is no retrospective classification if the criteria for that classification are not met until after the balance sheet date.

Discontinued operations are presented separately in the income statement and the cash flow statement. There are additional disclosure requirements in relation to discontinued operations.

The date of disposal of a subsidiary or disposal group is the date on which control passes. The consolidated income statement includes the results of a subsidiary or disposal group up to the date of disposal; the gain or loss on disposal is the difference between (a) the carrying amount of the net assets plus any attributable goodwill and amounts accumulated in other comprehensive income (that is, foreign translation adjustments, available for sale reserves); and (b) the proceeds of sale.

Resources

Authoritative pronouncements
- IFRS 5, 'Non-current assets held-for-sale and discontinued operations'
- IFRIC 17, 'Distributions of non-cash assets to owners'
- IAS 27, 'Consolidated and separate financial statements'

Pronouncements under discussions
- Exposure draft on amendments to IFRS 5

PwC guidance
- Manual of Accounting chapter 26, Disposals of subsidiaries, businesses and non-current assets

Tools practice aids and publications
- IFRS extracts from accounts

Summary of key requirements

Objective and scope

1 IFRS 5, 'Non-current assets held-for-sale and discontinued operations', specifies the measurement, presentation and disclosure requirements for assets held-for-sale (or disposal groups) and discontinued operations. [IFRS 5 para 1].

2 IAS 27, 'Consolidated and separate financial statements', provides guidance on the point at which a disposal is recorded and the calculation of the gain or loss on disposal.

Definitions

Non-current assets held for sale and disposal groups

3 The common feature of non-current assets held for sale and disposal groups is that the carrying value is expected to be realised principally through a sale transaction rather than through continuing use. [IFRS 5 para 6]. Also, partial sales of subsidiaries may qualify as held for sale if the sale will result in a loss of control, even if a non-controlling interest is retained. [Improvements to IFRSs, May 2008].

Non-current assets

4 Non-current assets are assets that do not meet the definition of a current asset. A non-current asset could be a head office building, a patented drug or a brand.

Disposal groups

5 A disposal group is a group of assets that are to be disposed of together as a single transaction, and the liabilities directly associated with those assets that will be transferred in the transaction. A disposal group is often a business or a part of a business or cash-generating unit. A disposal group can include current assets, non-current assets and related liabilities. Goodwill is included in the disposal group if it is a cash-generating unit to which goodwill has been allocated or if it is an operation within such a cash-generating unit.

Discontinued operations

6 A discontinued operation is a disposal group that meets certain specific criteria. Discontinued operations are a subset of disposal groups and are measured in the same way as disposal groups but have different presentation and disclosure requirements. A discontinued operation is a disposal group that is a major line of business or major geographical area of operations and is part of a single co-ordinated disposal plan. It can be clearly distinguished operationally and for financial reporting purposes, from the rest of the entity. It will have been a cash-generating unit (as defined in IAS 36) or a group of cash-generating units while being held for use. A subsidiary acquired exclusively with a view to resale is also a discontinued operation. [IFRS 5 para 31, App A].

7 The major line of business or major geographical area of operations criteria are usually satisfied if the operation is an operating segment, as defined in IFRS 8.

Initial recognition (classification) as held-for-sale

8 A non-current asset or disposal group is classified as held-for-sale when it is (i) immediately available for sale in its present condition; and (ii) the sale is highly probable. The held-for-sale criteria must be met at or before the balance sheet date. [IFRS 5 paras 7, 12].

'Immediately available for sale'

9 This condition is satisfied when management has the intention to sell the asset or disposal group and the ability to transfer it to the buyer in its present condition (that is, only normal procedures are required for the sale of the asset). [IFRS 5 para 7]. The legal formalities associated with the sale of land are an example of normal procedures.

'Highly probable'

10 The second condition to meet held-for-sale is that the sale must be highly probable. The standard defines 'highly probable' as 'significantly more likely than probable'. [IFRS 5 App A]. This creates a high threshold of certainty before recognition as held-for-sale. IFRS 5 expands on this requirement with some specific conditions:

- management at the appropriate level must be committed to a plan to sell;
- an active programme to locate a buyer and to complete the plan to sell has begun;
- the asset or disposal group is being actively marketed at a price that is reasonable in comparison to its fair value;
- the actions required to complete the plan indicate that it is unlikely that significant changes will be made to the plan and the plan is not likely to be withdrawn; and
- it is expected that the sale will be completed within one year from the date of classification as held-for-sale.

[IFRS 5 para 8].

Assets acquired with intent to dispose

11 An entity may acquire assets or businesses as part of a business combination that it intends to sell. This may be because of regulatory requirements, anti-trust rules or because they are not of interest to the acquirer. The requirements to be classified as held for sale are difficult to meet at the date of acquisition. Therefore, the standard provides that the acquired disposal group may be classified as held for sale if it is expected to be sold within one year and it is highly probable that the other criteria will be met within three months from the date of acquisition. [IFRS 5 para 11]. Assets or disposal groups that meet the held-for-sale criteria are not measured at fair value in accordance with IFRS 3. They are measured in the acquisition date balance sheet at fair value less cost to sell, as described below.

What is a sale?

12 Disposal through sale includes asset exchanges where the exchanges have commercial substance. [IFRS 5 para 10]. However, the distribution of assets to shareholders or a spin-off that does not include a sale do not constitute a sale transaction. Abandonment of assets or a business also does not qualify as a sale, so such assets or disposal groups will not be classified as held-for-sale. An abandoned business cannot be treated as a discontinued operation until it has actually been abandoned. However, it may meet the criteria for a discontinued operation when abandoned and, at that time, be subject to the relevant presentation and disclosure requirements. [IFRS 5 para 13].

One year rule

13 The sale of the assets or disposal group should be expected to be completed within one year from the date of classification as held for sale. An extension beyond one year is allowed in certain limited circumstances where the delay is caused by events or circumstances beyond the entity's control and there is sufficient evidence that the entity remains committed to its plan to sell the asset or disposal group. [IFRS 5 para 9, App B].

Measurement on initial recognition

14 Specific measurement requirements apply to non-current assets and disposal groups once they are classified as held for sale. A non-current asset or disposal group that has been classified as held-for-sale is measured at the lower of carrying amount or fair value less costs to sell.

15 Fair value is defined as ''*the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction*''. Costs to sell are the incremental costs that are directly attributable to the disposal of an asset (or disposal group). They do not include finance costs or income tax expenses. [IFRS 5 App 5]. The costs must result directly from, and be essential to, a sale transaction and would not have been incurred had the decision to sell not been made. Stranded costs arise in many transactions where the seller incurs an expense that would otherwise have been avoided had the disposal not taken place. Stranded costs should be presented as part of the costs of the discontinued operations. Where such costs arise as a consequence of the transaction, but are not essential to the transaction, they do not form part of the costs to sell.

16 The carrying amount includes all of the assets, including goodwill, and liabilities of the disposal group. The carrying amount of a disposal group does not include cumulative translation differences and other amounts that have been recorded directly in equity for the purpose of calculating the lower of carrying amount and fair value less costs to sell under IFRS 5.

Assets excluded from the scope of the measurement rules

17 The measurement rules of IFRS 5 do not apply to the following and instead the appropriate standard (referred to in brackets) is used:

- deferred tax assets (IAS 12, 'Income taxes');
- employee benefits assets (IAS 19, 'Employee benefits');
- financial assets within the scope of IAS 39 (IAS 39, 'Financial instruments: Recognition and measurement');
- investment property carried at fair value (IAS 40, 'Investment property');
- non-current assets measured at fair value under IAS 41, (IAS 41 'Agriculture');
- contractual rights under insurance contracts (IFRS 4, 'Insurance contracts').

[IFRS 5 para 5].

18 If a disposal group contains such assets, they are re-measured according to the relevant standard. If the disposal group also contains assets that are subject to the measurement rules of IFRS 5, the disposal group as a whole is then subject to the measurement and presentation rules of IFRS 5. [IFRS 5 para 4].

19 There are three or four stages of measurement, depending on whether it is a non-current asset or disposal group. The step process is as follows:

- Test for impairment under IAS 36 as a plan to dispose of an asset or cash-generating unit is an impairment indicator.
- Immediately before classification as held for sale, measure the non-current assets or assets and liabilities in the disposal group in accordance with the relevant standards. This ensures that any gains, losses, depreciation or amortisation or impairments are not masked by measurement under IFRS 5.
- For the disposal group only, measure all assets and liabilities outside the measurement scope of IFRS 5 in accordance with the relevant standard.
- Measure the non-current asset or disposal group at the lower of the carrying value and fair value less cost to sell on classification as held-for-sale.

[IFRS 5 paras 15, 18].

20 Any excess of carrying value over fair value less cost to sell is recorded as a loss in the income statement in the current period. Fair value less costs to sell in excess of carrying value is ignored and no gain is recorded on classification. Any losses are recorded as part of income from continuing operations unless the specific criteria for discontinued operations are also met. Any impairment losses arising are allocated to the disposal group in the same way as they would be allocated under IAS 36. The impairment is allocated first to goodwill and then to the other non-current assets on a pro rata basis. [IFRS 5 para 23].

Subsequent measurement – continuing classification as held for sale

21 Non-current assets held for sale and disposal groups are re-measured to the lower of the carrying amount or fair value less costs to sell at every balance sheet date from classification until disposal. The measurement process is similar to that which occurs on initial classification as held for sale. Depreciation and amortisation of tangible and intangible assets ceases on classification as held for sale. [IFRS 5 para 25].

22 All assets and liabilities included in a disposal group but outside the measurement scope of IFRS 5 continue to be measured under the relevant standards. The carrying value of the non-current asset or disposal group is then compared to the fair value less costs to sell at the balance sheet date. [IFRS 5 para 20]. Any excess of carrying value over fair value less costs to sell is a further impairment loss and is recognised as is described in paragraph 20 above.

23 Fair value less costs to sell may have increased relative to the carrying value since the last measurement date. Increases relating to the reversal of impairments of goodwill are not recognised. This is consistent with the general prohibition in IFRS against reversals of goodwill impairment. All other increases are recognised in the income statement to the extent they reverse previously recognised impairment losses. [IFRS 5 para 22]. These losses would include impairment losses recognised under IAS 36 (prior to classification as held for sale) and losses recognised on classification as held for sale, other than goodwill.

24 The non-current assets or disposal group cannot be written up beyond their previous (pre-impairment) carrying amounts, adjusted for depreciation that would have been applied without the impairment.

Subsequent measurement – reclassified to continuing use

25 The non-current assets or disposal group may cease to meet the held-for-sale criteria. Management may not be able to sell the assets for its expected price or there may be other changes in circumstances. The assets or disposal group is reclassified as held for use when the held-for-sale criteria are no longer met. [IFRS 5 para 26].

26 The assets or disposal group are re-measured as held for use at the lower of:
- the carrying amount before classification as held-for-sale adjusted for any depreciation, amortisation or revaluations that would have been recognised if not held-for-sale; and
- the recoverable amount at the date of being returned to held for use (measured in accordance with IAS 36).

[IFRS 5 para 27].

27 The adjustment to re-measure the disposal group is included in the income statement as part of continuing operations. [IFRS 5 para 28].

Derecognition

28 The date of disposal is the date on which control passes. At this date, the assets and liabilities of the subsidiary are derecognised and any gain or loss on disposal is recorded in the income statement. [IAS 27 para 30]. A disposal may be effected through a sale or it could be as a result of another transaction, such as a de-merger.

29 When an entity ceases to become a subsidiary, the consolidated income statement will include the results of the subsidiary up to the date of disposal and the gain or loss arising on the cessation. [IAS 27 para 30].

30 The calculation of the gain or loss on cessation is the difference between the carrying amount of the net assets (including goodwill) disposed of and any proceeds received. The calculation of net assets will include the appropriate portion of cumulative exchange differences and any other amounts recognised in other comprehensive income and accumulated in equity.

31 IAS 27 requires transactions with non-controlling interests to be treated as equity transactions. That is, if a parent disposes of a portion of a subsidiary but does not lose control, the difference between the proceeds and the carrying value of the net assets disposed would be recognised in equity (not profit and loss).

32 In addition, if a parent sells a portion of its subsidiary and loses control, a gain or loss would be recognised in the income statement on the remeasurement of any retained non-controlling interest, in addition to the gain or loss recognised in relation to the disposed amount. [IFRS 5 para 34].

33 A discontinued operation is a disposal group that is a major line of business or major geographical area of operations that is being held for sale as part of a disposal plan. The assets and liabilities of a discontinued operation are identified and presented in the balance sheet for disposal groups as described below.

34 A discontinued operation is presented as a single amount on the face of the income statement that includes:
- post tax profit or loss from discontinued operations;
- the post tax gain or loss recognised in the measurement to fair value less costs to sell; and
- when realised, the post tax gain or loss on disposal of the discontinued operation.

[IFRS 5 para 33(b)].

35 This single amount is analysed and disclosed in the notes or on the face of the income statement into:
- the revenue, expenses and pre-tax profit or loss of the discontinued operation;
- tax attributable to the profit or loss of the operation;
- the gain or loss on remeasurement to fair value less costs to sell or the gain or loss on disposal of a discontinued operation; and
- tax attributable to the gain or loss on remeasurement or disposal.

[IFRS 5 para 33(b)].

36 If the analysis is provided on the face of the income statement, it is shown in a section identified as relating to discontinued operations and separately from continuing operations. The analysis is not required for disposal groups that are newly acquired subsidiaries that meet the criteria for classification as held-for-sale on acquisition. [IFRS 5 para 33(c)].

37 When a subsidiary is disposed of and does not meet the criteria for a discontinued operation, any gain or loss is normally reported in the income statement in arriving at profit or loss. If material or relevant to an understanding of the entity's financial performance, the gain or loss should be disclosed separately on the face of the income statement or in the notes. [IAS 1 para 86].

38 The net cash flows, classified as operating, investing and financing, attributable to a discontinued operation for the current and comparative period are disclosed on the face of the cash flow statement or in the notes. These disclosures are not required for disposal groups that are newly acquired subsidiaries that meet the criteria for classification as held-for-sale on acquisition. [IFRS 5 para 33(c)].

39 The disclosures for the cash flow statement and income statement are presented for the comparative periods, so that the disclosures relate to all operations that have been discontinued by the latest balance sheet date. [IFRS 5 para 34]. Consolidation procedures are not affected by the fact that a discontinued operation is presented.

Balance sheet presentation

40 The assets and liabilities of disposal groups (including those that meet the criteria for discontinued operations) are presented separately from other assets and liabilities in the balance sheet. Offsetting assets and liabilities of a disposal group is not permitted. The assets are presented as a single line within current assets; liabilities are presented as a single line within current liabilities. This presentation is required from the point that the held-for-sale criteria are met. The balance sheet for previous periods is not re-presented in this manner unless the criteria were met at the previous period balance sheet date. [IFRS 5 paras 38, 40].

41 These single line items include all current and non-current assets and liabilities of the disposal group, including those affected by the re-measurement at fair value less cost to sell (for example, goodwill that may have been partially impaired or other non-current assets), those that are measured at fair value (for example, derivatives), and those measured in accordance with other IFRSs (for example, deferred tax and pensions). The major categories of assets and liabilities included within the single line items must be disclosed on the face of the balance sheet or in the notes. [IFRS 5 para 38]. This disclosure is not required for newly acquired subsidiaries classified as held-for-sale from the acquisition date. [IFRS 5 para 39].

Additional disclosures

42 Items recognised in other comprehensive income and accumulated in equity related to the disposal group or discontinued operation should also be presented separately. [IFRS 5 para 38]. This includes items such as the cumulative translation, available-for-sale and hedging reserves. It excludes any goodwill that had been previously written off to equity, as this is not reinstated under IFRS.

43 If a partial disposal will result in the loss of control of a subsidiary and meets the requirements for held-for-sale, all of the assets and liabilities of the subsidiary should be classified as held for sale, even if a non-controlling interest is retained. [Improvements to IFRSs, May 2008, IFRS 5 para 8A].

Additional disclosures

44 The notes to the financial statements should provide the following additional disclosures:

- a description of the non-current asset or disposal group (whether continuing or discontinued);
- a description of the facts and circumstances of the sale or expected sale and the expected manner and timing of the disposal;
- the gain or loss recognised for impairments and reversals of impairments and, if not separately shown on the face of the income statement, the line item in which they are included in the income statement;
- the reportable segment in which the disposal group is presented in accordance with IFRS 8, if applicable.

[IFRS 5 para 41].

45 Where an entity is subject to the requirements of IAS 33, 'Earnings per share', disclosure is required in the notes or on the face of the income statement of basic and diluted earnings per share from discontinued operations. [IAS 33 para 68].

46 IAS 7, 'Cash flow statements', also requires certain disclosures in respect of disposals of subsidiaries and other business units that may be relevant where an operation is discontinued. These include the total disposal consideration and the cash and cash equivalent element thereof; the cash and cash equivalents in the subsidiary or business disposed of; and the amount of the assets and liabilities other than cash and cash equivalents of the subsidiary or business disposed of summarised by each major category. [IAS 7 para 40].

Earnings per share

Overview

Earnings per share (EPS) is a ratio that is widely used by financial analysts, investors and others to gauge an entity's profitability and to value its shares. EPS is normally calculated in the context of ordinary shares of the entity. Earnings attributable to ordinary shareholders are therefore determined by deducting from net income the earnings attributable to holders of more senior equity instruments.

An entity whose ordinary shares are listed on a recognised stock exchange or is otherwise publicly traded is required to disclose both basic and diluted EPS with equal prominence in its separate or individual financial statements, or in its consolidated financial statements if it is a parent. Furthermore, entities that file or are in the process of filing financial statements with a securities commission or other regulatory body for the purposes of issuing ordinary shares (that is, not a private placement) are also required to comply with the standard.

Basic EPS is calculated by dividing the profit or loss for the period attributable to the equity holders of the parent by the weighted average number of ordinary shares outstanding (including adjustments for bonus and rights issues).

Diluted EPS is calculated by adjusting the profit or loss and the weighted average number of ordinary shares by taking into account the conversion of any dilutive potential ordinary shares. Potential ordinary shares are those financial instruments and contracts that may result in issuing ordinary shares such as convertible bonds and options (including employee share options).

Basic and diluted EPS for both continuing and total operations are presented with equal prominence in the statement of comprehensive income – or in the separate income statement where one is presented – for each class of ordinary shares. Separate EPS figures for discontinued operations are disclosed in the same statements or in the notes.

Resources

Standards and interpretations
- IAS 33, 'Earnings per share'

Exposure drafts and discussion papers
- Exposure draft on amendments to IAS 33, Earnings per share

PwC views
- PwC comment letter on exposure draft on earnings per share

PwC guidance
- Manual of Accounting chapter 14, Earnings per share

Tools practice aids and publications
- IFRS extracts from accounts

Summary of key requirements

Objective and scope

1 The objective of IAS 33, 'Earnings per share', is to prescribe principles for determining and presenting EPS to improve comparison between different entities in the same period and between different accounting periods for the same entity. [IAS 33 para 1].

2 The standard applies to entities whose ordinary shares are listed on a recognised stock exchange, or are otherwise publicly traded and to entities that are in the process of issuing such shares in public markets. The standard also applies to other entities that give EPS information voluntarily. [IAS 33 paras 2, 3].

3 When an entity presents both consolidated and separate entity financial statements together, the information on EPS only needs to be given on a consolidated basis. [IAS 33 para 4].

EPS

4 EPS is the profit or loss for the period attributable to ordinary equity holders (the numerator) divided by the number of ordinary shares (the denominator). The standard focuses on the methods that must be used for determining the denominator for the purpose of calculating basic EPS and diluted EPS.

Measurement – basic EPS

5 Basic EPS is calculated by dividing profit or loss attributable to ordinary equity holders by the weighted average number of ordinary shares outstanding during the period. [IAS 33 para 10].

6 Profit or loss attributable to ordinary equity holders is after deducting preference dividends and other adjustments in respect of preference shares.

7 The weighted average number of ordinary shares is calculated as the number outstanding at the beginning of the period (less treasury shares), adjusted by the time-weighted effect of increases and decreases in ordinary shares (and treasury shares) issued or bought back in the period. [IAS 33 paras 19, 20].

8 Ordinary shares are usually included in the weighted average number of shares when consideration is

receivable, which is generally the date of their issue. An exception to this is that ordinary shares that will be issued when a mandatorily convertible instrument is converted are included in the basic EPS calculation from the date that the contract is entered into. [IAS 33 paras 21, 23].

9 Ordinary shares issued in a business combination, accounted for using the acquisition method, are considered outstanding from the acquisition date. [IAS 33 para 22].

10 Part-paid shares are included in the weighted average number of ordinary shares as fractional shares to the extent that they are entitled to participate in dividends relative to fully-paid shares. Fractional shares are calculated as entitlement to dividend divided by the dividend entitlement of fully-paid shares. [IAS 33 para A15].

11 Where shares will be issued on the satisfaction of certain conditions they are called 'contingently issuable shares' and are included in the weighted average from the date when all the conditions are satisfied. Contingently returnable shares are not treated as outstanding. They are excluded from the calculation of basic EPS until no longer subject to recall. [IAS 33 para 24].

12 The weighted average number of ordinary shares for the period and all prior periods is adjusted for events, other than the conversion of potential ordinary shares that have changed the number of ordinary shares outstanding without a corresponding change in resources. Examples of such events would be capitalisation (bonus) issues, share splits, share consolidations and the bonus element of a rights issue. [IAS 33 paras 26, 27]. The standard contains specific guidance on how a bonus element in a rights issue should be calculated.

Measurement – Diluted EPS

13 Diluted EPS is measured in a similar way to basic EPS except that the profit and the weighted average number of ordinary shares is adjusted for the effects of all dilutive potential ordinary shares. A potential ordinary share is a financial instrument or other contract that may entitle its holder to ordinary shares. [IAS 33 paras 31, 5]. Common examples are convertible debt or preference shares, warrants and options.

Diluted earnings

14 Diluted earnings means the profit or loss adjusted for the effects of changes in income, expenses, tax and dividends that would have occurred had the dilutive potential ordinary shares been converted into ordinary shares. Such adjustments after taking account of tax include preference dividends or other items (such as differences arising on settlement) related to convertible preference shares, interest on convertible debt and any other changes in income or expense that would result from the conversion of dilutive potential ordinary shares. [IAS 33 para 33].

Dilutive potential ordinary shares

15 Potential ordinary shares are treated as dilutive only if their conversion into ordinary shares would decrease earnings or increase loss per share from *continuing* operations. Potential ordinary shares are not treated as dilutive (that is, they are treated as anti-dilutive) when their conversion would increase earnings per share or decrease loss per share from continuing operations. The effects of anti-dilutive potential ordinary shares are ignored when calculating diluted EPS. [IAS 33 paras 41 to 43].

16 Each issue or series of issues of potential ordinary shares should be considered individually to determine its potential for dilution. The sequence may affect whether or not potential ordinary shares are dilutive or anti-dilutive. To maximise the dilution of basic EPS, each issue or series of issues is considered from the most dilutive to the least dilutive. [IAS 33 para 44].

17 Potential ordinary shares should be included in the calculation of diluted EPS for the period in which they were outstanding. Potential ordinary shares that are converted to ordinary shares during the period should be included in diluted EPS from the beginning of the period to the date of conversion; and in both basic and diluted EPS thereafter. Any potential ordinary shares that expired or were cancelled during the period are included in the diluted EPS calculation for the portion of the period for which they were outstanding. [IAS 33 para 38].

Calculation of diluted EPS

18 For the calculation of diluted EPS, the weighted average number of ordinary shares is the same as for basic EPS, with the addition of the weighted average number of ordinary shares that would be issued on conversion of all the dilutive potential ordinary shares. Dilutive potential ordinary shares should be deemed to have been converted at the start of the period or at the date of their issue if later. [IAS 33 para 36].

19 The number of ordinary shares that would be issued on conversion of dilutive potential ordinary shares is determined from their terms of conversion. Where the terms could vary it should be assumed that they would be exercised at the rate or exercise price that would be most advantageous to the holder. [IAS 33 para 39].

20 Where options and other share purchase arrangements entitle the holder to an ordinary share at less than the average market price during the period, then they are

dilutive. In order to calculate the dilutive effect of these potential ordinary shares, they should be treated as:

- a contract to issue a certain number of shares at their average market price during the period. These shares are neither dilutive nor anti-dilutive and are, therefore, not included in the computation of diluted EPS; and
- a contract to issue a certain number of shares for no consideration. These shares are dilutive and are included in the computation of diluted EPS.

[IAS 33 para 46].

21 Contingently issuable shares are ordinary shares issuable for little or no cash or other consideration on satisfaction of specified conditions in a contingent share agreement. The number of contingently issuable shares included in the diluted EPS calculation is based on the number of shares that would be issuable if the end of the period was the end of the contingency period. [IAS 33 paras 5, 52].

22 Where the issue of shares is contingent on attaining a specified amount of earnings for a period and that amount has been achieved at the end of the period, but must be maintained for a further period, the shares, if dilutive, are included in diluted EPS, because the end of the period is taken as being the end of the contingency period. However, they are not included in basic EPS, because not all the conditions have been satisfied and earnings may change in the future. [IAS 33 para 53].

23 Employee share options that have fixed and determinable terms and non-vested ordinary shares are treated as options for the purpose of diluted EPS, even though their exercise may be contingent on vesting. They are treated as outstanding from the grant date. Employee share options with performance conditions are treated as contingently issuable shares, because their issue is contingent on satisfying performance conditions in addition to the passage of time. For share options and other share-based payment arrangements to which IFRS 2 applies, the assumed proceeds used in the diluted EPS calculation includes the fair value of any goods or services to be supplied to the entity in the future under the arrangement. [IAS 33 paras 48, 47A].

24 Where an entity has entered into a contract that may be settled in ordinary shares or cash at the entity's option, it should be assumed that the contract will be settled in shares and the resulting potential ordinary shares should be included in the calculation of diluted EPS if the effect is dilutive. Where a contract may be settled in ordinary shares or cash at the holder's option the more dilutive of cash or share settlement should be assumed for calculating diluted EPS. [IAS 33 paras 58, 60].

25 Contracts such as purchased put options and purchased call options, that is, options held by an entity over its own shares are not included in the calculation of diluted EPS, because including them would be anti-dilutive. [IAS 33 para 62]. The put would only be exercised if the exercise price was higher than the market price and the call would only be exercised if the exercise price was lower than the market price. However, written put options or forward purchase contracts, that is contracts that require the entity to purchase its own shares, are reflected in the calculation of diluted EPS if their effect is dilutive. [IAS 33 paras 62, 63].

Group reporting

26 Any potential ordinary shares issued by a subsidiary, joint venture or associate, that are potentially convertible into ordinary shares of the subsidiary, joint venture, associate or into ordinary shares of the parent, venturer or investor (the reporting entity), should be included in the diluted earnings per share calculation to the extent that the potential ordinary shares have a dilutive effect on the basic EPS of the reporting entity. [IAS 33 para 40].

Restatement

27 Basic and diluted EPS for prior periods should be restated for bonus issues, share splits and other similar events. In addition, if such changes occur after the reporting period, but before the financial statements are issued, the basic and diluted EPS figures for the year and for prior periods should be presented on the basis of the new number of shares. EPS calculations should also be adjusted for the effects of errors and changes in accounting policies accounted for retrospectively. [IAS 33 para 64].

28 Restatement of prior-period diluted EPS amounts is not allowed for a change in the previous assumptions used, for example assumed conversion of contingently issuable shares, or for the conversion of potential ordinary shares into ordinary shares outstanding. [IAS 33 para 65].

Presentation and disclosure

29 Entities should present in the statement of comprehensive income basic and diluted EPS for both continuing and total operations with equal prominence, for each class of ordinary shares. This applies even if the amounts are negative, that is a loss per share. Separate EPS figures for discontinued operations are disclosed in the statement of comprehensive income or in the notes. [IAS 33 paras 66, 68].

30 If an entity presents a separate income statement, it should present basic and diluted EPS for both continuing operations, discontinued operations and total operations in that statement. [IAS 33 paras 67A, 68A].

31 Entities should also disclose:

- The amounts used as the numerator in calculating basic and diluted EPS and a reconciliation of those amounts to the profit or loss for the period. The reconciliation should show the effect of each class of instrument that affects EPS.
- The weighted average number of ordinary shares used as the denominator in calculating basic and diluted EPS, and a reconciliation of these denominators to each other. The reconciliation should show the effect of each class of instrument that affects EPS.
- Instruments, including contingently issuable shares, that could potentially dilute EPS in the future, but were not included in diluted EPS for the period(s) presented because they were anti-dilutive, should be disclosed.

[IAS 33 para 70].

32 An entity is encouraged to disclose share transactions, other than those for which restatement of EPS is made (see above) that occur after the balance sheet date and that would have changed significantly the number of ordinary or potential ordinary shares outstanding at the end of the period if the transactions had occurred before the end of the period. [IAS 33 paras 70(d), 71].

Adjusted EPS figures

33 An entity may choose to present per share amounts for a reported component of the statement of comprehensive income or the income statement (where one is presented) that are additional to those required by the standard (for example, EPS excluding restructuring charges). Such per share amounts should be calculated using the weighted average number of ordinary shares determined in accordance with the standard. The basis on which the numerator is determined should be indicated and whether it is before or after tax. If the per share amount is for a component of the statement of comprehensive income or the separate income statement that is not reported as a line item in the statement of comprehensive income or in the separate income statement, a reconciliation between the component used and a reported line item should also be provided. Basic and diluted amounts for the additional EPS figures should be disclosed with equal prominence and presented in the notes. [IAS 33 paras 73, 73A].

Employee benefits

Overview

Employee benefits accounting – for pensions in particular – is complex. The liabilities in defined benefit pension plans are frequently material. They are long-term and difficult to measure and this gives rise to difficulty in measuring the cost attributable to each year.

Employee benefits are all forms of consideration given or promised by an entity in exchange for services rendered by its employees. These benefits include salary-related benefits (such as wages, profit-sharing, bonuses and compensated absences, such as paid holiday and long-service leave), termination benefits (such as severance and redundancy pay) and post-employment benefits (such as retirement benefit plans). Share-based payments are addressed in IFRS 2.

Post-employment benefits include pensions, post-employment life insurance and medical care. Pensions are provided to employees either through defined contribution plans or defined benefit plans.

Recognition and measurement for short-term benefits is straightforward, because actuarial assumptions are not required and the obligations are not discounted. However, long-term benefits, particularly post-employment benefits, give rise to more complicated measurement issues.

Defined contribution plans

Accounting for defined contribution plans is straightforward: the cost of defined contribution plans is the contribution payable by the employer for that accounting period.

Defined benefit plans

Accounting for defined benefit plans is complex because actuarial assumptions and valuation methods are required to measure the balance sheet obligation and the expense. The expense recognised is not necessarily the contributions made in the period.

The amount recognised on the balance sheet is the defined benefit obligation less plan assets adjusted for actuarial gains and losses (see 'corridor approach' below).

To calculate the defined benefit obligation, estimates (actuarial assumptions) about demographic variables (such as employee turnover and mortality) and financial variables (such as future increases in salaries and medical costs) are input into a valuation model. The benefit is then discounted to present value using the projected unit credit method. This normally requires the expertise of an actuary.

Where defined benefit plans are funded, the plan assets are measured at fair value using discounted cash flow estimates if market prices are not available. Plan assets are tightly defined, and only assets that meet the definition of plan assets may be offset against the plan's defined benefit obligations – that is, the net surplus or deficit is shown on the balance sheet.

The re-measurement at each balance sheet date of the plan assets and the defined benefit obligation gives rise to actuarial gains and losses. There are three permissible methods under IAS 19 for recognising actuarial gains and losses:

- Under the OCI approach, actuarial gains and losses are recognised immediately in other comprehensive income.
- Under the 'corridor approach', any actuarial gains and losses that fall outside the higher of 10 per cent of the present value of the defined benefit obligation or 10 per cent of the fair value of the plan assets (if any) are amortised over no more than the remaining working life of the employees.
- Faster recognition, including immediate recognition in full, in the income statement is allowed.

IAS 19 analyses the changes in the plan assets and liabilities into various components, the net total of which is recognised as an expense or income in the income statement. These components include:

- Current service cost (the present value of the benefits earned by active employees in the current period).
- Interest cost (the unwinding of the discount on the defined benefit obligation) .
- Expected return on any plan assets (expected interest, dividends and capital growth of plan assets) .
- Actuarial gains and losses, to the extent they are recognised in the income statement (see above).
- Past-service costs (the change in the present value of the plan liabilities relating to employee service in prior periods arising from changes to post-employment benefits).

Past-service costs are recognised as an expense on a straight-line basis over the average period until the benefits become vested. If the benefits are already vested, the past service cost is recognised as an expense immediately. Gains and losses on the curtailment or settlement of a defined benefit plan are recognised in the income statement when the curtailment or settlement occurs.

When plan assets exceed the defined benefit obligation creating a net surplus, IFRIC 14, 'IAS 19 – The limit on a defined benefit asset, minimum funding requirements and their interaction', provides guidance on assessing the amount that can be recognised as an asset. It also explains how the pension asset or liability may be affected by a statutory or contractual minimum funding requirement.

Resources

Standards and interpretations

- IAS 19, 'Employee benefits'
- IFRIC 14, 'The limit on a defined benefit asset, minimum funding requirements and their interaction'

Exposure drafts and discussion papers

- Exposure draft on discount rate for employee benefits
- Exposure draft of proposed amendments to IAS 37, 'Provisions, contingent liabilities and contingent assets', and IAS 19, 'Employee benefits'
- Exposure draft on IAS 19, 'Employee benefits – defined benefit plans'

PwC views

- PwC comment letter on the exposure draft of proposed amendments to IAS 37, 'Provisions, contingent liabilities and contingent assets', and IAS 19, 'Employee benefits'
- PwC comment letter on the exposure draft on discount rate for employee benefits

PwC guidance

- Manual of Accounting chapter 11, Employee benefits

Tools, practice aids and publications

- IFRS extracts from accounts
- Straight away 16, 'Significant changes proposed for recognition and measurement of employee benefit expense and disclosure'

Summary of key requirements

1 IAS 19, 'Employee benefits', deals with accounting for employee benefits, including in particular pension costs. IFRIC 14 'IAS 19 – The limit on a defined benefit asset, minimum funding requirements and their interaction' gives further guidance in relation to defined benefit pension plans.

Objective and scope

2 The objective of IAS 19 is to prescribe the accounting and disclosure for employee benefits. The standard requires an entity to recognise a liability when an employee has provided service in exchange for employee benefits to be paid in the future and an expense when the entity consumes the economic benefit from service provided by an employee.

3 IAS 19 applies to all types of employee benefits (except share-based payments within the scope of IFRS 2), including:

- Short-term benefits payable during employment, such as wages, salaries, holiday pay, sick leave and profit sharing and bonuses (if paid within 12 months of the end of the period), non-monetary benefits such as medical care, housing and cars and social security contributions.
- Long-term benefits payable during employment, such as profit sharing, bonuses and deferred compensation (if not wholly payable within 12 months of the end of the period), long-service leave, sabbatical leave, jubilee or other long-service benefits and long-term disability benefits.
- Termination benefits such as redundancy payments.
- Post-employment benefits such as pensions, other retirement benefits, post-employment life insurance and post-retirement medical care.

Each of these categories has different characteristics and is, therefore, accounted for differently. [IAS 19 para 4]

Benefits payable during employment

Short-term benefits

4 The accounting for wages, salaries and other short-term benefits payable in cash is generally straightforward. Where an employee has rendered service during the period the entity recognises the undiscounted amount of short-term employee benefits to be paid in exchange for that service as a liability (after deducting any amounts already paid) and as an expense, unless another standard requires or permits the inclusion of the benefits in the cost of an asset. [IAS 19 para 10].

5 IAS 19 provides guidance in respect of compensated absences, such as paid holiday and sick leave. The standard distinguishes accumulating absences, that is those that may be carried forward and used in future periods, from non-accumulating absences that lapse if not used in full. The former are recognised when the employee renders service, and the latter are recognised when the absences occur. If employees are entitled to a cash payment for any unused entitlement on leaving the entity, the accumulated absences is vesting. If there is no such entitlement, an obligation is recognised, but its measurement takes into account the possibility that employees may leave. [IAS 19 paras 11-13].

6 An entity recognises the expected cost of profit sharing and bonus payments when:

- the entity has a present legal or constructive obligation to make such payments as a result of past events; and
- a reliable estimate of the obligation can be made.

A present obligation arises only when the entity has no realistic alternative but to make the payments. [IAS 19 para 17]. A reliable estimate can only be made when the formal terms of the plan contain a formula for determining the amount payable; the amount payable is determined

before the financial statements are authorised for issue; or past practice gives clear evidence of the amount of the entity's constructive obligation. [IAS 19 para 20].

Long-term benefits

7 It might be expected that the same accounting principles as above for short-term benefits would apply to long-term benefits payable during employment, with appropriate adjustment for increased uncertainty and the time value of money. However, the approach to accounting for long-term employee benefits is fundamentally different. With the exception that both actuarial gains and losses and past service costs are recognised immediately, long-term employee benefits are accounted for in the same way as defined benefit pension benefits (see further below). [IAS 19 para 127].

Termination benefits

8 In broad terms, termination benefits are amounts payable when an employee ceases to work for an employer. In this context they are similar to post-employment benefits, such as pensions. However, whereas post-employment benefits are earned throughout an employee's working life, termination benefits arise as a result of an employer's decision, such as a factory closure. Termination benefits are not earned in a literal sense, although their magnitude may be set by reference to an employee's period of service. As well as lump sum payments, termination benefits include enhancement of retirement benefits or 'gardening leave'.

9 A liability and immediate expense in respect of termination benefits should be recognised when an entity has a demonstrable commitment to either:

- terminate the employment of an employee or group of employees before the normal retirement date; or
- provide termination benefits as a result of an offer made in order to encourage voluntary redundancy.

[IAS 19 para 133].

10 An entity is demonstrably committed to a termination when it has a detailed formal plan and has no realistic possibility of withdrawal. [IAS 19 para 134].

11 Measurement of the liability follows the same principles as IAS 37, 'Provisions, contingent liabilities and contingent assets'. [IAS 19 paras 139, 140].

Post-employment benefits

Types of plan

12 Post-employment benefits are defined by IAS 19 as *"employee benefits (other than termination benefits) which are payable after the completion of employment".* [IAS 19 para 7]. The most common type of post-employment benefit is a pension, although post-retirement health care is also common in some countries.

13 The accounting for post-employment benefits depends on the type of benefits that are promised.

Defined contribution plans

14 Defined contribution plans (often referred to as money purchase plans) are pension plans where the level of benefits depends on the value of contributions paid in respect of each member and the investment performance achieved on those contributions. Therefore, the employer's liability is limited to the fixed contributions it has agreed to pay – it has no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay the benefits. [IAS 19 para 7, 25].

Defined benefit plans

2.15 Defined benefit plans are pension plans where the rules specify the benefits to be paid and the entity has an obligation to finance them accordingly. The majority of these plans define benefits in relation to an employee's final salary (typically the pension will be based on a percentage of final salary for each year of pensionable service). Another form of defined benefit plan that is becoming increasingly common is the average salary plan where the pension is calculated by reference to average pay over an extended period. [IAS 19 paras 26-27].

Other plans

16 Defined benefit plans may be un-funded or wholly or partially funded. In funded plans, future liabilities for benefits are provided for in advance by the accumulation of assets held externally to the employing company's business, or through a qualifying insurance policy. In unfunded plans, pension liabilities are met out of the employer's own resources as they fall due. Other types of plan include multi-employer plans, state plans, group administration plans and insured plans. A description of each of these and how they are measured is given later in this summary.

Measurement and recognition – defined contribution plans

17 The accounting for a defined contribution plan is straightforward because the employer's obligation for each period is determined by the amounts to be contributed for that period. No actuarial assumptions are required to measure the obligation or the expense, and there are no actuarial gains or losses. Obligations are usually short-term in nature, and thus discounting is seldom required. [IAS 19 para 43].

18 The employer should recognise a liability for the contribution payable at the end of each period based on employee services rendered during the period, less any contributions already made. If the employer has made payments in excess of those required, the excess is a prepayment to the extent that the excess will lead to a reduction in future contributions or a cash refund [IAS 19 para 44(a)]. The contributions payable are recognised as an expense unless another standard requires or permits the inclusion of the contribution in the cost of an asset. [IAS 19 para 44(b)].

Measurement – defined benefit plans

19 An employer's obligation under a defined benefit plan is to provide the agreed benefits to current and former employees. [IAS 19 para 27(a)]. Benefits may be in the form of cash payments or in kind, such as medical and dental benefits. The benefits will typically be based on such factors as age, length of service and compensation. The cost of a defined benefit plan may be influenced by many variables such as salaries, employee turnover, mortality, investment returns and discount rates. [IAS 19 para 63].

20 Accounting for defined benefit plans is complex because actuarial assumptions are required to measure the obligation and the expenses, with the possibility that actual results differ from the assumed results. These differences are actuarial gains and losses. Obligations are measured on a discounted basis because they will often be settled many years after the employee renders the services. [IAS 19 para 48]. Actuaries, advising management, almost always perform the calculations of the defined benefit obligation and the current, and prior service cost, although this is not a requirement of IAS 19. [IAS 19 para 57].

21 The obligation should include both legal obligations under the formal terms of a plan and any constructive obligation that arises from the employer's usual business practices that leave it no realistic alternative but to pay employee benefits. [IAS 19 para 52]. A '*constructive obligation*' arises from actions, such as an established pattern of past practice, published policies or a sufficiently specific current statement, indicating that the entity will accept certain responsibilities and, as a result, the entity has created a valid expectation that it will discharge those responsibilities. [IAS 37 para 10].

22 Accounting for defined benefit plans requires an employer entity to undertake the following steps separately for each material employee benefit plan:

- make a reliable estimate of the amount of benefits earned in return for services rendered in current and prior periods, using actuarial techniques. [IAS 19 para 50(a)];
- determine the present value of the defined benefit obligation and current service cost, using the projected unit credit method. [IAS 19 para 50(b)];
- measure the fair value of any plan assets. [IAS 19 para 50(c)];
- assess the total amount of actuarial gains and losses and how they should be recognised (see 'Recognition' below). [IAS 19 para 50(d)];
- determine the past service cost when a plan has been introduced or changed. [IAS 19 para 50(e)]; and
- where a plan has been curtailed or settled, determine the resulting gain or loss. [IAS 19 para 50(f)].

Measurement of defined benefit obligation

23 Employers must use the projected unit credit method to determine the present value of the defined benefit obligation, the related current service cost and any past service cost. [IAS 19 para 50(b), 64]. The projected unit credit method sees each period of service as giving rise to an additional unit of benefit entitlement, and measures each unit separately to build up the final obligation. [IAS 19 para 65].

24 Use of the projected unit credit method involves a number of actuarial assumptions. Actuarial assumptions are an entity's best estimate of the variables that determine the ultimate cost of providing post-employment benefits. [IAS 19 paras 73]. These variables include demographic assumptions such as mortality, employee turnover and retirement age, and financial assumptions such as discount rates, salary and benefit levels, the expected rate of return on plan assets and where post-retirement medical benefits are provided, the medical cost trend rates. [IAS 19 para 73]. Assumptions should be mutually compatible, unbiased and neither imprudent nor excessively conservative. [IAS 19 paras 72, 74, 75]. IAS 19 provides guidance on the selection of certain key assumptions such as the discount rate and the expected rate of return on plan assets. [IAS 19 paras 78-91, 105-107]. Management, advised by actuaries, will select the assumptions to be used.

25 IAS 19 does not require an annual actuarial valuation of the defined benefit obligation. However, the employer is required to determine the present value of the defined benefit obligation and the fair value of the plan assets with sufficient regularity that the amounts recognised in the financial statements do not differ materially from the amounts that would be determined at the balance sheet date. [IAS 19 para 56]. More frequent valuations will be required in a volatile economic environment, for plans that materially affect the financial statements, and in periods in which benefits are amended.

Measurement of plan assets

26 Plan assets are measured at fair value, being market value where available or an estimated value where it is not. [IAS 19 para 102]. Fair value can be estimated by discounting expected future cash flows using a rate that reflects both the risk and expected maturity of the assets, or their potential disposal. [IAS 19 para 102].

27 Certain items are specifically excluded from plan assets, as follows:

- unpaid contributions due from the employer. [IAS 19 para 103];
- non-transferable financial instruments issued by the employer and held by the fund. [IAS 19 para 103]; and
- certain ('non-qualifying') insurance policies. [IAS 19 para 104].

Restrictions on the amount of any net surplus that may be recognised are discussed in paragraph 34 below.

Settlements and curtailments

28 A curtailment occurs when an entity either (a) is demonstrably committed to making a material reduction in the number of employees covered by a plan, or (b) amends the terms of a defined benefit plan such that a material element of future service by current employees will no longer qualify for benefits or qualifies for reduced benefits. Many curtailments are linked to a restructuring or reorganisation plan and should be recognised in the financial statements at the same time as the restructuring. [IAS 19 para 111].

29 Any entity settles its obligations when management enters into a transaction that eliminates all further legal or constructive obligation for part or all of the benefits provided under a defined benefit plan. Settlements are usually lump-sum cash payments made to or on behalf of plan participants in exchange for the right to receive specified future post-employment benefits. [IAS 19 para 112]. Acquisition of rights under an insurance policy is not a settlement if the entity retains an obligation to pay further amounts if the insurer fails to pay. [IAS 19 para 113].

30 Gains or losses on a settlement or curtailment should be recognised when the settlement or curtailment occurs. [IAS 19 para 109]. This is when the entity enters into a contractually binding agreement, and the employees concerned have made an irrevocable decision to agree to the proposals. Management's intent to curtail or settle a defined benefit plan is not a sufficient basis to recognise such an event. [IAS 19 BC79].

31 The accounting for a settlement or curtailment is the same. When a settlement or curtailment occurs, an entity should re-measure the defined benefit obligation (and plan assets) using current actuarial assumptions (for example, a new discount rate based on market interest rates). [IAS 19 para 110]. A settlement gain or loss is measured based on:

- any resulting change in the defined benefit obligation and fair value of plan assets; and
- the related share of previously unrecognised actuarial gains and losses (corridor approach) and past-service costs.

[IAS 19 para 109].

32 A settlement and curtailment occur together if the plan is terminated such that the obligation is settled and the plan no longer exists. Termination of a plan is not a curtailment or settlement if it is replaced by a new plan that offers benefits that are in substance identical. [IAS 19 para 114].

Recognition – defined benefit plans

Balance sheet

33 IAS 19 requires the amount recognised as a defined benefit liability (or asset, if negative) to be the net total of the following amounts:

- The present value of the defined benefit obligation at the balance sheet date.
- *Plus* any actuarial gains (less any actuarial losses) not recognised because of the application of the 'corridor' approach.
- *Minus* any past service cost not yet recognised.
- *Minus* the fair value at the balance sheet date of plan assets (if any) out of which the obligations are to be settled directly.

[IAS 19 para 54].

34 If the net balance amount is an asset or surplus, IAS 19 (supplemented by guidance in IFRIC 14) restricts the amount of the surplus that can be recognised to the economic benefit available to the entity either in the form of:

- a refund from the plan to which the entity has an unconditional right; or
- a reduction in future contributions. [IAS 19 para 58, IFRIC 14 para 11].

35 IFRIC 14 also gives guidance on when a minimum funding requirement may give rise to an additional liability. Such an additional liability arises only if two conditions are satisfied: (a) the entity has a statutory or contractual obligation to pay additional amounts to the plan; and (b) the entity's ability to recover those amounts in the future is restricted. [IFRIC 14 para 3].

Income statement

36 IAS 19 analyses the changes in the plan assets and liabilities into various components the net total of which is recognised as an expense or income in the income statement (except to the extent that another standard requires or permits them to be capitalised in the cost of an asset). The individual components are:

- Current service cost. (The present value of the benefits earned by active employees in the current period.)
- Interest cost. (The unwinding of the discount on the defined benefit obligation using the appropriate high-quality corporate bond rate (or government bond rate) at the beginning of the year.)
- Expected return on any plan assets. (Expected interest, dividends and capital growth of plan assets. The difference between the actual and expected return in a period is an actuarial gain or loss.)
- Actuarial gains and losses, to the extent they are recognised (see below).
- Past service costs. (The change in the present value of the plan liabilities relating to employee service in prior periods arising from changes to post-employment benefits. Past service costs are recognised over the period until the amended benefits vest. If the benefits are already vested, the past service cost is recognised as an expense immediately. Although described as past service costs, they may sometimes represent income.)
- The effect of any settlement or curtailment (see above).
- The effect of the limit imposed by paragraph 58(b) of IAS 19 on the amount of asset that may be recognised, unless actuarial gains and losses are recognised outside profit or loss (see below).

[IAS 19 para 61].

Recognition of actuarial gains and losses

37 Actuarial gains and losses arise when the values of plan assets and liabilities are re-measured at the balance sheet date. They result from unexpected increases or decreases in the fair value of the plan assets or the present value of the plan liabilities. Examples include:

- Experience gains and losses arising where actual events during the year differ from the actuarial assumptions in the previous valuation.
- The effects of changes in estimates and assumptions.
- The difference between the expected and actual return on plan assets.

38 There are three permissible methods under IAS 19 for recognising actuarial gains and losses. These are outlined in the paragraphs below.

39 The first method allows entities to recognise actuarial gains and losses in full as they arise in other comprehensive income (OCI), providing it does so for all of its defined benefit plans and for all of its actuarial gains and losses. [IAS 19 para 93A].

40 The second method is to account for actuarial gains and losses by viewing estimates of post-employment benefit obligations as a range (or ‘corridor’) around a best estimate. If actuarial gains and losses fall within the ‘corridor’, this suggests that estimates and assumptions were reasonably reliable, so the actuarial gains and losses need not be recognised in the income statement. In other words, the ‘corridor’ represents a tolerable margin of uncertainty. [IAS 19 para 95].

41 Actuarial gains and losses in excess of the ‘corridor limit’ are recognised over the expected average remaining working lives of employees. The limit is the greater of:

- 10 per cent of the present value of the defined benefit obligation (before deducting plan assets) at the end of the previous reporting period; and
- 10 per cent of the fair value of any plan assets at that date.

[IAS 19 para 92, 93].

42 The third method allows an entity to adopt any systematic method that results in faster recognition of actuarial gains and losses, provided that the same basis is applied to both gains and losses and the basis is applied consistently from period to period. Immediate recognition in the income statement of all actuarial gains and losses is permissible, although rare in practice. [IAS 19 para 93].

Other plans

Multi-employer plans

43 A multi-employer plan, is a plan, other than a state plan, that pools the assets contributed by various entities that are not under common control and uses those assets to provide benefits to employees of more than one entity, on the basis that contribution and benefit levels are determined without regard to the identity of the entity that employs the employees concerned. [IAS 19 para 7].

44 An entity is required to classify a multi-employer plan as either a defined contribution plan or a defined benefit plan according to the terms of the plan in the normal way. [IAS 19 para 29].

45 Where the plan is a defined benefit plan the employer should account for its proportionate share of the defined benefit obligation, plan assets and costs as for any other defined benefit plan. [IAS 19 para 29]. However, there may be circumstances where the employer has insufficient information and cannot follow defined benefit accounting. The employer would account for such a plan as a defined contribution plan and make supplemental disclosures. [IAS 19 para 30, 32].

State plans

46 State-sponsored plans should be accounted for in the same manner as multi-employer plans. [IAS 19 para 36]. State-sponsored plans are established by legislation and operated by national or local governments, or another entity created by government outside the control of the reporting entity. [IAS19 para 37]. Many state plans are funded on a pay-as-you-go basis, with contributions set at a level that is expected to be sufficient to fund the current period's benefit distributions. The benefit formula for these plans is often based on employee service, but the employer has no legal or constructive obligation to pay those benefits. The employer's only obligation is to pay contributions as they fall due. The employer may cease to employ individuals covered by the state plan or may cease operations altogether. It will, for most state plans, have no obligation to pay the benefits its employees earned in previous years. Most state plans are, therefore, defined contribution plans. [IAS 19 para 38].

Group administration plans

47 Group administration plans are different from multi-employer plans. Group administration plans are an aggregation of single-employer plans, combined to allow participating employers to pool assets for investment purposes and reduce investment management and administration costs. The claims of different employers are segregated for the sole benefits of their own employees. The information to allow employers to account properly for group administration plans is readily available and, therefore, pose no unique accounting problems. Group administration plans do not expose the participating employers to the actuarial risks associated with the current and former employees of other employers. [IAS 19 para 33].

Group plans for entities under common control

48 Defined benefit plans that share risks between various entities under common control (for example a parent and its subsidiaries) are not multi-employer plans. [IAS 19 para 34]. An entity that participates in such a plan should obtain information about the plan as a whole, measured in accordance with IAS 19. The net defined benefit cost should then be allocated among the participating entities as follows:

- If there is a contractual agreement or stated policy for charging the net defined benefit cost for the plan as a whole to participating entities, the entity should, in its separate or individual financial statements, recognise the net defined benefit cost so charged.
- If there is no such agreement or policy, the net defined benefit cost for the plan as a whole should be recognised in the separate or individual financial statements of the entity that is legally the sponsoring employer for the plan. The other group entities should recognise, in their separate or individual financial statements, a cost equal to their contribution payable for the period.

[IAS 19 para 34A].

Insured plans

49 An employer may pay insurance premiums to fund a post-employment benefit plan. These plans are generally treated as defined contribution plans unless the employer retains either a legal or constructive obligation to pay benefits as they fall due or to make supplemental payments if the insurer does not have sufficient assets. [IAS 19 para 39]. The employer may retain the obligation directly through a guarantee or commitment to the insurer or employees, or it may retain the obligation indirectly through the mechanism that sets contributions. [IAS 19 para 41].

50 Where the employer has retained the obligation, it accounts for the plan as a defined benefit plan, with the qualifying insurance policies as plan assets and other insurance policies as reimbursement rights. [IAS 19 para 42]. A qualifying insurance policy is one issued by a non-related party insurer where the proceeds can only be used to pay or fund employee benefits, are not available to the employer's creditors (even on bankruptcy) and cannot be repaid to the entity unless they are surplus assets or are to reimburse the entity for benefits paid. [IAS 19 para 7].

Disclosures

51 IAS 19 does not require any specific disclosures of short-term and other long-term benefits, but other standards do, for example IAS 24 requires employee benefits disclosures for key management personnel, and IAS 1 requires disclosure of the employee benefit expense. [IAS 19 paras 23, 131]. If there is uncertainty about the number of employees who will accept termination benefits, a contingent liability should be disclosed. [IAS 19 para 141]. If there is insufficient information available to use defined benefit accounting for a multi-employer plan, then that fact and the reason why should be disclosed. [IAS 19 para 30]. Specific disclosures for entities participating in a group plan are required. [IAS 19 para 34B].

Defined contribution plans

52 The only specific disclosure required by IAS 19 in respect of defined contribution plans is the amount recognised as an expense in the period. [IAS 19 para 46].

Defined benefit plans

53 IAS 19 contains extensive disclosure requirements in respect of defined benefit pension plans. [IAS 19 para 120, 120A]. Disclosures include:

- The accounting policy for recognising actuarial gains and losses.
- A description of the plans.
- Reconciliations of the opening and closing balances of both the present value of the defined benefit obligation and the fair value of plan assets (if any).
- A split of the defined benefit obligation into funded and unfunded amounts.
- A reconciliation of the present value of the defined benefit obligation and the fair value of plan assets to the assets and liabilities recognised on the balance sheet.
- The total income statement expense, split into its separate components.
- The amounts recognised in other comprehensive income, and the cumulative total of any actuarial gains and losses so recognised.
- A breakdown of plan assets into major sub-categories.
- How the expected rate of return is calculated.
- Details of the principal actuarial assumptions (we would expect this to include mortality given comments in the media and by regulators).
- Sensitivity analysis for medical cost trend rates.
- A five-year history of the present value of the defined benefit obligation, fair value of plan assets, experience adjustments thereon, and the surplus or deficit in the plan.
- The best estimate of future contributions to be paid.

Events after the reporting period and financial commitments

Overview

It is not generally practicable for preparers to finalise financial statements without a period of time elapsing between the balance sheet date and the date on which the financial statements are authorised for issue. The question therefore arises as to the extent to which events occurring between the balance sheet date and the date of approval (that is, 'events after the reporting period') should be reflected in the financial statements.

Events after the reporting period are either adjusting events or non-adjusting events. Adjusting events provide further evidence of conditions that existed at the balance sheet date – for example, determining after the year end the consideration for assets sold before the year end. Non-adjusting events relate to conditions that arose after the balance sheet date – for example, announcing a plan to discontinue an operation after the year end.

The carrying amounts of assets and liabilities at the balance sheet date are adjusted only for adjusting events or events that indicate that the going-concern assumption in relation to the whole entity is not appropriate. Significant non-adjusting post-balance-sheet events, such as the issue of shares or major business combinations, are disclosed.

Dividends proposed or declared after the balance sheet date but before the financial statements have been authorised for issue are not recognised as a liability at the balance sheet date. Details of these dividends are, however, disclosed.

An entity discloses the date on which the financial statements were authorised for issue and the persons authorising the issue and, where necessary, the fact that the owners or other persons have the ability to amend the financial statements after issue.

Resources

Standards and interpretations

- IAS 10, 'Events after the reporting period'

PwC guidance

- Manual of Accounting chapter 22, Events after the reporting period and financial commitments

Summary of key requirements

Objective and scope

1 IAS 10, 'Events after the reporting period', prescribes when an entity should adjust its financial statements for events that take place after the balance sheet date. The standard specifies the disclosures that an entity should give about the date of authorisation of the financial statements and about events that occur between the balance sheet date and the date of authorisation of the financial statements. It notes that an entity should not prepare financial statements on the going concern basis if events that occur after the balance sheet date indicate that the going concern assumption is not appropriate. Hence, the standard applies to accounting for and disclosing events after the balance sheet date. [IAS 10 paras 1, 2].

Definitions

2 'Events after the reporting period' are those events, favourable and unfavourable, that occur between the balance sheet date and the date when the financial statements are authorised for issue. The IAS identifies two types of events; 'adjusting' events, which provide evidence of conditions that existed at the balance sheet date and 'non-adjusting' events, which indicate conditions that arose after the balance sheet date. [IAS 10 para 3].

3 The date on which the financial statements are authorised for issue depends on the management structure, statutory requirements and procedure followed by the entity. Normally the date of approval is taken as being when the statements are approved by the directors for publication to external parties. [IAS 10 paras 4 to 7].

Recognition

4 Adjusting events are recognised in the financial statements of the period just ended, whereas non-adjusting events are not recognised, but some are disclosed in the notes to the financial statements. [IAS 10 paras 8, 10, 21].

5 Examples of adjusting events requiring recognition in the financial statements include:

- Settlement of a court case that confirms that the entity had a present obligation at the balance sheet date.
- Evidence that an asset was impaired at the balance sheet date, including the bankruptcy of a debtor and selling prices achieved for inventory after the balance sheet date.
- Finalisation of prices for assets sold or purchased before the balance sheet date.
- Discovery of fraud or error that indicates that the financial statements are misstated.

- Determination after the balance sheet date of bonuses relating to the year.

[IAS 10 para 9].

Dividends

6 Dividends declared (that is, dividends appropriately authorised and no longer at the entity's discretion) to holders of equity instruments after the balance sheet date should not be recognised as a liability at the balance sheet date as no obligation exists at that time. [IAS 10 paras 12, 13; IAS 32 AG13].

7 Dividends receivable should be recognised when the shareholders' right to receive payment is established. [IAS 18 para 30].

Going concern

8 An entity should not prepare its financial statements on a going concern basis if management determines after the balance sheet date either that it intends to liquidate the entity or to cease trading, or that it has no realistic alternative but to do so. [IAS 10 para 14]. IAS 1 (revised), 'Presentation of financial statements', contains specific disclosure requirements in this situation.

Disclosure

9 IAS 10 requires disclosure of the date when the financial statements were authorised for issue; who gave that authorisation; and, if shareholders or other parties have the power to amend the statements after issue, disclosure of that fact. [IAS 10 para 17].

10 Dividends declared before the financial statements were authorised for issue, but not recognised during the period covered by the financial statements, should be disclosed. [IAS 10 para 13]. IAS 1 (revised) extends this requirement to dividends proposed, but not recognised and specifies that both the amount of the dividend proposed or declared, but not recognised, and the related amount per share should be disclosed. [IAS 1 (revised) para 137].

11 If non-adjusting events are material, non-disclosure could influence the economic decisions of users of the financial statements. Therefore, an entity should disclose, for each material category of non-adjusting event, the nature of the event and an estimate of its financial effect, or a statement that such an estimate cannot be made. [IAS 10 para 21].

12 Examples of non-adjusting events that require disclosure are given in the standard. They include the following where they occur after the balance sheet date:

- A major business combination (see also IFRS 3 (revised)).
- Announcing a plan to discontinue an operation or a major restructuring.
- Major purchases of assets, classification of assets as held for sale (see also IFRS 5) or destruction of assets by, for example, fire or flood.
- Abnormal changes in foreign exchange rates or asset prices and significant changes in tax rates.
- Major share transactions. IAS 33, 'Earnings per share', requires an entity to give a brief description of such transactions, except when they involve capitalisation or bonus issues, share splits or share consolidations (which are all required to be adjusted in the EPS calculation under IAS 33).
- Entering into significant contingent liabilities or commitments or commencing major litigation relating to events occurring after the balance sheet date.

[IAS 10 para 22].

13 Where an entity receives information after the balance sheet date about conditions that existed at the balance sheet date, the disclosures relating to those conditions should be updated in light of the new information. [IAS 10 para 19].

Extractive industries

Overview

IFRS 6, 'Exploration for and evaluation of mineral resources', addresses the financial reporting for the exploration for and evaluation of mineral resources. It does not address other aspects of accounting by entities engaged in the exploration for and evaluation of mineral reserves (such as activities before an entity has acquired the legal right to explore or after the technical feasibility and commercial viability to extract resources have been demonstrated). Activities outside the scope of IFRS 6 are accounted for according to the applicable standards (such as IAS 16, 'Property, plant and equipment', IAS 37, 'Provisions, contingent liabilities and contingent assets', and IAS 38, 'Intangible assets'.)

The accounting policy adopted for the recognition of exploration and evaluation assets should result in information that is relevant and reliable. As a concession, certain further rules of IAS 8, 'Accounting policies, changes in accounting estimates and errors', need not be applied. This permits companies in this sector to continue, for the time being, to apply policies that were followed under national GAAP that would not comply with the requirements of IFRS. The accounting policy may be changed only if the change makes the financial statements more relevant and no less reliable, or more reliable and no less relevant – in other words, if the new accounting policy takes it closer to the requirements in the IASB's Framework.

Exploration and evaluation assets are initially measured at cost. They are classified as tangible or intangible assets, according to the nature of the assets acquired. Management applies that classification consistently. After recognition, management applies either the cost model or the revaluation model to the exploration and evaluation assets, based on IAS 16, 'Property, plant and equipment', or IAS 38, 'Intangible assets', according to nature of the assets. As soon as technical feasibility and commercial viability are determined, the assets are no longer classified as exploration and evaluation assets.

The exploration and evaluation assets are tested for impairment when facts and circumstances suggest that the carrying amounts may not be recovered. The assets are also tested for impairment before reclassification out of exploration and evaluation. The impairment is measured, presented and disclosed according to IAS 36, 'Impairment of assets', except that exploration and evaluation assets are allocated to cash-generating units or groups of cash-generating units no larger than a segment. Management discloses the accounting policy adopted, as well as the amount of assets, liabilities, income and expense and investing cash flows arising from the exploration and evaluation of mineral resources.

Resources

Standards and interpretations

- IFRS 6, 'Exploration for and evaluation of mineral resources'

Exposure drafts and discussion papers

- Draft version of the extractive activities discussion paper

Summary of key requirements

1 The standard applies to 'exploration and evaluation expenditures'. This means those expenditures incurred by an entity in connection with the exploration for, and evaluation of, mineral resources before the technical feasibility and commercial viability of extracting a mineral resource are demonstrable. Exploration for, and evaluation of, mineral resources covers the search for mineral resources, including minerals, oil, natural gas and similar non-regenerative resources after the entity has obtained legal rights to explore in a specific area, as well as determining the technical feasibility and commercial viability of extracting the mineral resource. [IFRS 6 App].

2 The standard does not apply to expenditures incurred before exploring for, and evaluating, mineral resources, such as expenditures incurred before the entity has obtained the legal rights to explore a specific area. It also does not apply after the entity has demonstrated the technical feasibility and commercial viability of extracting a mineral resource. [IFRS 6 paras 3-5].

Accounting policy

3 An entity's management uses its judgement in developing and applying an accounting policy for exploration and evaluation expenditures in accordance with paragraph 10 of IAS 8, 'Accounting policies, changes in accounting estimates and errors'. [IFRS 6 para 6]. Such a policy should result in information that is relevant to the economic decision-making needs or users and is reliable. [IAS 8 para 10].

Measurement

4 The accounting policy should specify the expenditures that are recognised as exploration and evaluation assets and these are initially measured at cost. The standard gives examples of expenditures that might be included as assets such as: the acquisition of rights to explore; topographical, geological, geochemical and geophysical studies; and exploratory drilling. [IFRS 6 paras 8, 9].

5 Expenditures incurred in relation to the development of mineral resources cannot be recognised as exploration and evaluation assets and are expensed. Obligations for removal and restoration costs are accounted for in accordance with IAS 37, 'Provisions, contingent liabilities and contingent assets'. [IFRS 6 paras 10, 11].

6 After initial recognition, an entity can either use the cost model or the revaluation model for its exploration and evaluation assets. [IFRS 6 para 12].

Classification

7 Exploration and evaluation assets have to be classified as tangible or intangible assets according to the nature of the assets acquired. Drilling rights are an example of expenditures classified as intangible assets and vehicles and drilling rigs are examples of expenditures that are classified as tangible assets. [IFRS 6 paras 15,16]. When the technical feasibility and commercial viability of extracting mineral resources has been demonstrated, exploration and evaluation assets are reclassified to other categories of assets in accordance with the entity's accounting policy. Such assets are tested for impairment before reclassification. [IFRS 6 para 17].

Impairment

8 Where circumstances suggest that the carrying amount of exploration and evaluation assets exceeds their recoverable amount they are assessed for impairment. IAS 36, 'Impairment of assets', is then applied except that paragraphs 8-17 of IAS 36 are replaced by paragraph 20 of IFRS 6. Paragraph 20 identifies the types of circumstances when exploration and evaluation assets might be impaired and require tested for impairment in accordance with IAS 36, for example:

- The exploration period has expired or will expire in the near future and it is not expected to be renewed.
- Further evaluation of mineral resources in the specific area is not budgeted for or planned.
- Exploration has not led to the discovery of commercially viable mineral resources.
- The exploration and evaluation asset is unlikely to be recovered in full from successful development or by sale.

[IFRS 6 paras 18-20].

9 For impairment testing an entity develops an accounting policy to allocate exploration and evaluation assets to cash-generating units or groups of cash generating units. These cash generating units can be no larger than an operating segment. The level identified for testing can include more than one cash-generating unit. [IFRS 6 paras 19-22].

Disclosure

10 An entity needs to explain the amounts recognised in its financial statements arising from the exploration for and evaluation of mineral resources including:

- giving its accounting policies and in particular its recognition policy for exploration and evaluation assets;
- disclosing the amounts of assets, liabilities, income and expense and operating and investing cash flows arising; and
- making the disclosures required by either IAS 16 or IAS 38, treating exploration and evaluation assets as a separate class of assets.

[IFRS 6 paras 23-25].

Financial instruments – Objectives and scope

Overview

Financial instruments are addressed in three standards: IAS 32 'Financial instruments; Presentation', which deals with distinguishing debt from equity and with netting; IAS 39, 'Financial instruments; Recognition and measurement', which contains requirements for recognition and measurement; and IFRS 7, 'Financial instruments; Disclosures', which deals with disclosures.

The objective of the three standards is to establish requirements for all aspects of accounting for financial instruments, including distinguishing debt from equity, netting, recognition, derecognition, measurement, hedge accounting and disclosure.

The scope of the standards is broad. The standards cover all types of financial instrument, including receivables, payables, investments in bonds and shares, borrowings and derivatives. They also apply to certain contracts to buy or sell non-financial assets (such as commodities) that can be net-settled in cash or another financial instrument.

In November 2009, the IASB published the first part of its three stage project to replace IAS 39, in the form of a new standard IFRS 9. See page [ ] for the IFRS 9 topic summary.

Resources

Standards and interpretations

- IFRS 7, 'Financial instruments: Disclosures'
- Annual improvements 2010 amendments to IFRS 7, 'Financial instruments: Disclosures'
- IFRS 9, 'Financial instruments'
- IAS 32, 'Financial instruments: Presentation'
- Amendment to IAS 32, 'Financial instruments: Presentation', and IAS 1, 'Financial statement presentation', on 'Puttable financial instruments and obligations arising on liquidation'
- Amendment to IAS 32, 'Financial instruments: Presentation', on 'Classification of rights issues'
- IAS 39, 'Financial instruments: Recognition and measurement'
- Amendment to IAS 39, 'Financial instruments: Recognition and measurement', and IFRS 7, 'Financial instruments: Disclosures', on the 'Reclassification of financial assets'
- Amendment to IAS 39, 'Financial instruments: Recognition and measurement', on 'Eligible hedged items'
- IFRIC 9, 'Re-assessment of embedded derivatives'
- Amendment to IFRIC 9, 'Re-assessment of embedded derivatives' and IAS 39, 'Financial instruments: Recognition and measurement', on 'Embedded derivatives'
- IFRIC 16, 'Hedges of a net investment in a foreign operation'

Exposure drafts and discussion papers

- Exposure draft, 'Fair value options for financial liabilities'
- Exposure draft, 'Financial instruments – amortised cost and impairment'
- Discussion paper on 'Credit risk in liability measurement'
- Discussion paper on 'Reducing complexity in reporting financial instruments'
- Discussion paper on 'Financial instruments with characteristics of equity'

PwC views

- PwC comment letter on discussion paper on 'Credit risk in liability measurement'
- PwC comment letter on discussion paper on 'Reducing complexity in reporting financial instruments'
- PwC comment letter on discussion paper on 'Financial instruments with characteristics of equity'

PwC guidance

- Manual of Accounting – Financial instruments chapter 3, Objectives and scope of IAS 32, IAS 39 and IFRS 7.

PwC views

- PwC comment letter to the IASB on exposure draft 'Financial instruments: Classification and measurement'

Tools practice aids and publications

- Financial instruments under IFRS: A guide through the maze

Summary of key requirements

Objectives

1 IAS 32 establishes principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and liabilities. It applies to classification of financial assets, financial liabilities and equity instruments from the issuer's perspective; the classification of related interest, dividends, losses and gains; and the circumstances in which financial assets and liabilities can be offset. [IAS 32 para 2].

2 IAS 39 establishes rules for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. IAS 39 also deals with derecognition of financial assets and liabilities and hedge accounting. [IAS 39 para 1].

3 IFRS 7 requires entities to provide disclosures that enable users to evaluate:

- the significance of financial instruments for the entity's financial position and performance; and
- the nature and extent of risks arising from financial instruments to which the entity is exposed and how the entity manages them.

[IFRS 7 para 1].

Scope

4 The scope of the three standards is very wide ranging. The definition of a financial instrument under IFRS is *''any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity''.* [IAS 32 para 11]. This definition encompasses cash, debt and equity investments, trade receivables and payables, debt, certain provisions, net cash-settled commodity contracts and derivatives (including embedded derivatives). However, certain financial instruments are excluded from the scope of one or all of the standards, as summarised in the table below.

Financial instruments – Objectives and scope

Within scope of IAS 32, IAS 39 and IFRS 7	Within scope of IAS 32 and IFRS 7 only	Out of scope
Debt and equity investments		Investments in subsidiaries, associates and joint ventures Contingent consideration in a business combination (Note 1)
Loans (due from others) and receivables	Lease receivables (Note 2)	
Debt (due to others)	Lease payables (Note 2) Own equity	Employee benefits Share-based payments
Cash and cash equivalents		
Derivatives – for example: • Interest rate swaps • Currency forwards/swaps • Purchased/written options • Commodity contracts (Note 3) • Collars/caps • Credit derivatives • Cash or net share settleable derivatives on own shares	Derivatives on own shares settled only by delivery of a fixed number of shares for a fixed amount of cash	Own use commodity contracts (Note 3)
Derivatives on subsidiaries, associates and joint ventures		
Embedded derivatives		
Loan commitments held for trading (Note 4)	Other loan commitments	
Financial guarantees (Note 5)		Insurance contracts

Note 1 – Contracts for contingent consideration in a business combination are addressed in IFRS 3, 'Business combinations'. Such contracts are scoped out of IAS 32, IFRS 7 and IAS 39. This exemption applies only to the acquirer, but from the perspective of the seller contingent consideration normally falls within the scope of IAS 39 as a financial asset (see also IFRS Manual of Accounting chapter 26). However, once the entity starts to apply IFRS 3 (revised), the scope exemption will be deleted and all contracts for contingent consideration will fall within the scope of IAS 39.

Note 2 – Lease receivables are included in IAS 39's scope for derecognition and impairment purposes only. Finance lease payables are subject to the derecognition provisions. Any derivatives embedded in lease contracts are also within IAS 39's scope.

Note 3 – Contracts to buy or sell non-financial items are within IAS 32's scope, IAS 39 and IFRS 7 if they can be settled net in cash or another financial asset and they do not meet the test of being entered into and continuing to be held for the purpose of receipt or delivery of non-financial items to meet the entity's expected purchase, sale or usage requirements (known as 'own use commodity contracts'). Settling net includes taking delivery of the underlying and selling it within a short period after delivery to generate a profit from short-term fluctuations in price.

Note 4 – Loan commitments are outside IAS 39's scope if they cannot be settled net in cash or by some other financial instrument unless: they are held for trading or to generate assets of a class that the entity has a past practice of selling; the entity chooses to include them; or they are to provide a loan at a below market rate of interest.

Financial instruments – Nature and characteristics

Overview

Financial instruments include a wide range of assets and liabilities, such as trade debtors, trade creditors, loans, finance lease receivables and derivatives. They are recognised and measured according to IAS 39's requirements and are disclosed in accordance with IFRS 7.

Financial instruments represent contractual rights or obligations to receive or pay cash or other financial assets. Non-financial items have a more indirect, non-contractual relationship to future cash flows.

A financial asset is cash; a contractual right to receive cash or another financial asset; a contractual right to exchange financial assets or liabilities with another entity under conditions that are potentially favourable; or an equity instrument of another entity.

A financial liability is a contractual obligation to deliver cash or another financial asset; or to exchange financial instruments with another entity under conditions that are potentially unfavourable.

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

A derivative is a financial instrument that derives its value from an underlying price or index; requires little or no initial net investment; and is settled at a future date.

Resources

Standards and interpretations

- IFRS 7, 'Financial instruments: Disclosures'
- Annual improvements 2010 amendments to IFRS 7, 'Financial instruments: Disclosures'
- IFRS 9, 'Financial instruments'
- IAS 32, 'Financial instruments: Presentation'
- Amendment to IAS 32, 'Financial instruments: Presentation', and IAS 1, 'Financial statement presentation', on 'Puttable financial instruments and obligations arising on liquidation'
- Amendment to IAS 32, 'Financial instruments: Presentation', on 'Classification of rights issues'
- IAS 39, 'Financial instruments: Recognition and measurement'
- Amendment to IAS 39, 'Financial instruments: Recognition and measurement', and IFRS 7, 'Financial instruments: Disclosures', on the 'Reclassification of financial assets'
- Amendment to IAS 39, 'Financial instruments: Recognition and measurement', on 'Eligible hedged items'
- IFRIC 9, 'Re-assessment of embedded derivatives'
- Amendment to IFRIC 9, 'Re-assessment of embedded derivatives' and IAS 39, 'Financial instruments: Recognition and measurement', on 'Embedded derivatives'
- IFRIC 16, 'Hedges of a net investment in a foreign operation'

Exposure drafts and discussion papers

- Exposure draft, 'Fair value options for financial liabilities'
- Exposure draft, 'Financial instruments – amortised cost and impairment'
- Discussion paper on 'Credit risk in liability measurement'
- Discussion paper on 'Reducing complexity in reporting financial instruments'
- Discussion paper on 'Financial instruments with characteristics of equity'

PwC views

- PwC comment letter on discussion paper on 'Credit risk in liability measurement'
- PwC comment letter on discussion paper on 'Reducing complexity in reporting financial instruments'
- PwC comment letter on discussion paper on 'Financial instruments with characteristics of equity'

PwC guidance

- Manual of Accounting – Financial instruments chapter 4, Nature and characteristics of financial instruments

Tools practice aids and publications

- Financial instruments under IFRS: A guide through the maze
- A practical guide for investment funds on IAS 32 amendments

Summary of key requirements

1 The definition of a financial instrument under IFRS is *''any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity''.* [IAS 32 para 11]. One of the key components of the definition is that all financial instruments are defined by contracts. It follows that non-contractual obligations, such as taxation, are not financial instruments.

2 A financial asset is any asset that is:

- Cash.
- An equity instrument of another entity.
- A contractual right:
  - to receive cash or another financial asset from another entity; or

  - to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity.
- A contract that will or may be settled in the entity's own equity instruments and is:
  - a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or
  - a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include puttable instruments and obligations arising on liquidation that are classified as equity or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments, for example, options to repurchase an entity's own equity shares.

[IAS 32 para 11].

Examples of financial assets are trade receivables, loans, investments in shares and finance lease receivables.

3 A financial liability is any liability that is:

- A contractual obligation:
  - to deliver cash or another financial asset to another entity; or
  - to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity.
- A contract that will or may be settled in the entity's own equity instruments and is:
  - a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or
  - a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include puttable instruments and obligations arising on liquidation that are classified as equity or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.

[IAS 32 para 11].

Examples of financial liabilities are trade payables, bank overdrafts and borrowings, issued debt and redeemable preference shares. An obligation to deliver 1,000 of an entity's own shares is not a financial liability (but is equity) whereas an obligation to deliver C1,000 worth of the shares is a financial liability.

4 An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities. [IAS 32 para 11]. Examples of equity instruments include non-puttable ordinary shares, some types of preference shares, share warrants or written call options that allow the holder to subscribe for or purchase a fixed number of non-puttable ordinary shares in the issuing entity in exchange for a fixed amount of cash or another financial asset. An amendment to IAS 32 issued in February 2008 results in certain puttable instruments and obligations arising only on liquidation of the entity being classified as equity, as a limited exception to the definition in paragraph 2.3.

5 Derivatives are financial instruments that derive their value from an underlying price or index, such as an interest rate, a foreign exchange rate or commodity price. Derivatives can be settled net or gross in cash/another financial asset. IAS 39 defines a derivative as a financial instrument or other contract with all of the following characteristics:

- 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').
- 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.
- It is settled at a future date.

[IAS 39 para 9].

Examples of derivatives are forwards, swaps, options or futures.

Financial instruments – Embedded derivatives

Overview

Some financial instruments and other contracts combine, in a single contract, both a derivative and a non-derivative. The derivative part of the contract is referred to as an 'embedded derivative'. Its effect is that some of the contract's cash flows vary in a similar way to a stand-alone derivative. For example, the principal amount of a bond may vary with changes in a stock market index. In this case, the embedded derivative is an equity derivative on the relevant stock market index.

Embedded derivatives that are not 'closely related' to the rest of the contract are separated and accounted for as stand-alone derivatives (that is, measured at fair value, generally with changes in fair value recognised in profit or loss). An embedded derivative is not 'closely related' if its economic characteristics and risks are different from those of the rest of the contract. IAS 39 sets out many examples to help determine when this test is (and is not) met.

Analysing contracts for potential embedded derivatives is one of the more challenging aspects of IAS 39.

Resources

Standards and interpretations

- IFRS 7, 'Financial instruments: Disclosures'
- Annual improvements 2010 amendments to IFRS 7, 'Financial instruments: Disclosures'
- IFRS 9, 'Financial instruments'
- IAS 32, 'Financial instruments: Presentation'
- Amendment to IAS 32, 'Financial instruments: Presentation', and IAS 1, 'Financial statement presentation', on 'Puttable financial instruments and obligations arising on liquidation'
- Amendment to IAS 32, 'Financial instruments: Presentation', on 'Classification of rights issues'
- IAS 39, 'Financial instruments: Recognition and measurement'
- Amendment to IAS 39, 'Financial instruments: Recognition and measurement', and IFRS 7, 'Financial instruments: Disclosures', on the 'Reclassification of financial assets'
- Amendment to IAS 39, 'Financial instruments: Recognition and measurement', on 'Eligible hedged items'
- IFRIC 9, 'Re-assessment of embedded derivatives'
- Amendment to IFRIC 9, 'Re-assessment of embedded derivatives', and IAS 39, 'Financial instruments: Recognition and measurement', on 'Embedded derivatives'
- IFRIC 16, 'Hedges of a net investment in a foreign operation'

Exposure drafts and discussion papers

- Exposure draft, 'Fair value options for financial liabilities'
- Exposure draft, 'Financial instruments – amortised cost and impairment'
- Discussion paper on 'Credit risk in liability measurement'
- Discussion paper on 'Reducing complexity in reporting financial instruments'
- Discussion paper on 'Financial instruments with characteristics of equity'

PwC views

- PwC comment letter on discussion paper on 'Credit risk in liability measurement'
- PwC comment letter on discussion paper on 'Reducing complexity in reporting financial instruments'
- PwC comment letter on discussion paper on 'Financial instruments with characteristics of equity'

PwC guidance

- Manual of Accounting – Financial instruments chapter 5, Embedded derivatives in host contracts

Tools practice aids and publications

- IFRS extracts from accounts
- Financial instruments under IFRS: A guide through the maze

Summary of key requirements

Overview

1 Some financial instruments and other contracts combine, in a single contract, both a derivative and a non-derivative. The derivative part of the contract is referred to as an 'embedded derivative' and the rest of the contract as the 'host'. IAS 39 paragraph 10 describes an embedded derivative as a component of a hybrid (combined) instrument that also includes a non-derivative host contract – with the effect that some of the cash flows of the contract vary in a way similar to a stand-alone derivative.

2 Embedded derivatives that meet certain conditions must be separated and accounted for as stand-alone derivatives (that is, measured at fair value generally with changes in fair value recognised in profit or loss). The main condition in practice is that the embedded derivative is not 'closely related' to the host contract. IAS 39 sets out many examples to help determine when this 'closely related' test is (and is not) met.

Identifying whether a contract contains embedded derivatives

3 An indication of the presence of embedded derivatives is when the amounts to be received or delivered under a

contract vary because they are linked to a market price or a market index. If the amounts to be received or delivered under the contract do not vary, there would be no embedded derivatives.

4 Embedded derivatives are often contained in financial contracts. However, non-financial contracts like operating leases, commodity and other long-term supply contracts also may contain them.

5 Certain terms and phrases in contracts may indicate the presence of an embedded derivative. Such terms and phrases include:

- Pricing based on a formula.
- The right to purchase/sell additional quantities.
- Terms allowing or requiring the contract to being exchanged into something else.
- Phrases such as indexed to/adjusted by/referenced to.
- Premium/strike/limits.
- The right to cancel/extend/repurchase/return.

6 Where the cash flows or volumes of the contract vary, preparers need to consider whether that variability, if looked at separately from the host contract, meets the definition of a derivative. The key aspects to consider are:

- The amounts that vary are linked to underlying price, rate or index.
- There was little or no initial net investment (in the clause that leads to variability, not in the whole combined contract).
- The variability in amount will be settled at a future date.

7 If the variability clause fails the definition of a derivative there would be no embedded derivative to separate.

Determining whether an embedded derivative needs to be accounted for separately

8 If the definition of a derivative is met then management should consider if the embedded derivative needs to be accounted for separately from the host contract. If separate accounting is required, the embedded derivative will be accounted for in the same way as a stand-alone derivative – that is, measured at fair value, with changes in fair value recognised in profit or loss unless the embedded derivative is part of a qualifying hedge relationship. The host contract will be accounted for in the same way as a similar host contract that does not contain an embedded derivative.

9 An embedded derivative should be separated from its host contract if:

- the entire (combined) contract is not measured at fair value with changes in fair value recognised in profit or loss, and
- the economic characteristics and risks of the embedded derivative are not closely related to those of the host contract.

10 If the host contract is measured at fair value through profit or loss then the embedded derivative is not separated. This is because separating the derivative would not result in a different accounting treatment. If the host contract contains a substantial embedded derivative that does not appear to be closely related (see para 11 below) to the host contract, the whole instrument may be designated at fair value through profit or loss using the fair value option.

11 As noted in paragraph 9(b) above, an embedded derivative is not separated from its host contract if the embedded derivative's economics and risks are closely related to those of the host contract. For example, in floating-rate debt, the derivative could be an interest rate cap that sets a limit (or 'cap') on the maximum rate to be paid. Because the cash flows under the cap and the debt are both a function of the floating interest rate specified in the contract, their economics and risks are considered closely related. Hence, and in absence of other complications, such a cap would not be separated.

12 The application guidance in IAS 39 sets out a large number of examples that illustrate that derivatives are (and are not) considered closely related to a variety of host contracts.

Re-assessment of contracts containing embedded derivative

13 The decision to separate or not to separate the embedded derivative may depend on market conditions on the date when the decision is made. IFRIC 9 explains that such decisions should be made when the entity first becomes party to the contract and generally are not re-considered at later dates (for example, the next reporting date). However, re-assessment is required if the contractual terms change and the change significantly modifies the expected future cash flows associated with the embedded derivative, host contract or both. The re-assessment will also be required if the entity that was party to the hybrid contract is acquired by another entity under IFRS 3 (revised) 'Business combinations' paragraph 16, which is applicable prospectively for annual periods beginning on or after 1 July 2009. Such re-assessment is carried out on the basis of conditions existing at the acquisition date.

Financial instruments – Classification of financial assets and financial liabilities

Overview

The way that financial instruments are classified under IAS 39 drives how they are subsequently measured and where changes in measurement are accounted for.

Under IAS 39, prior to the impact of IFRS 9 (see separate topic summary on page 79), there are four classes of financial asset: available for sale, held to maturity, loans and receivables, and fair value through profit or loss. The factors to take into account when classifying financial assets include:

- Are the cash flows arising from the instrument fixed or determinable? Does the instrument have a maturity date?
- Are the assets held for trading? Does management intend to hold the instruments to maturity?
- Is the instrument a derivative or, does it contain an embedded derivative?
- Is the instrument quoted on an active market?
- Has management designated the instrument into a particular classification at inception?

Financial liabilities are at fair value through profit or loss if they are designated as such (subject to various conditions), if they are held for trading or if they are derivatives (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument). Otherwise they are classified as 'other liabilities'.

Financial assets and liabilities are measured either at fair value or at amortised cost, depending on their classification. Changes are taken to either the income statement or directly to equity.

An amendment to IAS 39, 'Financial instruments: Recognition and measurement', and IFRS 7, 'Financial instruments: Disclosures', was published in October 2008. It allows the reclassification of certain financial assets previously classified as 'held for trading' or 'available-for-sale' to another category under limited circumstances. Various disclosures are required where a reclassification has been made. Derivatives and assets designated as 'at fair value through profit or loss' under the fair value option are not eligible for this reclassification. This amendment was effective for annual periods beginning or after 1 July 2008, although a subsequent amendment confirmed that any reclassifications made on or after 1 November 2008 should take effect only from the date of the reclassification and may not be backdated.

Resources

Standards and interpretations

- IFRS 7, 'Financial instruments: Disclosures'
- Annual improvements 2010 amendments to IFRS 7, 'Financial instruments: Disclosures'
- IFRS 9, 'Financial instruments'
- IAS 32, 'Financial instruments: Presentation'
- Amendment to IAS 32, 'Financial instruments: Presentation', and IAS 1, 'Financial statement presentation', on 'Puttable financial instruments and obligations arising on liquidation'
- Amendment to IAS 32, 'Financial instruments: Presentation', on 'Classification of rights issues'
- IAS 39, 'Financial instruments: Recognition and measurement'
- Amendment to IAS 39, 'Financial instruments: Recognition and measurement', and IFRS 7, 'Financial instruments: Disclosures', on the 'Reclassification of financial assets'
- Amendment to IAS 39, 'Financial instruments: Recognition and measurement', on 'Eligible hedged items'
- IFRIC 9, 'Re-assessment of embedded derivatives'
- Amendment to IFRIC 9, 'Re-assessment of embedded derivatives', and IAS 39, 'Financial instruments: Recognition and measurement', on 'Embedded derivatives'
- IFRIC 16, 'Hedges of a net investment in a foreign operation'

Exposure drafts and discussion papers

- Exposure draft, 'Fair value options for financial liabilities'
- Exposure draft, 'Financial instruments – amortised cost and impairment'
- Discussion paper on 'Credit risk in liability measurement'
- Discussion paper on 'Reducing complexity in reporting financial instruments'
- Discussion paper on 'Financial instruments with characteristics of equity'

PwC views

- PwC comment letter on discussion paper on 'Credit risk in liability measurement'
- PwC comment letter on discussion paper on 'Reducing complexity in reporting financial instruments'
- PwC comment letter on discussion paper on 'Financial instruments with characteristics of equity'

PwC guidance

- Manual of Accounting – Financial instruments chapter 6, Classification of financial instruments

Tools practice aids and publications

- IFRS extracts from accounts
- Straight away 7, guidance on IFRS 9, 'Financial instruments'
- Straight away guidance on IAS 32 amendment for rights issues
- Financial instruments under IFRS: A guide through the maze

Summary of key requirements

These requirements stem from IAS 39 prior to the impact of IFRS 9 (see separate topic summary on page 75).

Fair value through profit or loss

1 There are two conditions under which financial instruments are categorised as at fair value through profit or loss (FVTPL). Either they are classified as held-for-trading, and therefore have to be classified as such, or they are designated by the entity upon initial recognition.

2 Financial assets and financial liabilities are held-for-trading, if they have been acquired or incurred in order to sell or repurchase them in the near future, or if they are part of a portfolio that is managed together and where there is a recent pattern of short-term profit taking. Moreover, derivatives except those that are financial guarantee contracts or designated and effective hedging instruments, but including embedded derivatives that are required to be separated from the host contract (see topic summary), are held-for-trading under IAS 39.

3 Management may also designate a financial asset or financial liability as at FVTPL in three circumstances:

- Where a hybrid contract containing one or more embedded derivatives that are not closely related to the host contract (see topic summary), [IAS 39 para 11A].
- To eliminate or significantly reduce an accounting mismatch
- Where a group of financial instruments is managed together (following a documented investment or risk management strategy), and its performance is evaluated and it is reported to management on a fair value basis.

Financial instruments can only be designated at FVTPL at inception. Once they have been designated this is irrevocable [IAS 39 para 50].

The following three categories apply only to financial assets.

Held to maturity

4 Financial assets with fixed or determinable payments that the entity has the ability and intent to hold to maturity fall into this category, unless they meet the definition of a loan or receivable. For example, a quoted redeemable bond with a fixed coupon would be classified as held-to-maturity, if the entity is able and intends to hold it until redemption.

Securities classified as held-to-maturity are measured at amortised cost. The category is an exception to the fair value measurement model in IAS 39 and consequently its use is restricted. If an entity classifies securities as held to maturity and then sells them, this questions or taints management's intent to hold all securities in this category to maturity. If an entity sells or reclassifies more than an insignificant amount of held-to-maturity securities in a financial year, it must reclassify all of its remaining held-to-maturity instruments to available for sale (and, therefore, measure them at fair value) and cannot classify any further financial assets as held to maturity for the two years following the sale or reclassification.

Loans and receivables

5 Loans and receivables have fixed or determinable payments, and are not quoted in an active market. If an entity may not recover substantially all of its initial investment, unless this is due to credit deterioration, a financial asset that otherwise meets the definition of loans and receivables is classified as available-for-sale. If management has designated a financial asset as FVTPL or available for sale (see below), it is not a loan or receivable.

Available for sale

6 All other financial assets fall into this category. An entity can designate any financial asset that isn't held-for-trading as available-for-sale. In October 2008, in response to market conditions, the IASB amended IAS 39 to allow reclassification of certain financial assets out of 'held-for-trading' or 'available-for-sale' and into another category under limited circumstances. Derivative and assets designated as at FVTPL as described in the overview are not eligible for this reclassification.

Financial liabilities

7 All financial liabilities other than those at FVTPL fall into the category other liabilities.

Financial instruments – Financial liabilities and equity

Overview

The classification of a financial instrument by the issuer as either a liability (debt) or equity can have a significant impact on an entity's apparent gearing (debt-to-equity ratio) and reported earnings. It could also affect the entity's debt covenants.

The critical feature of debt is that under the terms of the instrument, the issuer is or can be required to deliver either cash or another financial asset to the holder; it cannot avoid this obligation. For example, a debenture under which the issuer is required to make interest payments and redeem the debenture for cash is a financial liability.

An instrument is classified as equity when it represents a residual interest in the issuer's assets after deducting all its liabilities, or put another way, when the issuer has no obligation under the terms of the instrument to deliver cash or other financial assets to another entity. Ordinary shares, or common stock, where all the payments are at the discretion of the issuer are examples of equity of the issuer.

The classification of the financial instrument into either debt or equity is based on the substance of the contractual arrangement of the instrument, rather than its legal form. This means, for example, that a redeemable preference share, which is economically the same as a bond, is accounted for in the same way as a bond. Therefore, the redeemable preference share is treated as a liability rather than equity, even though legally it is a share of the issuer.

Other instruments may not be as straightforward. An analysis of the terms of each instrument in the light of the detailed classification requirements is necessary, particularly as some financial instruments contain both debt and equity features. Such instruments – for example, bonds that are convertible into a fixed number of equity shares – are split into debt and equity (being the option to convert) components.

The treatment of interest, dividends, losses and gains in the income statement follows the classification of the related instrument. If a preference share is classified as debt, its coupon is shown as interest. However, the coupon on an instrument that is treated as equity is shown as a distribution.

An amendment to IAS 32, 'Financial instruments: Presentation', and IAS 1, 'Presentation of financial statements', was published in February 2008. This amendment ensures entities classify the following types of financial instrument as equity, provided they have particular features and meet specific conditions:

- Puttable financial instruments (for example, some shares issued by co-operative entities and some partnership interests).
- Instruments or components of instruments that impose on the entity an obligation to deliver to another party a *pro rata* share of the net assets of the entity only on liquidation (for example, some shares issued by limited life entities).

This amendment is effective for annual periods beginning on or after 1 January 2009.

Resources

Standards and interpretations

- IFRS 7, 'Financial instruments: Disclosures'
- Annual improvements 2010 amendments to IFRS 7, 'Financial instruments: Disclosures'
- IFRS 9, 'Financial instruments'
- IAS 32, 'Financial instruments: Presentation'
- Amendment to IAS 32, 'Financial instruments: Presentation', and IAS 1, 'Financial statement presentation', on 'Puttable financial instruments and obligations arising on liquidation'
- Amendment to IAS 32, 'Financial instruments: Presentation', on 'Classification of rights issues'
- IAS 39, 'Financial instruments: Recognition and measurement'
- Amendment to IAS 39, 'Financial instruments: Recognition and measurement', and IFRS 7, 'Financial instruments: Disclosures', on the 'Reclassification of financial assets'
- Amendment to IAS 39, 'Financial instruments: Recognition and measurement', on 'Eligible hedged items'
- IFRIC 9, 'Re-assessment of embedded derivatives'
- Amendment to IFRIC 9, 'Re-assessment of embedded derivatives', and IAS 39, 'Financial instruments: Recognition and measurement', on 'Embedded derivatives'
- IFRIC 16, 'Hedges of a net investment in a foreign operation'

Exposure drafts and discussion papers

- Exposure draft, 'Fair value options for financial liabilities'
- Exposure draft, 'Financial instruments – amortised cost and impairment'
- Discussion paper on 'Credit risk in liability measurement'
- Discussion paper on 'Reducing complexity in reporting financial instruments'
- Discussion paper on 'Financial instruments with characteristics of equity'

PwC views
- PwC comment letter on discussion paper on 'Credit risk in liability measurement'
- PwC comment letter on discussion paper on 'Reducing complexity in reporting financial instruments'
- PwC comment letter on discussion paper on 'Financial instruments with characteristics of equity'

PwC guidance
- Manual of accounting – Financial instruments chapter 7, Financial liabilities and equity

Tools practice aids and publications
- Straight away 4, IAS 32 amendment for rights issues
- Financial instruments under IFRS: A guide through the maze
- A practical guide for investment funds on IAS 32 amendments

Summary of key requirements

1 An issuer of a financial instrument should classify a financial instrument, or *its component parts,* on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the contractual arrangement's substance and the definitions of a financial liability, a financial asset and an equity instrument. [IAS 32 para 15]. It is necessary to examine the contractual terms of each component carefully, bearing in mind the definitions of a financial liability and an equity instrument, to determine whether they exhibit characteristics of a financial liability or equity. Once the characteristics of the individual components are determined, they can be combined to arrive at the overall assessment of whether the entire instrument is classified as a financial liability, or an equity instrument, or a compound instrument containing both liability and equity features.

Definitions

2 A financial liability is defined as any liability that is:
- A contractual obligation:
  - to deliver cash or another financial asset to another entity; or
  - to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity.
- A contract that will or may be settled in the entity's own equity instruments and is:
  - a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or
  - a derivative that will or may be settled other than by exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

[IAS 32 para 11].

3 An equity instrument is defined as any contract that evidences a residual interest in an entity's assets after deducting all of its liabilities. [IAS 32 para 11]. Therefore, only those instruments that do not meet the definition of a liability will fall to be classified as equity. In other words, the entity must have an unconditional right to avoid delivery of cash or another financial asset. A typical example is an entity's non-puttable ordinary shares. For the purposes of determining whether a financial instrument is an equity instrument rather than a financial liability, the issuer is required to apply the expanded definition of an equity instrument that is essentially a converse of the above definition of a financial liability. [IAS 32 para 16].

Contractual obligation to settle in cash or another financial asset

4 It is apparent from the above definitions that the critical feature that distinguishes a liability from an equity instrument is the existence of a contractual obligation to deliver cash or another financial asset to the holder or to exchange a financial asset or a financial liability with the holder under conditions that are potentially unfavourable to the issuer. In other words, if the issuer does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the obligation meets the definition of a liability. [IAS 32 para 17].

5 Such a contractual obligation could be established explicitly or indirectly. However, the obligation must be established through the terms and conditions of the financial instrument. [IAS 32 para 20]. Economic compulsion, by itself, would not result in a financial liability being classified as a liability. Similarly, a restriction on the ability of an entity to satisfy a contractual obligation, such as lack of access to foreign currency or the need to obtain approval for payment from a regulatory authority, does not negate the entity's contractual obligation or the holder's contractual right under the instrument. [IAS 32 para 19(a)]. For example, an obligation is not negated even if the instrument's terms are such that the amount payable on redemption is dependent on the company having sufficient distributable profits or reserves.

Puttable instruments

6 A financial instrument that gives the holder the right to put it back to the issuer for cash or another financial asset (a 'puttable instrument') is a financial liability. For example,

an entity that issues a preference share that is puttable by the holder at some future date would recognise a financial liability. This is so even when the amount of cash or other financial assets to be delivered to the holder is not fixed, but is determined on the basis of an index or other item that has the potential to increase or decrease the final amount payable, or when the puttable instrument's legal form gives the holder a right to a residual interest in the issuer's assets. [IAS 32 para 18(b)]. Only if the issuer has an unconditional right to avoid redemption, or in the limited circumstances described below, should the instrument be classified as an equity instrument.

7 The IASB issued an amendment to IAS 32 early in 2008 that introduced a limited exception to the principles in IAS 32 for certain puttable instruments and other instruments containing obligations arising on liquidation. Such instruments that meet very specific criteria are classified as equity, rather than financial liabilities. These criteria include being the most subordinated instrument of the entity and entitling the holder to a pro-rata share of net assets on liquidation. This amendment is effective for accounting periods beginning on or after 1 January 2009 and earlier application is permitted.

Contracts that will or may be settled in an entity's own equity instruments

8 Some financial instruments are settled in the issuer's own equity instruments (for example by an issue of its ordinary shares), rather than cash or other financial assets. Such a financial instrument will be classified as equity only if it can be settled by a fixed number of its own equity shares in exchange for a fixed amount of cash. [IAS 32 para 22]. By fixing the amount paid and the number of shares received the holder benefits from any upside and suffers the loss from any fall in the residual value of the entity, hence the equity classification is appropriate.

9 However, an entity may have a contractual right or obligation to receive or deliver a number of its own shares or other equity instruments that varies so that the fair value of the entity's own equity instrument to be received or delivered equals the amount of the contractual right or obligation. Such a contract may be for a fixed amount or an amount that fluctuates in part or in full in response to changes in a variable, which can include the entity's own share price. [IAS 32 para 21]. Such a contract would be classified as a financial liability.

Contingent settlement provisions

10 The obligation to deliver cash or financial assets need not be actual, it may be contingent on the occurrence or non-occurrence of uncertain future events (or on the outcome of uncertain circumstances) that are beyond the control of both the issuer or the holder of the instrument. Examples of such uncertain future events include changes in stock market index, or changes in the issuer's key performance indicators such as revenue or debt-to-equity ratios.

11 As the issuer does not have an unconditional right to avoid delivering cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability) the financial instrument will be classified as a liability. However, if the contingent settlement provision that could require settlement in cash or another financial asset (or otherwise in such a way that it would be a financial liability) is not *genuine* or only applies on the liquidation of the issuer, then the contingent settlement provision should be ignored for the purposes of determining the classification of the instrument. [IAS 32 para 25].

Derivative financial instruments

12 Derivatives that only result in the delivery of a fixed amount of cash or other financial assets for a fixed number of an entity's own equity instruments are classified as equity instruments. [IAS 32 para 16(b)(ii)]. All other derivatives on own equity are treated as derivative financial liabilities or assets and accounted for as such. This includes derivatives that may be settled gross by delivery of a variable number of own shares; or may be settled by delivery of a fixed number of own shares for a variable amount of cash (or other financial assets). [IAS 32 paras 21, 24].

13 When a derivative financial instrument gives one party a choice over how it is settled (for example, the issuer or holder can choose to settle the contract net in cash, or by exchange shares for cash), it is a financial asset or a financial liability, unless all of the settlement alternatives would result in it being an equity instrument. [IAS 32 para 26].

Compound financial instruments

14 Not all instruments are either debt or equity. Some, known as compound instruments, contain elements of both in a single contact. In this case the issuer should identify the instrument's component parts and account for them separately, allocating the proceeds between liabilities and equity. The debt element is determined first by fair valuing the cash flows excluding any equity component and the residual is assigned to equity. For example, the vanilla debt element of a convertible bond is recognised as a financial liability, whereas the option to convert the bond into a fixed number of ordinary shares should be separately recognised as equity, even though the bond and the option are part of the same financial instrument. [IAS 32 paras 28-32].

15 On conversion of a convertible instrument into the entity's ordinary shares at maturity, then the entity derecognises the liability component and recognises it as equity. There is no gain or loss on conversion at maturity. [IAS 32 para AG32].

Interest, dividends, gains and losses

16 The treatment of interest, dividends, losses and gains in the statement of comprehensive income follows the classification of the related instrument. Therefore, interest, dividends, gains and losses on financial instruments classified as liabilities are recognised in the income statement. On the other hand, interest, dividends, gains and losses arising in respect of equity instruments (for example on the redemption of an equity share) are recognised directly in equity and do not affect profit or loss. [IAS 32 para 35].

Treasury shares

17 When an entity purchases its own shares and holds them in treasury ('treasury shares'), any consideration paid or received for the purchase or sale of an entity's own equity instruments should be recognised directly in equity and no gain or loss should be recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instrument. [IAS 32 paras 33, AG36].

Financial instruments – Recognition and derecognition

Overview

Recognition

Recognition issues for financial assets and financial liabilities tend to be straightforward. An entity recognises a financial asset or a financial liability at the time it becomes a party to a contract.

Derecognition

Derecognition is the term used for ceasing to recognise a financial asset or financial liability on an entity's balance sheet. These rules are more complex.

Assets

An entity that holds a financial asset may raise finance using the asset as security for the finance, or as the primary source of cash flows from which to repay the finance. The derecognition requirements of IAS 39 determine whether the transaction is a sale of the financial assets (and therefore the entity ceases to recognise the assets) or whether finance has been secured on the assets (and the entity recognises a liability for any proceeds received). This evaluation might be straightforward. For example, it is clear with little or no analysis that a financial asset is derecognised in an unconditional transfer of it to an unconsolidated third party, with no risks and rewards of the asset being retained. Conversely, derecognition is not allowed where an asset has been transferred, but substantially all the risks and rewards of the asset have been retained through the terms of the agreement. However, in many other cases, the analysis is more complex. Securitisation and debt factoring are examples of more complex transactions where derecognition will need careful consideration.

Liabilities

An entity may only cease to recognise (derecognise) a financial liability when it is extinguished – that is, when the obligation is discharged, cancelled or expired, or when the debtor is legally released from the liability by law or by the creditor agreeing to such a release.

Resources

Standards and interpretations

- IFRS 7, 'Financial instruments: Disclosures'
- Annual improvements 2010 amendments to IFRS 7, 'Financial instruments: Disclosures'
- IFRS 9, 'Financial instruments'
- IAS 32, 'Financial instruments: Presentation'
- Amendment to IAS 32, 'Financial instruments: Presentation', and IAS 1, 'Financial statement presentation', on 'Puttable financial instruments and obligations arising on liquidation'
- Amendment to IAS 32, 'Financial instruments: Presentation', on 'Classification of rights issues'
- IAS 39, 'Financial instruments: Recognition and measurement'
- Amendment to IAS 39, 'Financial instruments: Recognition and measurement', and IFRS 7, 'Financial instruments: Disclosures', on the 'Reclassification of financial assets'
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- PwC comment letter on discussion paper on 'Credit risk in liability measurement'
- PwC comment letter on discussion paper on 'Reducing complexity in reporting financial instruments'
- PwC comment letter on discussion paper on 'Financial instruments with characteristics of equity'

PwC guidance

- Manual of Accounting – Financial instruments chapter 8, Recognition and derecognition

Tools practice aids and publications

- IFRS extracts from accounts
- IAS 39 – Derecognition of financial assets in practice
- Financial instruments under IFRS: A guide through the maze

Summary of key requirements

Recognition

1 A financial asset or liability is recognised on the balance sheet when an entity becomes a party to the contract. [IAS

39 para 14]. If a transfer of a financial asset does not qualify for derecognition, the transferee cannot recognise the transferred asset as its asset. [IAS 39 para AG34].

Derecognition of financial assets

2 IAS 39's rules for removing or 'derecognising' a financial asset or financial liability are complex. The criteria for derecognising a financial asset are summarised below. [IAS 39 para AG36].

Consolidate all subsidiaries

3 When evaluating derecognition in its consolidated financial statements, an entity should first consolidate all subsidiaries and special purpose entities in accordance with IAS 27, 'Consolidated and separate financial statements', and SIC 12, 'Consolidation – Special purpose entities', and then apply the derecognition analysis to the resulting group. [IAS 39 para 15]. This ensures that the derecognition analysis produces the same answer regardless of whether the entity transfers financial assets, or a portion thereof, directly to third party investors or transfers them through a consolidated SPE or trust which, in turn, transfers them directly to third party investors. [IAS 39 para BC64].

Should the criteria be applied to part or all of the asset?

4 The next step is to determine whether the derecognition criteria should be applied to part or all of an asset (or a group of similar assets). The derecognition rules should only be applied to a part of a financial asset (or a part of a group of similar financial assets) if the part being considered for derecognition meets one of the following conditions:

- the part comprises only specifically identified cash flows from a financial asset, for example, only the interest payments on a receivable; or
- the part comprises only a fully proportionate (*pro rata*) share of all the cash flows from a financial asset or of specifically identified cash flows from a financial asset. For example, an arrangement in which the counterparty obtains the rights to a 90 per cent share of all cash flows of a debt instrument and would therefore suffer 90 per cent of any default on the instrument. A disproportionate share of the cash flows such as a transfer of the first 90 per cent of cash flows from an asset would not meet this requirement and hence the derecognition rules would need to be applied to the asset in its entirety.

[IAS 39 para 16(a)].

Have the rights to the cash flows expired?

5 Once the consolidated group has been established and the asset to be assessed for derecognition has been identified, the first test is to determine whether the rights to the cash flows from the asset have expired. This would be the case, for example, when a loan is extinguished, in the normal course, by payment of the entire amount due, thereby discharging the debtor from any further obligation. If the rights to the cash flows have expired, the asset should be derecognised. [IAS 39 para 17(a)]. Derecognition at this step is usually obvious and requires little or no analysis.

Is there a transfer?

6 If the cash flows have not expired, it is necessary to determine if a transfer has taken place. If no transfer has taken place then the asset should continue to be recognised. [IAS 39 para 17(b)].

7 Under IAS 39, a transfer can take two forms. [IAS 39 para 18]. The first is when an entity transfers the contractual rights to receive the cash flows of the financial asset. IAS 39 does not explain what is meant by the phrase *''transfers the contractual rights to receive the cash flows of the financial asset''*. A literal reading of the words would suggest that the phrase would apply to an asset's legal sale, or a legal assignment of the rights to the cash flows from the asset. However, some types of financial asset (for example, a receivable or a portfolio of receivables), cannot be 'sold' in the same way as other types (for example, a bond), but they can be transferred by means of a novation or an equitable assignment. Both novation and assignment will generally result in the transfer of contractual rights to receive the financial asset's cash flows.

8 Determining whether the contractual rights to cash flows have been transferred is not affected by the transferor retaining the role of an agent to administer collection and distribution of cash flows. In addition, credit notes, both contractual or discretionary, issued by a transferor do not preclude a transfer of contractual rights to receive cash flows from an asset.

9 The second form of transfer is when the entity has retained the contractual rights to receive the cash flows of a financial asset but has assumed an obligation to pay the cash flows to a third party. Such 'pass-through' arrangements arise where the entity continues to collect cash receipts from a financial asset (or more typically a pool of financial assets), but assumes an obligation to pass on those receipts to another party that has provided finance in connection with the financial asset. They are common in securitisations and sub-participation arrangements.

10 Under IAS 39, an entity (transferor) that retains the contractual rights to receive the cash flows of a financial asset (the 'original asset') but assumes a contractual obligation to pay the cash flows to one or more recipients (the 'eventual recipients') is regarded as having transferred the original asset if, and only if, all of the following conditions are met:

- The transferor has no obligation to pay amounts to the eventual recipients, unless it collects equivalent amounts from the original asset. Short-term advances by the transferor to the eventual recipients with the right of full recovery of the amount lent plus accrued interest at market rates do not violate this condition.
- The transferor is prohibited by the transfer contract's terms from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows.
- The transferor has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. In addition, the transferor is not entitled to reinvest such cash flows, except in cash or cash equivalents as defined in IAS 7, 'Statement of cash flows', with any interest earned on such investments being passed to the eventual recipients. [IAS 39 paras 19(a)-(c)].

Have substantially all the risks and rewards been transferred?

11 If it is determined that a transfer of the rights to receive the cash flows has taken place or the entity has assumed an obligation to pay the cash flows from the asset that meets the conditions in paragraph 2.10 above, it is necessary to assess to what extent the risks and rewards of the asset have been transferred. If substantially all of the risks and rewards of the asset have been transferred the asset should be derecognised. [IAS 39 para 20(a)]. If substantially all of the risks and rewards of the asset have been retained, derecognition is precluded. [IAS 39 para 20(b)].

12 Determining whether an entity has transferred substantially all the risks and rewards of ownership will often be readily apparent from the terms and conditions of the transfer. Where this is not obvious, the entity needs to compute and compare its exposure to the variability in the present value of the transferred asset's future net cash flows before and after the transfer. The computation and comparison should be made using as the discount rate an appropriate current market interest rate. All reasonably possible variability in net cash flows (as to amounts and timing) should be considered and greater weight given to those outcomes that are more likely to occur, that is, the amounts and timing need to be probability weighted. [IAS 39 para 22].

Has the entity retained control of the asset?

13 If some risks and rewards have been transferred and some have been retained, it is necessary to look at whether the entity has retained control of the asset. The definition of control under IAS 39 is different from the definition of control used elsewhere in IFRS (which looks to what the entity is able to do with the asset). In the context of IAS 39, control is based on whether the *transferee* has the *practical ability* to sell the transferred asset. IAS 39 explains that the transferee has the 'practical ability' to sell the transferred asset if:

- the transferee can sell the asset in its entirety to an unrelated third party; and
- the transferee is able to exercise that ability unilaterally and without imposing additional restrictions.

[IAS 39 para 23].

14 The above conditions should be evaluated by considering what the transferee is able to do in practice, not what contractual rights it has with respect to the transferred asset (or indeed what contractual prohibition exists). [IAS 39 paras 23, AG43].

15 If the transferor has not retained control, it derecognises the financial asset and recognises separately as assets or liabilities any rights and obligations created or retained in the transfer. [IAS 39 para 20(c)(i)].

Continue to recognise to the extent of continuing involvement

16 If the entity has retained control, it continues to recognise the financial asset to the extent of its continuing involvement in the financial asset. [IAS 39 para 20(c)(ii)]. Where this is the case, the accounting is complex and needs careful consideration.

Derecognition of financial liabilities

17 A financial liability is derecognised when it is extinguished, that is when the obligation is discharged, cancelled or expired. This condition is met when the liability is settled by paying the creditor or when the debtor is released from primary responsibility for the liability, either by process of law or by the creditor. [IAS 39 paras 39, AG57].

18 Entities frequently negotiate with bankers or bond-holders to cancel existing debt and replace it with new debt with the same lender on different terms. For example, an entity may decide to cancel its exposure to high-interest fixed-rate debt, pay a fee or penalty on cancellation and replace it with variable-rate debt. IAS 39 provides guidance to distinguish between the settlement of debt that is replaced by new debt and the restructuring of existing debt. The distinction is based on whether or not the new debt has substantially different terms from the old debt. [IAS 39 para 40].

Financial instruments – Measurement of financial assets and financial liabilities

Overview

All financial assets and financial liabilities are measured initially at fair value under IAS 39. The fair value of a financial instrument is normally the transaction price – that is, the amount of the consideration given or received. However, in some circumstances, the transaction price may not be indicative of fair value. In such a situation, an appropriate fair value is determined using data from current observable transactions in the same instrument or based on a valuation technique whose variables include only data from observable markets.

The measurement of financial instruments after initial recognition depends on their initial classification. All financial assets are measured at fair value except for loans and receivables, held-to-maturity assets and, in rare circumstances, unquoted equity instruments whose fair values cannot be measured reliably, or derivatives linked to and that must be settled by the delivery of such unquoted equity instruments that cannot be measured reliably.

Loans and receivables and held-to-maturity investments are measured at amortised cost. The amortised cost of a financial asset or financial liability is measured using the 'effective interest method'.

Available-for-sale financial assets are measured at fair value, with changes in fair value recognised in other comprehensive income. For available-for-sale debt securities, interest is recognised in income using the 'effective interest method'. Dividends on available-for-sale equity securities are recognised in profit or loss as the holder becomes entitled to them.

Derivatives (including separated embedded derivatives) are measured at fair value. All fair value gains and losses are recognised in profit or loss except where they qualify as hedging instruments in cash flow hedges.

Financial liabilities are measured at amortised cost using the effective interest method unless they are classified at fair value through profit or loss.

Financial assets and financial liabilities that are designated as hedged items may require further adjustments under the hedge accounting requirements.

All financial assets, except those measured at fair value through profit or loss, are subject to review for impairment. Where there is objective evidence that such a financial asset may be impaired, the impairment loss is calculated and recognised in profit or loss.

Resources

Standards and interpretations

- IFRS 7, 'Financial instruments: Disclosures'
- Annual improvements 2010 amendments to IFRS 7, 'Financial instruments: Disclosures'
- IFRS 9, 'Financial instruments'
- IAS 32, 'Financial instruments: Presentation'
- Amendment to IAS 32, 'Financial instruments: Presentation', and IAS 1, 'Financial statement presentation', on 'Puttable financial instruments and obligations arising on liquidation'
- Amendment to IAS 32, 'Financial instruments: Presentation', on 'Classification of rights issues'
- IAS 39, 'Financial instruments: Recognition and measurement'
- Amendment to IAS 39, 'Financial instruments: Recognition and measurement', and IFRS 7, 'Financial instruments: Disclosures', on the 'Reclassification of financial assets'
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- PwC comment letter on discussion paper on 'Financial instruments with characteristics of equity'

PwC guidance
- Manual of Accounting – Financial instruments chapter 9, Measurement of financial assets and liabilities

Tools practice aids and publications
- Straight away 7: Guidance on IFRS 9, 'Financial instruments'
- Straight away 6: IASB issues exposure draft 'Financial instruments: Amortised cost and impairment'
- Financial instruments under IFRS: A guide through the maze

Summary of key requirements

Initial measurement

1 A financial asset or liability is recognised initially at fair value plus directly attributable transaction costs, except when the instrument is classified as at fair value through profit or loss. [IAS 39 para 43].

2 The best evidence of fair value of a financial instrument at initial recognition is the transaction price (that is, the fair value of the consideration given or received). However, in some circumstances, the consideration given or received may not necessarily be the instrument's fair value. In that situation, a gain or loss on initial recognition may arise. The entity is permitted to recognise this 'day 1' gain or loss only if the fair value is estimated by comparison with other observable current market transactions in the same instrument (that is, without modification or repackaging) or based on a valuation technique whose variables include only available data from observable markets. [IAS 39 para AG76].

Transaction costs

3 Transaction costs are incremental costs that are directly attributable to the acquisition or issue of a financial asset or financial liability. They are included in the initial measurement of financial assets (added to the amount recognised) or liabilities (deducted from the amount recognised) except for those measured at fair value through profit or loss. [IAS 39 para 9].

4 For financial instruments that are measured at fair value through profit or loss, transaction costs (net of any fees received) are not added to (deducted from) the initial fair value, but are immediately recognised in profit or loss on initial recognition. [IAS 39 para IG E1.1].

5 For available-for-sale financial asset, transaction costs are recognised in other comprehensive income as part of a change in fair value at the next remeasurement date. For financial assets with fixed or determinable payments that do not have an indefinite life, the transaction costs are amortised to profit or loss using the effective interest method. For those financial assets that do not have fixed or determinable payments and have an indefinite life, the transaction costs are recognised in profit or loss when the asset is derecognised or becomes impaired. [IAS 39 para IG E1.1].

6 Transaction costs expected to be incurred on a financial instrument's transfer or disposal are not included in the financial instrument's measurement. [IAS 39 para IG E1.1].

Subsequent measurement of financial assets

7 Financial assets are classified in one of four categories. Following their initial recognition, the classification determines how the financial asset is subsequently measured, including any profit or loss recognition.

Fair value through profit or loss (FVTPL)

8 Financial assets at fair value through profit or loss (including derivative assets) are measured at fair value with changes in fair value recognised in profit or loss.

Held-to-maturity investments

9 Held-to-maturity investments are also measured at amortised cost using the effective interest method. Gains and losses are accounted for in the same way as loans and receivables. [IAS 39 paras 46(b), 56].

Loans and receivables

10 Loans and receivables are measured at amortised cost using the effective interest method. [IAS 39 paras 46(a), AG68]. In addition, gains and losses are recognised in profit or loss when loans and receivables are derecognised or impaired. Special rules apply for gain or loss recognition when loans and receivables are designated as hedged items. [IAS 39 paras 46(a), AG68].

Available-for-sale financial assets

11 Available-for-sale financial assets are measured at fair value. However, there is an exemption from measurement at fair value of an available-for-sale asset if its fair value cannot be measured reliably. This exemption only applies to unquoted equity instruments and derivative contracts based on those instruments. These instruments are measured at cost. [IAS 39 para 46(c)].

12 All gains and losses arising from changes in fair value of available-for-sale financial assets are recognised directly in other comprehensive income, except for interest calculated using the effective interest method, foreign exchange gains and losses on available-for-sale debt instruments, dividends on available-for-sale equity

investments and all impairment losses. These are recognised in profit or loss. [IAS 39 para 55(b)].

Amortised cost and the effective interest method

13 Where financial assets and financial liabilities are carried at amortised cost, the measurement of amortised cost is based on the 'effective interest method'. Under this method, interest income and expense is recognised in the period in which they are accrued rather than the period in which they are received or paid. The effective interest method is used for amortising premiums, discounts and transaction costs for both financial assets and financial liabilities.

Fair value measurement considerations

14 Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. [IAS 39 para 9]. However, transaction costs incurred on disposal or transfer of a financial instrument are not included in the fair value.

15 There is a general presumption that fair value can be reliably measured for all financial instruments. IAS 39 provides detailed guidance for determining the fair value of financial instruments. The standard provides a hierarchy for determining an instrument's fair value, which gives the highest priority to quoted prices in active markets. [IAS 39 para 48A].

16 In the absence of an active market, fair value is established by using a valuation technique. Such valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis and option pricing models. If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity should use that technique. [IAS 39 para AG74]. On 31 October 2008, the IASB Expert Advisory Panel issued further guidance on 'measuring and disclosing the fair value of financial instruments in markets that are no longer active'.

Impairment of financial assets

17 IAS 39 deals with impairment of financial assets through a two-step process. First, an entity carries out an impairment review of its financial assets at each balance sheet date to determine if there is objective evidence of impairment as a result of one or more events ('loss events') that occurred after the asset's initial recognition. [IAS para 59]. Secondly, if there is objective evidence of impairment, the entity should measure and record the impairment loss in the reporting period. [IAS 39 para 58].

18 If there is objective evidence that an impairment loss on a financial asset carried at amortised cost has been incurred, the amount of the loss should be measured as the difference between the asset's carrying amount and the present value of estimated future cash flows. The expected cash flows should exclude future credit losses that have not been incurred and should be discounted at the financial asset's original effective interest rate (that is, the effective interest rate computed at initial recognition). [IAS 39 para 63]. For financial assets carried at cost, as an exemption from measurement at fair value if its fair value cannot be measured reliably, the estimated future cash flows are discounted at the current market rate of return for a similar financial asset. Any impairment losses should not be reversed. [IAS 39 para 66].

19 For financial assets carried at fair value, recognition of an impairment loss is only relevant for available-for-sale financial assets since changes in fair value are recognised in other comprehensive income rather than in profit or loss. If there is objective evidence of impairment of an available-for-sale financial asset, the cumulative loss that had been recognised directly in other comprehensive income is reclassified from equity to profit or loss even though the financial asset has not been derecognised. [IAS 39 paras 67, 68]. For equity AFS instruments, impairment must be recognised if the fair value is below cost and the decline of fair value below cost is significant or prolonged. [IAS 39 para 61]. Any subsequent losses are also recognised in profit or loss until the asset is derecognised.

20 For financial assets measured at amortised cost, a previously recognised impairment loss should be reversed either directly or by adjusting an allowance account if the decrease can be related objectively to an event occurring after the impairment was recognised. The reversal is recognised in profit or loss with a corresponding increase in the carrying amount. However, the reversal is limited to what the amortised cost would have been at the date of reversal in the absence of impairment. [IAS 39 para 65].

21 For available-for-sale debt instruments, past impairment losses are similarly reversed through profit or loss when fair value increases. [IAS 39 para 70].

22 Impairment losses recognised in profit or loss for an investment in an equity instrument classified as available for sale should not be reversed through profit or loss. [IAS 39 para 69].

Reclassifications between categories of financial assets

23 When a held-for-trading financial asset is reclassified out of fair value through profit or loss category in the limited circumstances described in paragraphs 50(c), 50B, 50C and 50D of IAS 39, its fair value at the date of reclassification becomes its new cost or amortised cost, as applicable. Any gain or loss already recognised in profit or loss should not be reversed. [IAS 39 paras 50D, 50F].

24 When a held-to-maturity investment is reclassified as available-for-sale because of 'tainting' of the held-to-maturity portfolio (that is, the entity no longer has the positive intent or ability to hold it to maturity), it should be remeasured at fair value at the date of reclassification and the difference between its previous carrying amount and fair value should be recognised in other comprehensive income. [IAS 39 paras 51, 52].

25 When an available-for-sale financial asset with fixed maturity is reclassified as held-to-maturity investment once any tainting period has elapsed, the fair value carrying amount of the financial asset on that date becomes its new amortised cost. Any previous gain or loss on that asset that has been recognised directly in other comprehensive income should be amortised to profit and loss over the remaining life of the held-to-maturity investment using the effective interest method. Any difference between the new amortised cost and maturity amount should also be amortised in a similar manner, similar to the amortisation of a premium or discount. If the financial asset is subsequently impaired, any gain or loss that has been recognised directly in other comprehensive income is reclassified from equity to profit or loss. [IAS 39 para 54(a)].

26 When an available-for-sale financial asset (that would have met the definition of loans and receivables if it had been so designated at initial recognition) is reclassified out of fair value through profit or loss because the entity intends and has the ability to hold the financial asset for the foreseeable future, the fair value carrying amount of the financial asset becomes its new amortised cost. Any previous gain or loss on that asset that has been recognised directly in other comprehensive income remains in other comprehensive income until the financial asset is sold or otherwise disposed of, when it is recognised in profit or loss. If the financial asset is subsequently impaired, any gain or loss that has been recognised directly in other comprehensive income is reclassified from equity to profit or loss. [IAS 39 para 50F,54(b)].

Subsequent measurement of financial liabilities

27 After initial recognition, an entity should measure financial liabilities carried at amortised cost using the effective interest method. [IAS 39 para 47]. Financial liabilities at fair value through profit or loss are measured at fair value except for a derivative liability that is linked to and must be settled by delivery of an unquoted equity instrument whose fair value cannot be reliably measured. These financial liabilities are measured at cost.

Financial instruments – Hedge accounting

Overview

'Hedging' is the process of using a financial instrument (usually a derivative) to mitigate all or some of the risk of a hedged item. 'Hedge accounting' changes the timing of recognition of gains and losses on either the hedged item or the hedging instrument so that both are recognised in profit or loss in the same accounting period.

To qualify for hedge accounting, an entity (a) at the inception of the hedge, formally designates and documents a hedge relationship between a qualifying hedging instrument and a qualifying hedged item; and (b) both at inception and on an ongoing basis, demonstrates that the hedge is highly effective.

There are three types of hedge relationship:
- Fair value hedge – a hedge of the exposure to changes in the fair value of a recognised asset or liability, or a firm commitment.
- Cash flow hedge – a hedge of the exposure to variability in cash flows of a recognised asset or liability, a firm commitment or a highly probable forecast transaction.
- Net investment hedge – a hedge of the foreign currency risk on a net investment in a foreign operation.

For a fair value hedge, the hedged item is adjusted for the gain or loss attributable to the hedged risk. That element is included in the income statement where it will offset the gain or loss on the hedging instrument.

For a cash flow hedge, gains and losses on the hedging instrument, to the extent it is an effective hedge, are initially included in other comprehensive income. They are reclassified to profit or loss when the hedged item affects the income statement. If the hedged item is the forecast acquisition of a non-financial asset or liability, the entity may choose an accounting policy of adjusting the carrying amount of the non-financial asset or liability for the hedging gain or loss at acquisition, or leaving the hedging gains or losses deferred in equity and reclassifying them to profit and loss when the hedged item affect profit or loss

Hedges of a net investment in a foreign operation are accounted for similarly to cash flow hedges.

Resources

Standards and interpretations
- IFRS 7, 'Financial instruments: Disclosures'
- Annual improvements 2010 amendments to IFRS 7, 'Financial instruments: Disclosures'
- IFRS 9, 'Financial instruments'
- IAS 32, 'Financial instruments: Presentation'
- Amendment to IAS 32, 'Financial instruments: Presentation', and IAS 1, 'Financial statement presentation', on 'Puttable financial instruments and obligations arising on liquidation'
- Amendment to IAS 32, 'Financial instruments: Presentation', on 'Classification of rights issues'
- IAS 39, 'Financial instruments: Recognition and measurement'
- Amendment to IAS 39, 'Financial instruments: Recognition and measurement', and IFRS 7, 'Financial instruments: Disclosures', on the 'Reclassification of financial assets'
- Amendment to IAS 39, 'Financial instruments: Recognition and measurement', on 'Eligible hedged items'
- IFRIC 9, 'Re-assessment of embedded derivatives'
- Amendment to IFRIC 9, 'Re-assessment of embedded derivatives', and IAS 39, 'Financial instruments: Recognition and measurement', on 'Embedded derivatives'
- IFRIC 16, 'Hedges of a net investment in a foreign operation'

Exposure drafts and discussion papers
- Exposure draft, 'Fair value options for financial liabilities'
- Exposure draft, 'Financial instruments – amortised cost and impairment'
- Discussion paper on 'Credit risk in liability measurement'
- Discussion paper on 'Reducing complexity in reporting financial instruments'
- Discussion paper on 'Financial instruments with characteristics of equity'

PwC views
- PwC comment letter on discussion paper on 'Credit risk in liability measurement'
- PwC comment letter on discussion paper on 'Reducing complexity in reporting financial instruments'
- PwC comment letter on discussion paper on 'Financial instruments with characteristics of equity'

PwC guidance
- Manual of Accounting – Financial instruments chapter 10, Hedge accounting

Tools practice aids and publications
- IFRS extracts from accounts
- Financial instruments under IFRS: A guide through the maze
- IAS 39 – Achieving hedge accounting in practice
- IAS 39 – Hedging aligning theory with practice

Summary of key requirements

1 'Hedging' is a risk management activity. More specifically, it is the process of using a financial instrument (usually a derivative) to mitigate all or some of the risk of a hedged item. Without hedge accounting, gains and losses on a hedging instrument may be recognised in a different period to those of a hedged item that they are designed to mitigate. In simple terms, 'hedge accounting' corrects for this effect by ensuring that gains and losses resulting from a hedge relationship are recognised in profit or loss in the same accounting period. This is achieved by changing the time of recognition of gains and losses on either the hedged item or the hedging instrument so that both are recognised in profit or loss in the same accounting period.

Hedged items

2 A hedged item is an asset, liability, firm commitment, highly probable forecast transaction or net investment in a foreign operation that exposes the entity to risk of changes in fair value or future cash flows that could affect profit or loss. In particular, a hedged item could be:

- A single asset, liability, firm commitment or highly probable forecast transaction.
- A group of assets, liabilities, firm commitments or highly probable forecast transactions with similar risk characteristics.
- A portion of the risk or cash flows of a financial asset or liability.
- A non-financial asset or liability (such as inventory) for either foreign currency risk or the entire price risk
- A held-to-maturity investment for either foreign currency risk or credit risk (but not interest rate risk).
- The foreign currency risk on a net investment in a foreign operation.

[IAS 39 paras 78-80, 82].

3 Generally, only assets, liabilities, firm commitments or highly probable forecast transactions that involve a party external to the reporting entity can be designated as hedged items. However, there are exceptions to this rule for certain foreign currency intra-group transactions. [IAS 39 para 80].

Hedging instruments

4 Derivatives that involve an external party may be designated as hedging instruments. However written options or net written options structures cannot be designated as hedging instruments. [IAS 39 para AG94]. An external non-derivative financial asset or liability may be designated as a hedging instrument only in a hedge of foreign currency risk. [IAS 39 para 72, 77].

5 A proportion of the entire hedging instrument, such as 50 per cent of the notional amount, may be designated as the hedging instrument. However, a hedging instrument may not be designated for only a portion of the time period during which it is outstanding. [IAS 39 para 75].

Hedge accounting criteria

6 In order to qualify for hedge accounting, an entity should formally designate and document the hedging relationship at the inception of the hedge. This includes identifying the hedging instrument, the hedged item or transaction, the nature of the risk being hedged and how the entity will assess hedge effectiveness, together with the entity's risk management objective and strategy for undertaking the hedge. [IAS 39 para 88(a)].

7 The entity also measures the effectiveness of the hedge, both at inception and on an ongoing basis. To qualify for hedge accounting the hedge must both be expected to be highly effective and be determined actually to have been highly effective. IAS 39 does not require a hedge to be perfectly effective in order for hedge accounting to be used. A hedge is regarded as highly effective if both of the following conditions are met:

- At the inception of the hedge and in subsequent periods, the hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated.
- The actual results of the hedge are within a range of 80-125 per cent.

[IAS 39 paras 88(b), AG 105-113].

8 If the hedged item is a forecast transaction such as forecast sales or purchases in a foreign currency, the transaction must be highly probable and must give rise to an exposure that could ultimately affect profit or loss in order for it to qualify for hedge accounting.

Hedge accounting rules

9 In order to apply hedge accounting the above criteria must be met and the hedging relationship must fall into one of three defined categories described below.

Fair value hedges

10 A 'fair value hedge' is a hedge of the exposure to changes in fair value of a recognised asset, liability or unrecognised firm commitment, or identified portion thereof, that is attributable to a particular risk and could affect profit or loss. An example is an interest rate swap hedging a fixed rate borrowing. A fair value hedge is accounted for as follows:

- The hedging instrument is measured at fair value if it is a derivative. Non-derivatives may only be designated as hedging instruments for hedges of a foreign currency risk and in that case, the foreign currency

element of the non-derivative that is remeasured in accordance with IAS 21, 'The effects of changes in foreign exchange rates'.
- The carrying amount of the hedged item is adjusted for gains and losses related to the hedged risk. These gains and losses are also recognised in profit or loss. The result is that there is no net profit and loss effect, other than any hedge ineffectiveness.
  - If the hedged item is normally carried at amortised cost, the hedged item is not adjusted to its full fair value but for the hedged risk only. For example, a fixed rate borrowing is still basically measured at amortised cost and is adjusted only for the hedged risk (for example, interest rate risk) arising over the period of the hedge.
  - Where the hedged item is an available-for-sale financial asset, the gain or loss attributable to the hedged risk is recognised in profit or loss, rather than equity, although the remainder of any fair value gain or loss is recognised in equity.

[IAS 39 paras 72, 89].

11 A 'cash flow hedge' is a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with a recognised asset or liability or a highly probable forecast transaction and could affect profit or loss. An example is an interest rate swap hedging a variable rate borrowing. A cash flow hedge is accounted for as follows:
- The carrying value of the hedged item is not adjusted during the period of the hedge (see fourth bullet point below).
- The hedging instrument is measured at fair value if it is a derivative. Non-derivatives may only be designated as hedging instruments for hedges of a foreign currency risk and in that case the foreign currency element of the non-derivative that is remeasured in accordance with IAS 21, 'The effects of changes in foreign exchange rates'. The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge is recognised directly in equity. The ineffective portion of the gain or loss on the hedging instrument is recognised in profit or loss.
- The gain or loss deferred in equity is reclassified to profit or loss when the hedged cash flows affect profit or loss.
- If the hedged cash flows result in the recognition of a non-financial asset or liability on the balance sheet, the entity can choose an accounting policy of adjusting the initial carrying amount of the asset or liability by the amount deferred in equity. This choice should be applied consistently to all such hedges. This policy choice affects only the balance sheet: it has no effect on when the hedging gains and losses are recognised in profit or loss.

[IAS 39 paras 95, 97-98].

Hedge of a net investment

12 A 'hedge of a net investment' in a foreign operation is a hedge of the reporting entity's interest in the net assets of that operation. For this purpose, net investment includes any monetary items that are accounted for as part of the net investment under IAS 21. In the consolidated financial statements, the foreign operation's net assets are retranslated with gains and losses being recognised in equity. The hedging instrument (whether a derivative or a non-derivative) is accounted for similarly to a cash flow hedge with the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge being recognised directly in equity. The ineffective portion is recognised in profit or loss. The gain or loss that has been recognised in equity is reclassified to profit or loss on the foreign operation's disposal or partial disposal. [IAS 39 para 102].

Discontinuing hedge accounting

13 Hedge accounting is discontinued prospectively if any of the following occur:
- The hedge fails the effectiveness tests.
- The hedging instrument is sold, terminated or exercised.
- The hedged item is settled.
- The entity revokes the hedge relationship.
- In a cash flow hedge, the forecast transaction that is hedged is no longer highly probable.

[IAS 39 paras 91, 101].

14 When a non-derivative asset or liability has been adjusted for changes in fair value under a hedging relationship, the adjusted carrying amount becomes its new amortised cost. Any hedging adjustment is then amortised to profit or loss over the remaining period to the asset or liability's maturity. [IAS 39 para 92].

15 If a cash flow hedge relationship ceases, the amounts accumulated in equity will be maintained in equity until the hedged item affects profit or loss. However, if the hedge accounting ceases because the forecast transaction that was hedged is no longer expected to occur, the gains and losses deferred in equity are recognised in profit or loss immediately. Similarly, any amounts accumulated in equity while a hedge of net investment was effective remain in equity until the disposal of the related net investment. [IAS 39 para 101].

Financial instruments – Disclosure

Overview

There have been significant developments in risk management concepts and practices in recent years. New techniques have evolved for measuring and managing exposures to risks arising from financial instruments. This, coupled with the significant volatility experienced in the financial markets, has increased the need for more relevant information and greater transparency about an entity's exposures arising from financial instruments and how those risks are managed. Financial statement users and other investors need such information to make more informed judgements about risks that entities run from the use of financial instruments and their associated returns.

IFRS 7 sets out disclosure requirements that are intended to enable users to evaluate the significance of financial instruments for an entity's financial position and performance, and to understand the nature and extent of risks arising from those financial instruments to which the entity is exposed.

IFRS 7 does not just apply to banks and financial institutions. All entities that have financial instruments are affected – even simple instruments such as borrowings, accounts payable and receivable, cash and investments.

IFRS 7 does not consider the presentation of financial assets and liabilities as either current or non-current, or whether they can be offset. This is considered in IAS 1, 'Presentation of financial statements'.

Resources

Standards and interpretations

- IFRS 7, 'Financial instruments: Disclosures'
- Annual improvements 2010 amendments to IFRS 7, 'Financial instruments: Disclosures'
- IFRS 9, 'Financial instruments'
- IAS 32, 'Financial instruments: Presentation'
- Amendment to IAS 32, 'Financial instruments: Presentation', and IAS 1, 'Financial statement presentation', on 'Puttable financial instruments and obligations arising on liquidation'
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- Amendment to IAS 39, 'Financial instruments: Recognition and measurement', on 'Eligible hedged items'
- IFRIC 9, 'Re-assessment of embedded derivatives'
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- IFRIC 16, 'Hedges of a net investment in a foreign operation'

Exposure drafts and discussion papers

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- PwC comment letter on discussion paper on 'Financial instruments with characteristics of equity'

PwC guidance

- Manual of Accounting – Financial instruments chapter 11, Presentation and disclosure
- IFRS 7, 'Frequently asked questions'

Tools practice aids and publications

- IFRS extracts from accounts
- Financial instruments under IFRS: A guide through the maze

Summary of key requirements

Objective and general matters

1 The objective of IFRS 7 is to provide disclosures that will enable users to evaluate the significance of financial instruments:

- for an entity's financial position and performance; and
- to understand the nature and extent of risks arising from those financial instruments to which the entity is exposed and how the entity manages those risks. [IFRS 7 para 1].

2 The standard requires various disclosures by class or by category. Categories are those defined in IAS 39 and include financial assets at fair value through profit or loss, held-to-maturity investments, loans and receivables, available for sale assets'; financial liabilities at fair value through profit or loss and other financial liabilities at amortised cost. IFRS 7 does not provide a prescriptive list

of classes of financial instruments. An entity groups financial instruments into appropriate classes that take into account the nature of the information disclosed and the instrument's characteristics. In addition, an entity provides sufficient information to permit reconciliation to the line items presented in the balance sheet. [IFRS 7 para 6].

3 An entity is permitted to disclose the information required by the standard either in the notes or on the face of the balance sheet or income statement. [IFRS 7 paras 8, 20]. Entities might present the information about the nature and extent of risks arising from financial instruments required by IFRS 7 outside the financial statements in a separate management commentary or business review. This is permissible where the information is incorporated by cross-reference from the financial statements and is made available to users of the financial statements on the same terms as the financial statements and at the same time. [IFRS 7 App B para 6].

Income statement and balance sheet disclosures

4 Disclosures relating to the income statement incorporate many requirements such as interest income and expense and gains and losses (including impairment losses) on financial instruments included in profit or loss. [IFRS 7 para 20].

5 Additional disclosures include those relating to hedges, such as disclosing separately gains or losses on hedged items attributable to the hedged risk and hedging instruments in fair value hedges, as well as the ineffectiveness recognised in profit or loss that arises from cash flow hedges and net investment hedges. [IFRS 7 para 24].

6 In terms of the balance sheet, apart from incorporating many of the requirements from IAS 32, a key addition is the disclosure of the carrying amount of each category of financial instruments (as defined by IAS 39) and the fair value of each class of financial instrument should be disclosed. There are further disclosures relating to loans and receivables and financial liabilities that have been designated as at fair value through profit and loss, reclassification, derecognition, assets pledged as collateral, allowance accounts for credit losses, certain compound financial instruments and defaults and breaches. [IFRS 7 paras 9 to 19].

7 Other requirements include disclosure of specific accounting policies, such as criteria for designating financial assets as available-for-sale and as fair value through profit or loss and the criteria determining that there is objective evidence that an impairment loss has occurred. [IAS 1 para 108; IFRS 7 para 21].

8 In October 2008, the IASB amended IAS 39 to allow the reclassification of certain financial assets out of 'held-for-trading' or 'available-for-sale' into another category under limited circumstances (see also the classification and measurement topic summary). IFRS 7 has also been amended to incorporate further disclosure requirements relating to any assets reclassified as a result of this amendment to IAS 39.

Financial instrument risk disclosures

9 IFRS 7 takes a different approach to 'risk disclosures' from the previous standards. In principle, these disclosures should be given 'through the eyes of management'. That is, entities are required to communicate to the market how they perceive, manage and measure the risk they are exposed to. Essentially, IFRS 7 requires the company to tell the users of the financial statements what risks weigh on the minds of management and what it is doing about them. [IFRS 7, paras 31, 32, 34].] However, note certain minimum disclosures are also required to the extent they are not already covered by the 'through the eyes of management' information.

Qualitative disclosures

10 The standard requires qualitative disclosure to include information on the process that an entity uses to manage and measure financial risk. [IFRS 7 para 33].

Quantitative disclosures

11 The standard requires quantitative risk disclosures based on the information provided internally to the entity's key management personnel. [IFRS 7 para 34, 35].

12 In addition, IAS 1, 'Presentation of financial statements', includes requirements regarding qualitative and quantitative disclosures about the entity's objectives, policies and processes for managing capital. [IAS 1 para 124].

13 IFRS 7 disclosures focus on the risks that arise from financial instruments and typically include, but are not limited to, credit risk, liquidity risk and market risk, as defined in appendix A to the standard. Operational risk is not covered by IFRS 7.

Credit risk

14 Credit risk is the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation. Disclosures here include information relating to collateral and other credit enhancements available. This also covers the nature and carrying amount of assets obtained as collateral. If non-financial assets are obtained that are not readily

convertible to cash and the entity does not plan to use them in its operations, the policy for disposing of such assets is disclosed. [IFRS 7 para 36, 38].

15 There are specific disclosures relating to impaired or past due assets and assets that would be either past due or impaired absent a renegotiation of terms. [IFRS 7 para 36, 37]. A financial asset is past due when a counterparty has failed to make a payment when contractually due. [IFRS 7 App A]. This includes loans and receivables that are one day overdue. IFRS 7 also requires disclosures on credit quality of fully performing assets. [IFRS 7 para 36(c)]. Practically, applying some of these disclosure requirements could be an onerous exercise.

Liquidity risk

16 This is the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities. Disclosures here include a maturity analysis for financial liabilities showing the remaining contractual payments to maturity and a description of the approach to managing the inherent liquidity risk. [IFRS 7 para 39]. These amounts are undiscounted and include all payments, for example interest. Entities need to consider how to obtain this information, especially in cases such as derivatives where current systems may not provide the required information. If an entity manages liquidity risk on the basis of expected maturity dates, it can disclose an additional maturity analysis of the expected maturity dates of both financial assets and liabilities. However, in such a case, it should clarify how the expected dates are determined and the principal reasons for differences from the contractual maturity analysis required above. [IFRS 7 para IG 30].

17 The March 2009 amendment to IFRS 7 changed the minimum disclosure requirements for liquidity risk. An additional and separate liquidity analysis should be disclosed for derivative financial liabilities for which contractual maturities are essential for understanding the timing of the cash flows. The amendment confirms the requirement for a maturity analysis to be based on undiscounted contractual cash flows for non-derivative financial liabilities. It also clarifies the treatment of financial guarantees, which should be included in the maturity analysis at the maximum amount and allocated to the earliest period in which the guarantee could be called. Whilst some entities have voluntarily produced a maturity analysis of financial assets alongside the analysis of financial liabilities, the amendment introduces a requirement for a maturity analysis for financial assets when this is necessary for users of financial statements to understand the liquidity risk of the entity.

Market risk

18 Market risk is defined as the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: currency risk, interest rate risk and other price risk such as share or commodity price risk.

19 To meet these requirements, a sensitivity analysis for each component of market risk (currency, interest rate and other price risk) to which an entity is exposed should be given. This should illustrate how ‘reasonably possible’ changes in the relevant risk variable would impact profit or loss and equity. The assumptions used in the analysis should be disclosed, and any changes in assumptions since the last period and the reasons for those changes should be given. [IFRS 7 para 40].

20 If an entity prepares a sensitivity analysis, such as value-at-risk (VaR), which reflects interdependencies between risk variables (for example, interest rates and exchange rates) and uses it to manage financial risks, it may use that sensitivity analysis in place of the analysis described above. However, it cannot choose just to apply VaR for disclosure purposes, but continue to manage each risk variable separately. [IFRS 7 para 41].

21 This requirement could prove the most challenging for management to prepare, particularly for multinational groups. Finance directors will need to spend more time with their investor relations team to ensure that key messages are communicated, the strength (or otherwise) of internal risk management processes is explained, new information is properly understood by external stakeholders and any significant differences with key competitors are explained. It follows that those who have a good story to tell, and tell it clearly, will potentially be rewarded in the market place.

Fair value hierarchy

22 The March 2009 amendment introduced to IFRS a three-level fair value hierarchy similar to that required under US GAAP. Each class of financial instrument is categorised into one level of the hierarchy, determined on the basis of the lowest level input that is significant to the fair value is measurement. The three levels of the hierarchy are:

- Level 1: Quoted prices (unadjusted) in active markets for identical assets or liabilities.
- Level 2: Inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly (that is, prices) or indirectly (that is, derived from prices).
- Level 3: Inputs for the asset or liability that are not based on observable market data.

23 Each class of financial instruments that is measured at fair value in the financial statements is then disclosed at the appropriate level in the hierarchy. The position in the hierarchy also drives a series of additional disclosures, namely:

- Significant transfers during the period between levels one and two of the fair value hierarchy.
- A reconciliation of movements in the level 3 balance, from the beginning to the end of the period. The reconciliation should include gains and losses, transfers in and out of level 3, purchases, sales and settlements.
- Analyses of the gains and losses recognised on financial instruments within level 3, including where in the statement of comprehensive income they are recognised.
- Sensitivity analysis of the assumptions applied to level 3 measurements.

Presentation of financial instruments

24 The principles for presenting financial instruments as current or non-current, or on a net or gross basis, are included within IAS 1. IAS 1 requires assets and liabilities to be presented as current or non-current, or broadly in order of liquidity if that is more appropriate.

25 Assets or liabilities should be presented by an entity as current when:

- It expects to realise, sell or consume the asset or settle the liability in its normal operating cycle.
- It is held primarily for trading.
- It is due to be realised or settled within the 12 months after the reporting period.
- The entity does not have the unconditional right to defer settlement of the liability for at least twelve months after the reporting period.
- The asset is cash or a cash equivalent, unless it is restricted from being exchanged or used to settle a liability for at least 12 months after the reporting period.

26 The classification of an asset or liability is at the balance sheet date. Therefore, a change in terms of an instrument (for example, the refinancing of a loan which would otherwise mature within 12 months of the reporting period) subsequent to that date would not be an adjusting subsequent event.

27 An entity should present a financial asset and liability offset in the balance sheet if, and only if:

- The entity currently has a legally enforceable right to set off the recognised amounts.
- The entity intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

In consideration of the presentation of particular items, recognition and derecognition should also be considered (see the recognition and derecognition topic summary).

Financial instruments – IFRS 9

Overview

In November 2009, the IASB published the first part of its three stage project to replace IAS 39, in the form of a new standard IFRS 9, 'Financial Instruments'. This first phase deals with the classification and measurement of financial assets. The standard applies for annual periods beginning on or after 1 January 2013. Early application is permitted, although IFRS 9 has not yet been endorsed for use in the EU.

The summary below reflects the main requirements of IFRS 9. IFRS 9 as issued in November 2009 applies only to financial assets.

IFRS 9 replaces the multiple classification and measurement models in IAS 39 with a single model that has only two classification categories: amortised cost and fair value. Classification under IFRS 9 is driven by the entity's business model for managing the financial assets and the contractual characteristics of the financial assets.

A financial asset is measured at amortised cost if two criteria are met:
(a) the objective of the business model is to hold the financial asset for the collection of the contractual cash flows; and
(b) the contractual cash flows under the instrument solely represent payments of principal and interest.

The new standard removes the requirement to separate embedded derivatives from financial asset hosts. It requires a hybrid contract to be classified in its entirety at either amortised cost or fair value.

Two of the existing three fair value option criteria become obsolete under IFRS 9, as a fair value driven business model requires fair value accounting, and hybrid contracts are classified in their entirety at fair value. The remaining fair value option condition in IAS 39, financial instruments; Recognition and measurement', is carried forward to the new standard – that is, management may still designate a financial asset as at fair value through profit or loss on initial recognition if this significantly reduces an accounting mismatch. The designation at fair value through profit or loss will continue to be irrevocable.

IFRS 9 prohibits reclassifications except in rare circumstances when the entity's business model changes.

There is specific guidance for contractually linked instruments that create concentrations of credit risk, which is often the case with investment tranches in a securitisation.

IFRS 9's classification principles indicate that all equity investments should be measured at fair value. However, management has an option to present in other comprehensive income unrealised and realised fair value gains and losses on equity investments that are not held-for-trading.

IFRS 9 removes the cost exemption for unquoted equities and derivatives on unquoted equities, but provides guidance on when cost may be an appropriate estimate of fair value.

Resources

Standards and interpretations

- IFRS 7, 'Financial instruments: Disclosures'
- Annual improvements 2010 amendments to IFRS 7, 'Financial instruments: Disclosures'
- IFRS 9, 'Financial instruments'
- IAS 32, 'Financial instruments: Presentation'
- Amendment to IAS 32, 'Financial instruments: Presentation', and IAS 1, 'Financial statement presentation', on 'Puttable financial instruments and obligations arising on liquidation'
- Amendment to IAS 32, 'Financial instruments: Presentation', on 'Classification of rights issues'
- IAS 39, 'Financial instruments: Recognition and measurement'
- Amendment to IAS 39, 'Financial instruments: Recognition and measurement', and IFRS 7, 'Financial instruments: Disclosures', on the 'Reclassification of financial assets'
- Amendment to IAS 39, 'Financial instruments: Recognition and measurement', on 'Eligible hedged items'
- IFRIC 9, 'Re-assessment of embedded derivatives'
- Amendment to IFRIC 9, 'Re-assessment of embedded derivatives', and IAS 39, 'Financial instruments: Recognition and measurement', on 'Embedded derivatives'
- IFRIC 16, 'Hedges of a net investment in a foreign operation'

Exposure drafts and discussion papers

- Exposure draft, 'Fair value options for financial liabilities'
- Exposure draft, 'Financial instruments – amortised cost and impairment'
- Discussion paper on 'Credit risk in liability measurement'
- Discussion paper on 'Reducing complexity in reporting financial instruments'
- Discussion paper on 'Financial instruments with characteristics of equity'

PwC views

- PwC comment letter on discussion paper on 'Credit risk in liability measurement'

- PwC comment letter on discussion paper on 'Reducing complexity in reporting financial instruments'
- PwC comment letter on discussion paper on 'Financial instruments with characteristics of equity'

Tools practice aids and publications

- 'Straight away' 18, Guidance for financial liabilities unchanged except for those at fair value through profit or loss
- 'Straight away' 07, guidance on IFRS 9, 'Financial instruments'
- IFRS in brief: Special edition – Proposed changes to accounting for financial instruments

Summary of key requirements

1 IAS 39 has been criticised for being difficult to understand, apply and interpret. In response, the IASB has begun a fast-track project to replace IAS 39. The project has three phases: classification and measurement; impairment and amortised cost measurement; and hedge accounting. As regards the first phase, in November 2009, the IASB published a new standard, IFRS 9, 'Financial Instruments', that sets out new requirements for how financial assets should be classified and measured. The requirements of IFRS 9 are described in more detail below.

2 The new standard has two measurement categories: amortised cost and fair value. In order to determine the financial assets that fall into each measurement category, companies will first need to consider whether the financial asset is a debt or equity investment

Debt instruments

3 If the financial asset is a debt investment, companies will *need to* consider whether both the following tests are met:

- the objective of the entity's business model is to hold the assets to collect the contractual cash flows; and
- the asset's contractual cash flows represent only payments of principal and interest. Interest is consideration for the time value of money and the credit risk associated with the principal amount outstanding during a particular period of time.

4 If both these tests are met, then the financial asset is eligible for amortised cost measurement even if the financial assets are acquired in the secondary market at a discount that reflects incurred credit losses. However, companies will have the ability to designate a financial asset as at fair value through profit or loss if doing so reduces or eliminates a measurement or recognition inconsistency ('accounting mismatch'). If the financial asset does not pass one or both of the above tests then it must be measured at fair value through profit or loss. The new standard removes the held-to-maturity and available-for-sale categories presently in IAS 39, and the tainting rules associated with the former.

5 Reclassifications between fair value and other categories are required only when the entity changes how it manages its financial instruments (that is, changes its business model). Such changes are expected to be very infrequent. The reclassification must be significant to the entity's operations and demonstrable to external parties. Any reclassification should be accounted for prospectively. At the date of a reclassification of a financial asset from amortised cost to fair value, the asset should be remeasured at fair value and this value will be the new carrying amount. Any difference between the previous carrying amount and the fair value would be recognised in a separate line item in the income statement.

6 All other reclassifications are prohibited.

Equity instruments

7 Investments in equity instruments are always measured at fair value. Equity instruments that are held-for-trading are required to be classified as fair value through profit or loss. For all other equities, a company has the ability to make an irrevocable election, on an instrument-by-instrument basis, to present changes in fair value in other comprehensive income (OCI) rather than profit or loss. If this election is made, all fair value changes excluding dividends (as long as they are return on investment) will be reported in OCI. There would be no recycling of amounts from OCI to profit and loss for example on sale of an equity investment, nor would there be any impairment requirements. However, the entity may transfer the cumulative gain or loss within equity.

8 The new standard removes the requirement in IAS 39 to measure unquoted equity investments at cost when fair value cannot be determined reliably. However, it indicates that in limited circumstances, cost may be an appropriate estimate of fair value. For example, when insufficient more recent information is available from which to determine fair value; or when there is a wide range of possible fair value measurements and cost represents the best estimate of fair value within that range. On the other hand, the new standard includes indicators of when cost might not be representative of fair value. These include changes in the performance of the investee, the market for its equity or the economic environment in which the investee operates.

Embedded derivatives

9 The accounting for embedded derivatives in host contracts that are financial assets is simplify by removing the requirement to consider whether or not they are closely related and should, therefore, be separated. The

classification approach in the new standard applies to all financial assets, including those with embedded derivatives.

10 Many embedded derivatives introduce variability to cash flows. This is not consistent with the notion that the instrument's contractual cash flows solely represent the payment of principal and interest. If an embedded derivative was considered closely related under the existing requirements, this does not automatically mean the instrument will qualify for amortised cost treatment under the new standard. Many hybrid contracts with financial asset hosts will, therefore, be measured at fair value in their entirety.

11 The accounting for embedded derivatives in non-financial host contracts and financial liabilities remains unchanged.

Contractually linked instruments (tranches)

12 The payments on some financial assets are contractually linked to the payments received on a pool of other instruments. These are referred to as contractual linked instruments. They are often issued by SPEs in various tranches with the more senior tranches being repaid in priority to the more junior ones. The classification criteria for the holder of such contractual linked instruments (tranches) should be assessed using a 'look through' approach. This approach looks through to the pool of underlying instruments to assess both the characteristics of these underlying instruments and the tranche's exposure to credit risk relative to the pool of underlying instruments.

13 To measure an individual tranche at amortised cost, the tranche itself (without looking through to the pool of underlying instruments) must give rise to cash flows that are solely payments of principal and interest. In addition, the underlying pool must only contain instruments that:

- meet the test of giving rise to cash flows that are payments of solely principal and interest;
- reduce the cash flow variability of the above instruments and, when combined with those instruments, result in cash flows that are solely payments of principal and interest; or
- align the cash flows (for example, for interest rates or currencies) of the tranches with the cash flows of the pool of underlying instruments.

In addition, the credit risk of the tranche must be equal to or lower than the weighted average credit risk of the underlying pool of financial instruments.

14 If it is impracticable to look through, fair value measurement is required.

Transition and effective date

15 The requirements in IFRS 9 are applied retrospectively with some exceptions to provide relief. For example, if it is impracticable to retrospectively apply the effective interest method or impairment requirements, the entity should determine the amortised cost of the instrument, or any impairment on the financial asset, in each period, determined by using its fair value at the end of each comparative period.

16 The effective date of IFRS 9 is 1 January 2013. Early application is permitted, although IFRS 9 has not yet been endorsed for use in the EU. If an entity adopts the new standard early, additional disclosures are required. The standard provides transition relief from restating comparative information for entities that adopt IFRS 9 for reporting periods before 1 January 2012.

17 The date of initial application may be any date between the issue of the new standard and 31 December 2010, for entities adopting the new IFRS before 1 January 2011 or the beginning of the first reporting period in which the entity adopts this IFRS, for entities adopting this IFRS on or after 1 January 2011.

First-time adoption of IFRS

Overview

IFRS 1 is effective for an entity's first IFRS financial statements and interim reports presented under IAS 34 that are part of that first period. An entity moving from national GAAP to IFRS should apply these requirements. The basic requirement is full retrospective application of all IFRSs effective at the reporting date. However, there are a number of optional exemptions and mandatory exceptions to the requirement for retrospective application.

The exemptions cover standards for which the IASB considers that retrospective application could prove to be too difficult or could result in a cost likely to exceed any benefits to users. The exemptions are optional. Any, all or none of the exemptions may be applied.

The optional exemptions relate to:

- Business combinations.
- Fair value or revaluation as deemed cost for property, plant and equipment and other assets.
- Employee benefits.
- Cumulative translation differences.
- Compound financial instruments.
- Assets and liabilities of subsidiaries, associates and joint ventures.
- Designation of previously recognised financial instruments.
- Share-based payment transactions.
- Insurance contracts.
- Decommissioning liabilities included in the cost of property, plant and equipment.
- Leases.
- Service concession arrangements.
- Borrowing costs.
- Investments in subsidiaries, jointly controlled entities and associates.

The exceptions cover areas in which retrospective application of the IFRS requirements is considered inappropriate. The exceptions are mandatory, not optional.

The mandatory exceptions relate to:

- Hedge accounting.
- Estimates.
- Non-controlling interests.

Comparative information is prepared and presented on the basis of IFRS. Almost all adjustments arising from the first-time application of IFRS are against opening retained earnings of the first period that is presented on an IFRS basis.

Certain reconciliations from previous GAAP to IFRS are also required.

Resources

Standards and interpretations

- IFRS 1, 'First-time adoption of International Financial Reporting Standards'
- Amendments to IFRS 1 'Additional exemptions for first-time adopters'
- Amendments to IFRS 1, 'First-time adoption of International Financial Reporting Standards' and IAS 27, 'Consolidated and separate financial statements' – Cost of an investment in a subsidiary, jointly controlled entity or associate
- Amendment to IFRS 1 – Limited exemption from comparative IFRS 7 disclosures for first-time adopters
- Improvements to IFRS 2010

PwC guidance

- Manual of Accounting chapter 3, First-time adoption of International Financial Reporting Standards

Tools practice aids and publications

- IFRS extracts from accounts
- Straight away 14, IFRS 1 amendment – Limited exemption from comparative IFRS 7 disclosures

Summary of key requirements

Objective and scope

1 The objective of IFRS 1, 'First-time adoption of International Financial Reporting Standards', is to ensure that an entity's first IFRS financial statements provide high quality information that is transparent and comparable over all periods presented, is a suitable starting point for accounting under IFRS and can be generated at a cost that does not exceed its benefit to users. [IFRS 1 para 1]. This objective also applies to interim reports prepared under IAS 34, 'Interim financial reporting', for part of the period covered by those first IFRS financial statements.

2 The guidance and requirements in IFRS 1 are used when an entity prepares its first IFRS financial statements. These are the first annual financial statements in which IFRS is adopted and which contain an explicit and unreserved statement of compliance with IFRSs. IFRS 1 is also applied to interim reports prepared under IAS 34 for part of the period covered by the first IFRS financial statements. [IFRS 1 paras 2, 3].

Accounting policies

3 The standard requires companies to select accounting policies that comply with the IFRSs in force at the closing balance sheet date for the first IFRS financial statements.

The selected accounting polices are applied retrospectively to all of the periods presented in the first IFRS financial statements. Successive versions of the same standard are not applied in different periods. The transitional guidance in individual standards and the guidance in IAS 8, 'Accounting policies, changes in accounting estimates and errors', for companies that change their accounting policies apply to existing IFRS users and cannot be used by first-time adopters. [IFRS 1 paras 7, 9].

Opening IFRS balance sheet

4 First-time adopters must prepare an opening IFRS balance sheet at *"the date of transition to IFRSs".* [IFRS 1 para 6]. This is the beginning of the earliest period for which full comparative information is presented in accordance with IFRS. [IFRS 1 App A]. Three statements of financial position must be presented, including the opening balance sheet, if IFRS is adopted in periods beginning on or after 1 July 2009. [IFRS 1 para 21]. If IFRS is adopted prior to this time, the opening balance sheet is not required to be presented. The accounting policies selected are used to prepare the opening IFRS balance sheet, which:

- Includes all the assets and liabilities required by IFRSs.
- Excludes any assets and liabilities not permitted by IFRSs.
- Classifies all assets, liabilities and equity in accordance with IFRSs.
- Measures all items in accordance with IFRSs.

[IFRS 1 para 10].

5 The adoption of IFRSs, and creation of the first IFRS balance sheet, is likely to result in adjustments to the amounts recorded under the entity's previous GAAP. The impact of these adjustments is generally recorded in retained earnings, although there are limited adjustments made to goodwill.

Optional exemptions from full retrospective application

6 There are various optional exemptions, each of which can be considered separately by first-time adopters. Some of the exemptions are applied to all relevant items in the opening IFRS balance sheet, but some can be applied to individual items.

Business combinations

7 IFRS 3 (revised) need not be applied retrospectively to business combinations that took place before the date of the transition. This is a significant simplification for many entities, but the application of the exemption is quite complex. An entity can choose to restate a particular business combination in accordance with the IFRS business combinations guidance in force at the balance sheet date in the first IFRS financial statements, but if it does so all subsequent business combinations must be restated. [IFRS 1 App C para C1].

8 When the exemption is applied to a previous business combination:

- The classification of the combination as an acquisition or a uniting of interests is not changed. [IFRS 1 App C para C4(a)].
- The assets and liabilities acquired or assumed in the combination that were recognised under previous GAAP are recognised in the acquirer's opening IFRS balance sheet, unless recognition is not permitted by IFRSs. The assets and liabilities acquired or assumed in a business combination that were not recognised under previous GAAP would be recognised if they would have qualified for recognition in the acquiree's opening IFRS balance sheet. [IFRS 1 App C para C4(b)(c)].
- Assets acquired and liabilities assumed in the combination that are measured at fair value under IFRSs are restated to fair value on the opening IFRS balance sheet. [IFRS 1 App C para C4(d)].
- The deemed cost of assets acquired and liabilities assumed in the combination is the carrying value under the previous GAAP immediately after the business combination. [IFRS 1 App C para C4(e)].
- Assets and liabilities that were not recognised after the business combination under the previous GAAP are recognised on the opening IFRS balance sheet only if they would be recognised in the acquired entity's opening IFRS balance sheet. [IFRS 1 App C para C4(f)].
- Goodwill written off directly to equity under previous GAAP is not reinstated as an asset on transition to IFRS. It is also not taken to the income statement as part of any subsequent gain or loss on disposal of the subsidiary. [IFRS 1 App C para C4(i)].
- Goodwill recognised as an asset under previous GAAP is only adjusted on transition in specific circumstances, including recognition of an intangible under IFRS that was not recognised under previous GAAP, reclassification of an intangible to goodwill that was recognised under previous GAAP that does not qualify for recognition under IFRS, or an impairment loss at the date of transition. [IFRS 1 App C para C4(g)(h)].

Fair value as deemed cost

9 Fair value may be used as deemed cost for any item of property, plant and equipment (PPE) at the date of transition. A revaluation made under previous GAAP may also be used as deemed cost if the revaluation resulted in a carrying amount that was broadly comparable to fair value at the time of the valuation or was based on a price index that was applied to cost. In addition, a first-time adopter may have established a deemed cost in

accordance with previous GAAP by measuring the assets at their fair value at one particular date because of an event such as a privatisation or initial public offering. These event-driven fair value measurements may be used as deemed cost for IFRSs at the date of that measurement. This exemption may be applied to any individual item of PPE. An entity that uses the exemption is not required to adopt a policy of regular revaluation under IAS 16, 'Property, plant and equipment,' in future periods. A similar exemption may be applied to investment property and to intangible assets for which there is an active market. [IFRS 1 App D paras D5 to D8].

Employee benefits

10 Employee benefits obligations are measured in accordance with IAS 19, 'Employee benefits'. Companies may choose under IAS 19 to adopt an accounting policy in which actuarial gains and losses are recognised in the income statement over a period. When this policy is adopted, some actuarial gains and losses are unrecognised at each balance sheet date. However, a first-time adopter can elect to recognise all cumulative actuarial gains and losses at the date of transition to IFRS, even if it elects to apply this 'corridor' approach prospectively from the date of transition to IFRS. The exemption must be applied to all of an entity's pension plans if it is used. [IFRS 1 App D para D10].

11 Alternatively, first-time adopters can apply the corridor approach allowed in IAS 19 retrospectively by not taking advantage of the exemption, in which case some actuarial gains and losses will be unrecognised on transition to IFRS.

12 Certain disclosures required by IAS 19 may be made prospectively from the date of transition as the amounts are determined. [IFRS 1 App D para D11].

Cumulative translation differences

13 Certain foreign currency translation differences, such as those on the opening net assets of a net investment in a foreign subsidiary, are recognised in reserves under IAS 21, 'The effects of changes in foreign exchange rates'. The exemption in IFRS 1 allows the cumulative translation difference to be set to zero at the date of transition for all subsidiaries. Entities are not, therefore, required to identify the cumulative translation differences that occurred prior to their date of transition to IFRS. [IFRS 1 App D para D12 to D13].

Compound financial instruments

14 Compound financial instruments are analysed into debt and equity components based on the circumstances at the instrument's inception. When the liability component of an instrument has been settled, two amounts remain in equity – the original equity component and the interest on the liability component that is a part of retained earnings. Entities are not required to identify separately the two elements of equity if the liability is not outstanding at the date of the date of transition. [IFRS 1 App D para D18].

Assets and liabilities of subsidiaries, associates and joint ventures

15 In certain situations, a subsidiary becomes a first-time adopter at a later date than its parent. Where this is the case, the subsidiary has a choice of measuring its assets and liabilities either based on the carrying amounts in the parent's consolidated financial statements (effectively using the earlier transition date of its parent group) or at the carrying amounts using IFRS 1 at its own date of transition to IFRS. An associate or joint venture that becomes a first-time adopter later than an entity that has significant influence or joint control over it can also take this exemption. However, if an entity becomes a first-time adopter later than its subsidiary, joint venture or associate, it should measure the assets and liabilities of its subsidiary, joint venture or associate in its consolidated financial statements at the same carrying amount as in the financial statements of the subsidiary (or joint venture or associate). Such amounts should be adjusted for any consolidation or equity method adjustments. Similarly, if a parent becomes a first-time adopter for its separate financial statements earlier or later than for its consolidated financial statements, it measures its assets and liabilities at the same amounts in both financial statements, except for consolidation adjustments. [IFRS 1 App D paras D16 to D17].

Designation of previously recognised financial instruments

16 IAS 39, 'Financial instruments: Recognition and measurement', permits a financial asset to be designated on initial recognition as available-for-sale or a financial instrument (provided it meets certain criteria) to be designated on initial recognition as a financial asset or financial liability 'at fair value through profit or loss'. Despite this, any entity is permitted to make an available-for-sale designation at the date of transition to IFRS. Additionally, any entity presenting its first IFRS financial statements may designate any financial asset or liability as at fair value through profit or loss at the date of transition if the asset or liability meets the criteria prescribed in IAS 39 at that date. [IFRS 1 paras App D para D19].

Share-based payment transactions

17 A first-time adopter need not apply the requirements of IFRS 2, 'Share-based payment', to equity instruments that

were granted before 7 November 2002. Also, it need not apply the requirements of IFRS 2 to equity instruments that were granted after 7 November 2002 and that had vested before the date of transition to IFRS. IFRS 2 can only be applied to these equity instruments if the entity has publicly disclosed their fair value, determined at the measurement date (as defined in IFRS 2). IFRS 2 also need not be applied to liabilities arising from share-based payment transactions that were settled before the date of transition to IFRS. [IFRS 1 paras App D para D2 to D3].

Insurance contracts

18 A first-time adopter can use the transitional provisions in IFRS 4. [IFRS 1 App D par. D4]. Most of IFRS 4's requirements do not need to be applied to comparative information related to annual periods beginning before 1 January 2005 if it is impracticable. There is also relief from some disclosure requirements in respect of that comparative information. [IFRS 4 paras 42 to 44].

Decommissioning liabilities

19 A decommissioning liability can be measured at the date of transition to IFRS in accordance with IAS 37, 'Provisions, contingent liabilities and contingent assets'. The first-time adopter then discounts the liability back to when it first arose and adds that amount to the related fixed asset. The asset is depreciated with the appropriate additional amount up to the date of transition to IFRS. [IFRS 1 App D para D21].

Leases

20 Arrangements must be examined to determine whether they contain a lease. There is an exemption in IFRS 1 permitting this to be done based on facts and circumstances at the date of transition to IFRS. [IFRS 1 App D para D9].

Service concession arrangements

22 A first-time adopter can use the transitional provisions in IFRIC 12, 'Service concession arrangements'. Where it is impracticable to apply IFRIC 12 retrospectively, an entity may recognise financial assets and intangible assets that existed at the start of the earliest period presented and measure them at their previous carrying amounts at that date. An impairment test should be carried out at that date or, if impracticable, as at the start of the current period. [IFRS 1 App D para D22; IFRIC 12 para 30].

Borrowing costs

23 IAS 23, 'Borrowing costs', requires the capitalisation of borrowing costs attributable to qualifying assets. An entity is permitted to apply the transitional provisions of the revised standard at the date of transition to IFRS. This would allow an entity to apply the revised IAS 23 to borrowing costs relating to qualifying assets for which the commencement date for capitalisation is on or after the date of transition to IFRS. An alternative treatment is permitted by IAS 23 paragraph 28, which permits an entity to designate any date as the commencement date for capitalisation. [IFRS 1 App D para D23].

Investments in subsidiaries, jointly controlled entities and associates

24 A first-time adopter can measure its investment in subsidiaries, jointly controlled entities and associates at cost, as defined in IAS 27, or 'deemed cost' in its separate financial statements. Deemed cost is defined as fair value at the date of transition or the carrying value under previous GAAP. [IFRS 1 App D para D14 to D15].

Expiry of exemptions

25 Some of the exemptions allowed by IFRS 1 are not available to entities that adopt IFRS in the future. Particular care is needed to ensure that where an entity proposes to take an exemption, that exemption is still available.

Exceptions from retrospective application

26 There are three exceptions from retrospective application. These are in the areas of hedge accounting, estimates and non-controlling interests.

Hedge accounting

28 An entity must measure all derivatives at fair value and eliminate all deferred losses and gains arising on derivatives that were reported in accordance with previous GAAP at the date of transition. An entity should not reflect in its opening balance sheet a hedging relationship that does not qualify for hedge accounting in accordance with IAS 39. However, if an entity designated a net position as a hedged item in accordance with previous GAAP, it may designate an individual item within that net position as a hedged item in accordance with IFRSs, provided that it does so no later than the date of transition to IFRSs. [IFRS 1 App B para B4 to B5].

29 If, before the date of transition to IFRSs, an entity had designated a transaction as a hedge, but the hedge does not meet the conditions for hedge accounting in IAS 39, hedge accounting should be discontinued in accordance with IAS 39. Transactions entered into before the date of transition to IFRSs should not be retrospectively designated as hedges. [IFRS 1 App B para B6].

Estimates

30 IFRS 1 does not permit the use of hindsight to revise estimates or to make new estimates. Estimates included in the opening IFRS balance sheet must be consistent with estimates made at the same date under previous GAAP, unless there is objective evidence of an error. [IFRS 1 para 14]. For example, a provision for a liability associated with litigation recognised under previous GAAP would not be revised under IFRS just because the outcome of the case is known when the first IFRS financial statements are later prepared.

31 However, an entity may need to make estimates at the transition date under IFRS that were not required under previous GAAP. Such estimates under IFRS should reflect conditions at the date of the opening IFRS balance sheet. In particular, estimates at the date of transition of market prices, interest rates or foreign exchange rates should reflect market conditions at that date. [IFRS 1 para 16].

Non-controlling interests

32 A first-time adopter should apply the following requirements of IAS 27 (revised) prospectively from the date of transition to IFRSs:

- the requirement that total comprehensive income is attributed to the owners of the parent and to the non-controlling interests even if this results in the non-controlling interests having a deficit balance;
- the requirements for the accounting for changes in the parent's ownership interest in a subsidiary that do not result in a loss of control; and
- the requirements for accounting for a loss of control over a subsidiary.

However, if a first-time adopter elects to apply IFRS 3 (revised) retrospectively to past business combinations, it shall also apply IAS 27 (revised). [IFRS 1 App B para B7].

Disclosures

Reconciliations

33 Companies are required to disclose reconciliations of:

- Equity from previous GAAP to IFRS at the date of transition to IFRS and at the end of the last period presented in the entity's most recent annual financial statements under previous GAAP.
- Total comprehensive income from previous GAAP to IFRS for the last period in the entity's most recent annual financial statements.

[IFRS 1 para 24(a)(b)].

34 Material adjustments to the cash flow statement should be explained and the disclosures required by IAS 36, 'Impairment of assets', should be given when impairment losses are recognised or reversed in the opening IFRS balance sheet. [IFRS 1 para 24(c)]. When a company uses fair value as deemed cost, it must disclose for each line item affected the aggregate fair values and the aggregate adjustment to the previous carrying amounts. [IFRS 1 para 30]. When a company uses deemed cost for its investment in subsidiaries, associates or jointly controlled entities, it must disclose the deemed cost (whether fair value or previous GAAP) and the aggregate adjustments to the previous carrying amounts. [IFRS 1 para 31]. If an entity designates financial assets and liabilities as available for sale or fair value through profit and loss, the entity shall disclose the fair value of each category and previous carrying amounts. [IFRS 1 para 29].

35 Interim financial reports should disclose the same annual reconciliations as the annual financial statements described above (or cross refer to another published document containing them) and should also disclose a reconciliation of the total comprehensive income for the comparative interim period and of the equity at the end of that period. When an entity reports quarterly, the annual reconciliations (or a cross reference as above) are required only in the first quarter's interim financial report. Interim financial reports are likely to require additional disclosures beyond those required by IAS 34, 'Interim financial reporting', to properly explain the transition to IFRS. [IFRS 1 para 32].

Comparatives

36 The first IFRS financial statements should contain one full year of comparative information presented in accordance with IFRSs. [IFRS 1 para 21]. Securities regulators might require full comparative information in accordance with IFRSs for additional periods. Entities may decide to provide additional comparative information prepared in accordance with previous GAAP. Such information must be labelled clearly as not compliant with IFRSs and the principal adjustments that would be required to comply with IFRS should be explained. There is a similar requirement for historical summaries. [IFRS 1 para 22].

Foreign currencies

Overview

Many entities do business with overseas suppliers or customers, or have overseas operations. This gives rise to two main accounting issues:

- Some transactions (for example, those with overseas suppliers or customers) may be denominated in foreign currencies. These transactions are expressed in the entity's own currency ('functional currency') for financial reporting purposes.
- An entity may have foreign operations – such as overseas subsidiaries, branches or associates – that maintain their accounting records in their local currency. Because it is not possible to combine transactions measured in different currencies, the foreign operation's results and financial position are translated into a single currency, namely that in which the group's consolidated financial statements are reported ('presentation currency').

The methods required for each of the above circumstances are summarised below.

Expressing foreign currency transactions in the entity's functional currency

A foreign currency transaction is expressed in the functional currency using the exchange rate at the transaction date. Foreign currency balances representing cash or amounts to be received or paid in cash ('monetary items') are reported at the end of the reporting period using the exchange rate on that date. Exchange differences on such monetary items are recognised as income or expense for the period. Non-monetary balances that are not re-measured at fair value and are denominated in a foreign currency are expressed in the functional currency using the exchange rate at the transaction date. Where a non-monetary item is re-measured at fair value in the financial statements, the exchange rate at the date when fair value was determined is used.

Translating functional currency financial statements into a presentation currency

Assets and liabilities are translated from the functional currency to the presentation currency at the closing rate at the end of the reporting period. The income statement is translated at exchange rates at the dates of the transactions or at the average rate if that approximates the actual rates. All resulting exchange differences are recognised in other comprehensive income.

The financial statements of a foreign operation that has the currency of a hyperinflationary economy as its functional currency are first restated in accordance with IAS 29, 'Financial reporting in hyperinflationary economies'. All components are then translated to the presentation currency at the closing rate at the end of the reporting period.

Resources

Standards and interpretations
- IAS 21, 'The effects of changes in foreign exchange rates'
- IAS 29, 'Financial reporting in hyperinflationary economies'

PwC guidance
- Manual of Accounting chapter 6, Hyper-inflation
- Manual of Accounting chapter 7, Foreign currencies

Tools practice aids and publications
- IFRS extracts from accounts
- Financial reporting in hyper-inflationary economies – Understanding IAS 29

Summary of key requirements

Overview

1 Many entities do business with overseas suppliers or customers, or have overseas operations. For accounting purposes, this gives rise to two main issues:

- Some transactions (for example, those with overseas suppliers or customers) may be denominated in foreign currencies.
- An entity may have foreign operations – such as overseas subsidiaries or branches – that maintain their accounting records in their local currency.

As it is not possible to combine transactions measured in different currencies, an entity first determines its functional currency (see paras 3-9). Secondly, all foreign currency transactions and balances are translated into its functional currency and exchange differences recognised accordingly (see paras 10-20). A group needs to present its consolidated results in a single currency, which is the presentation currency. The results of all entities in the group are, therefore, translated into that presentation currency (see paras 21-29). For the specific requirements that apply on the disposal or part disposal of foreign operations refer to paragraph 30 and the required disclosures on foreign exchange are discussed in paragraph 31.

Key definitions

2 Some of the definitions that are key to understanding the standard are given below:

- Foreign currency: A currency other than the entity's functional currency.

- Functional currency: The currency of the primary economic environment in which the entity operates.
- Foreign operation: An entity that is a subsidiary, associate, joint venture, or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity.
- Exchange difference: The difference resulting from translating a given number of units of one currency into another currency at different exchange rates.
- Closing rate: The spot exchange rate at the end of the reporting period.
- Presentation currency: The currency in which financial statements are presented.
- Monetary items: These are units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency. An entity's own equity instruments can be considered 'currency' in a contract that can be settled in a value equal to a fixed or determinable amount.

[IAS 21 para 8].

Functional currency

3 First, each individual entity, whether a stand-alone entity, an entity with foreign operations or a foreign operation itself, should determine its functional currency. Any transaction not in the functional currency is a foreign currency transaction, which must be translated appropriately. Functional currency is not a choice but depends on facts and circumstances. [IAS 21 para IN8]. IAS 21 provides guidance in the form of primary and secondary indicators on how to determine an entity's functional currency.

Identification of the functional currency

4 The functional currency is the currency of the primary economic environment in which the entity operates, which is normally the one in which it primarily generates and expends cash. [IAS 21 para 8]. An entity's management considers the following factors (primary indicators) in determining its functional currency:

- the currency that mainly influences sales prices for goods and services;
- the currency of the country whose competitive forces and regulations mainly determine the sales prices of goods and services; and
- the currency that mainly influences labour, material and other costs of providing goods and services.

[IAS 21 para 9].

5 The currency that mainly influences sales prices (the first bullet point above) and labour, material and other costs (the third bullet point above) will normally be the currency in which those sales prices or costs are denominated and settled. However, this will not always be the case – the emphasis is on the currency that impacts the prices or costs. [IAS 21 paras IN7, 9].

6 Further factors (secondary indicators) that may also provide evidence of an entity's functional currency are the currency in which funds from financing activities are generated and in which receipts from operating activities are retained. [IAS 21 para 10].

7 Four additional factors are considered in determining the functional currency of a foreign operation and whether its functional currency is the same as that of the reporting entity. These are:

- the autonomy of a foreign operation from the reporting entity;
- the level of transactions between the two; whether the foreign operation generates sufficient cash flows to meet its cash needs; and
- whether its cash flows directly affect those of the reporting entity.

[IAS 21 para 11].

8 When the above indicators are mixed and the functional currency is not obvious management uses its judgement to determine the functional currency that most faithfully represents the economic effects of the underlying transactions, events and conditions. [IAS 21 para 12].

Change in functional currency

9 An entity's management may determine that its functional currency has changed when, there is a change in the underlying transactions, events or conditions relevant to the entity. [IAS 21 para 13]. Where there is a change in the functional currency of an entity, the translation procedures, (see below para 23), applicable to the new functional currency should be applied *prospectively* from the date of change. [IAS 21 para 35].

10 When an entity determines that its functional currency has changed it frequently elects to change it presentation currency to be consistent. A change in presentation currency is a change in accounting policy which needs to be accounted for retrospectively in accordance with IAS 8, 'Accounting policies, changes in accounting estimates and errors'. Comparative information should be retranslated, using the methodology for translating from functional currency to presentation currency. This is relatively straightforward for assets and liabilities, but may be more complex for equity amounts since an entity's management would need to recalculate historical information from a number of years in order to arrive at the correct opening balance sheet position.

Expressing foreign currency transactions in the entity's functional currency

11 A foreign currency transaction should be recorded in the entity's functional currency on initial recognition using the spot rate at the date of the transaction. IAS 21 permits the use of an average rate if it is a reasonable approximation of the actual rate. [IAS 21 paras 21, 22].

12 At each end of the subsequent reporting period:

- Foreign currency monetary items should be translated using the closing rate.
- Non-monetary items denominated in a foreign currency and measured at historical cost should be translated using the spot rate at the transaction date.
- Non-monetary items denominated in a foreign currency and measured at fair value (for example, a property revalued under IAS 16, 'Property, plant and equipment') should be translated using the exchange rates at the date when the value is determined.

[IAS 21 para 23].

13 Certain non-monetary assets (for example, inventory) are measured at the lower of cost or net realisable value. Each of these amounts will be translated at the exchange rate on the date on which the amount was determined and then compared. Therefore, an impairment loss in the entity's functional currency may have to be recognised which would not be recognised if the foreign currency was the functional currency or vice versa. [IAS 21 para 25].

Recognition of exchange differences – Monetary items

14 Exchange differences arising when monetary items are settled or when monetary items are translated at rates different from those at which they were translated when initially recognised or in previous financial statements are reported in profit or loss in the period. [IAS 21 para 28]. There are two exceptions to this rule: (i) in consolidation, monetary items that form part of a reporting entity's net investment in a foreign operation and (ii) monetary items designated as either cash flow hedges or hedges of a net investment. [IAS 21 para 32; IAS 39 paras 95–98, 102].

(i) Monetary items that form part of a reporting entity's net investment in a foreign operation

15 Exchange differences arising on a monetary item that forms part of a reporting entity's net investment in a foreign operation should be recognised in profit or loss in the separate financial statements of the affected entity. However, in the consolidated financial statements, such exchange differences should be recognised in other comprehensive income and reclassified in profit or loss on disposal or partial disposal of the net investment. [IAS 21 para 32].

16 A common example of a monetary item that forms part of a reporting entity's net investment in a foreign operation is a loan from a parent to its subsidiary for which settlement is neither planned nor likely to occur in the foreseeable future. However, loans between fellow subsidiaries ('sister company loans') may also qualify. [IAS 21 para 15A]. The currency of the loan is irrelevant: IAS 21 permits inter-company items denominated in any currency to be part of a net investment in a foreign operation.

(ii) Monetary items designated as either cash flow hedges or hedges of a net investment

17 Monetary items that are designated and effective as hedging instruments in a cash flow or net investment hedge are accounted for in accordance with specific rules of IAS 39. [IAS 39 paras 95-98, 102]. In summary, to the extent the hedge is effective, gains and losses on the monetary item are initially recognised in other comprehensive income. They are subsequently recognised in ('reclassified to') profit or loss when the hedged item affects profit or loss.

(iii) Monetary available-for-sale financial instruments

18 A change in the carrying amount of a monetary available-for-sale financial asset is analysed between the foreign exchange component, interest, any impairment and the remaining fair value movement. The foreign exchange component, interest and any impairment are recognised in profit or loss. The remaining fair value movement is recognised in other comprehensive income. [IAS 39 paras AG 83, IG.E.3.2].

Non-monetary items

19 Any exchange component of gains or losses arising on non-monetary items should be recognised in other comprehensive income or in profit or loss depending on where the underlying gain or loss on the non-monetary item is recognised. [IAS 21 para 30].

Non-monetary available-for-sale financial instruments

20 It follows from the previous paragraph that the entire change in the carrying amount of a non-monetary available-for-sale financial asset, including the effect of changes in foreign currency rates, is reported in equity at the end of the reporting period, unless the asset is impaired. [IAS 39 paras AG 83, IG.E.3.4].

Taxation

21 The associated tax effects of gains and losses on foreign currency transactions and translation should be accounted for in accordance with IAS 12, 'Income taxes'. In summary, current and deferred tax is recognised in the income statement unless the tax relates to items that are credited or charged, in the same or a different period, directly to equity. [IAS 12 paras 58, 61].

Translation from the functional currency to the presentation currency

22 The process above describes how the results and financial position of an entity are measured in its functional currency. However, the entity may choose to report its financial statements in a different currency – termed the 'presentation currency'. An entity may choose to present its financial statements in any currency. If the presentation currency differs from the functional currency, an entity should translate its results and financial position into the presentation currency using the method set out below. [IAS 21 para 38].

23 Furthermore, if a group contains foreign operations – such as overseas subsidiaries or branches, whose functional currency differs from that of the parent, the results and financial position of each entity in the group is translated into a single currency (the group's 'presentation currency') in order for the group to report its consolidated financial statements. The translation method is also that set out below. [IAS 21 para 44].

Translation method

24 The results and financial position of an entity whose functional currency is not the currency of a hyper-inflationary economy are translated into a different presentation currency using the following procedures:

- Assets and liabilities for each balance sheet (including comparatives) should be translated at the closing rate at the end of the reporting period.
- Income and expenses for each income statement (including comparatives) should be translated at exchange rates at the dates of the transactions (or an average rate, if it approximates the actual rate).
- All resulting exchange differences should be recognised in other comprehensive income. [IAS 21 para 39].

Hyper-inflationary economies

25 If an entity's functional currency is the currency of a hyper-inflationary economy, its financial statements are restated under IAS 29, 'Financial reporting in hyper-inflationary economies', prior to translation into a different presentation currency. This is because the effects of hyper-inflation would otherwise reduce the comparability of prior period information and therefore its usefulness. IAS 29 requires such an entity's financial statements to be restated in terms of the measuring unit current at the end of the reporting period. [IAS 21 para 43]. This measuring unit is calculated by applying a general price index to the underlying financial statements.

26 All items of the balance sheet and income statement, including comparatives, are then translated into a different presentation currency at the closing rate at the date of the most recent balance sheet. However, if the presentation currency is not hyper-inflationary, the comparative amounts are those that were presented in the previous year (that is, they are not adjusted for subsequent changes in the price level or subsequent changes in exchange rates). [IAS 21 para 42].

Goodwill and fair value adjustments

27 Any goodwill and any fair value adjustments to the carrying amount of assets or liabilities arising on acquiring a foreign operation should be treated as the foreign operation's assets and liabilities and translated at the closing rate in accordance with the method described in paragraph 2.23 above. [IAS 21 para 47].

Intra-group monetary items

28 An intra-group monetary asset or liability between two entities with different functional currencies creates a foreign currency exposure. Even though the balance sheet amounts are eliminated, the resulting foreign currency gain or loss is not eliminated in the consolidated financial statements because the monetary item can only be denominated in one currency. This creates a foreign currency gain or loss in the entity with the different functional currency. [IAS 21 para 45]. These gains or losses remain on consolidation. They are reported in the group's consolidated income statement unless the monetary item forms part of a reporting entity's net investment in a foreign operation (see para 15 above). [IAS 21 paras 32].

Different reporting dates

29 IAS 27 allows the use of different reporting dates in the consolidation of subsidiary companies in certain circumstances. The assets and liabilities of a foreign operation are translated at the exchange rate at the end of the reporting period of the foreign operation. Adjustments are made for significant changes in exchange rates up to the end of the reporting period of the reporting entity in accordance with IAS 27. [IAS 21 para 46].

Non-controlling interests

30 For subsidiaries that are not wholly owned, the accumulated exchange differences arising from translation that are attributable to non-controlling interests should be allocated to, and reported as part of, the non-controlling interests in the consolidated balance sheet. [IAS 21 para 41].

Disposal and partial disposal of an interest in a foreign operation

31 The cumulative amount of deferred exchange differences related to a foreign operation is transferred from equity to the income statement on the disposal or partial disposal of the foreign operation. [IAS 21 para 48]. Disposal of a foreign operation may be in the form of a sale, liquidation, repayment of share capital, or abandonment of all or part of the entity. For periods beginning on or after 1 July 2009, disposal may also be in the form of loss of control of a subsidiary, joint control of a joint venture or significant influence over an associate. However, an impairment of the investment due to losses suffered is not a disposal or partial disposal. [IAS 21 para 49]. Only a proportionate share of the related accumulated exchange differences is recognised in the case of a partial disposal.

32 An entity does not distinguish between dividends paid out of pre-acquisition profits or post-acquisition profits. A parent recognises any dividend received as income and separately considers whether its investment in a subsidiary has been impaired. IAS 21, therefore, does not regard a dividend from pre-acquisition profits as always being a disposal or a partial disposal.

Disclosures

33 Some of the key disclosures required by IAS 21 include:

- The amount of exchange differences included in profit or loss for the period, except for those arising on financial instruments measured at fair value through profit or loss in accordance with IAS 39, ‘Financial instruments: Recognition and measurement’. [IAS 21 para 52(a)].
- Net exchange differences classified in a separate component of equity and a reconciliation of the amount of such exchange differences at the beginning and end of the period. [IAS 21 para 52(b)].
- If the presentation currency differs from the functional currency, that fact and the reason for using a different presentation currency. [IAS 21 para 53].
- If there is a change in the functional currency of either the reporting entity or a significant foreign operation, that fact and the reason for the change. [IAS 21 para 54].
- When an entity presents its financial statements in a currency that is different from its functional currency, it should describe those financial statements as complying with IFRS only if they comply with all the requirements of each applicable standard and each applicable interpretation, including the translation method set out above. [IAS 21 para 55]. Additional disclosures are required where an entity displays certain supplementary financial information in a currency that is different from the presentation currency, and that information is not translated in accordance with the standard (also called ‘convenience’ translations). [IAS 21 para 57].

Insurance contracts

Overview

Insurance contracts are contracts where an entity accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if the insured event adversely affects the policyholder. The risk transferred in the contract must be insurance risk, which is any risk except for financial risk.

IFRS 4 applies to all issuers of insurance contracts whether or not the entity is legally an insurance company. It does not apply to accounting for insurance contracts by policyholders.

IFRS 4 is an interim standard pending completion of Phase 2 of the IASB's project on insurance contracts. It allows entities to continue with their existing accounting policies for insurance contracts if those policies meet certain minimum criteria. One of the minimum criteria is that the amount of the insurance liability is subject to a liability adequacy test. This test considers current estimates of all contractual and related cash flows. If the liability adequacy test identifies that that the insurance liability is inadequate, the entire deficiency is recognised in the income statement.

Accounting policies modelled on IAS 37, 'Provisions, contingent liabilities and contingent assets', are appropriate in cases where the issuer is not an insurance company and where there is no specific local GAAP for insurance contracts (or the local GAAP is only directed at insurance companies).

Disclosure is particularly important for information relating to insurance contracts, as entities can continue to use local GAAP accounting policies for measurement. IFRS 4 has two main principles for disclosure. Entities should disclose:

- Information that identifies and explains the amounts in its financial statements arising from insurance contracts.
- Information that enables users of its financial statements to evaluate the nature and extent of risks arising from insurance contracts.

Resources

Standards and interpretations
- IFRS 4, 'Insurance contracts'

Exposure drafts and discussion papers
- IASB discussion paper 'Preliminary views on insurance contracts'

PwC guidance
- Manual of Accounting chapter 8, Insurance contracts

PwC views
- PwC Comment letter on 'Preliminary views on insurance contracts'

Publications tools and practice aids
- IFRS extracts from accounts

Summary of key requirements

Objective and scope

1 IFRS 4 applies to insurance and reinsurance contracts that an insurer issues and reinsurance contracts that it holds. Any entity that issues an insurance contract is 'an insurer' whether or not it is legally an insurance company. IFRS 4 does not apply to certain contracts that meet the definition an insurance contract that are covered by other standards, such as certain product warranties or retirement benefit obligations. [IFRS 4 App A]. IFRS 4 does not apply to accounting for insurance contracts held by policyholders.

IFRS 4 allows insurers to continue to use their existing accounting policies for liabilities arising from insurance contracts as long as the existing policies meet certain minimum requirements set out in IFRS 4.

Definition

2 The key principle of the definition of an insurance contract is that there should be significant insurance risk transferred from the policyholder to the insurer whereby the insurer agrees to compensate the policyholder for an uncertain future event that adversely affects the policyholder. Insurance risk is any risk other than financial risk. [IFRS 4 App A].

The definition's key principle is that there should be significant insurance risk arising from an uncertain future event that adversely affects the policyholder. There should be:

- a specified uncertain future event that adversely affects the policyholder;
- the event arises from a scenario with commercial substance and from a pre-existing risk; and
- the additional benefits due if the insured event occurs are significant compared to all other scenarios.

Recognition and derecognition of insurance liabilities

3 An insurance liability arises from a contractual relationship between the insurer and the policyholder. This contract must exist at the balance sheet date in order to recognise an insurance liability. [IFRS 4 para 14(a)].

4 An insurer may only remove an insurance liability from its balance sheet when it is discharged, cancelled or expires. [IFRS 4 para 14(c)].

Measurement

Existing accounting policies

IFRS 4 allows entities to continue with their existing accounting policies for insurance contracts if those policies meet certain minimum criteria. Accounting policies modelled on IAS 37, 'Provisions, contingent liabilities and contingent assets', are appropriate in cases where the issuer is not an insurance company and where there is no specific local GAAP for insurance contracts (or the local GAAP is only directed at insurance companies).

Liability adequacy test

The amount of the insurance liability is subject to a liability adequacy test. The liability adequacy test should consider current estimates of all contractual cash flows and of related cash flows, for example claims handling costs. If the liability is inadequate in light of the estimated future cash flows the entire deficiency must be recognised in profit or loss. [IFRS 4 para 16].

Changes in accounting policy

6 Insurers are only allowed to change their existing accounting policies for insurance contracts where the change results in presenting information that is more relevant and no less reliable, or more reliable and no less relevant than before [IFRS 4 para 22].

IFRS 4 gives specific guidance on changes in accounting policies relating to:

- The use of current interest rates.
- The continuation of certain existing practices (including measuring insurance liabilities on an undiscounted basis and using non-uniform accounting policies for insurance contracts of subsidiaries).
- Excessive prudence.

Distinction between insurance and investment contracts

An insurance contract must transfer significant insurance risk. A contract that does not transfer significant insurance risk is known as an investment contract and is accounted for under IAS 39 'Financial instruments: Recognition and measurement'. Some insurance contracts may have a significant deposit component. Paragraph 10 of IFRS 4 sets out criteria when deposit components within insurance contracts should be unbundled as follows:

- Unbundling is required if:
  - the insurer can measure the deposit component (including any embedded surrender options) separately (that is, without considering the insurance component); and
  - the insurer's accounting policies do not otherwise require it to recognise all obligations and rights arising from the deposit component.
- Unbundling is permitted (but not required) if the insurer can measure the deposit component separately but its accounting policies require it to recognise all obligations and rights arising from the deposit component, regardless of the basis used to measure those rights and obligations.
- Unbundling is prohibited if an insurer cannot measure the deposit component separately.

Embedded derivatives

7 Insurance contracts can contain embedded derivatives. IAS 39 applies to embedded derivatives contained in insurance contracts unless the embedded derivative is itself an insurance contract.

Insurance contracts acquired in a business combination

Insurance contracts can be transferred as part of a business combination. The acquirer must measure insurance liabilities assumed and insurance assets acquired at fair value. The acquirer may (but is not required to) expand the presentation of insurance liabilities and assets into two components:

- a liability measured in accordance with the insurer's accounting policies for insurance contracts that it issues; and
- an intangible asset, representing the fair value of the contractual insurance rights and obligations acquired to the extent that the liability does not reflect that fair value.

[IFRS 4 para 31].

9 The measurement of the intangible asset is consistent with the related liability. The intangible is excluded from the scope of IAS 36, 'Impairment of assets', and IAS 38, 'Intangible assets', and its recoverability is assessed as part of the required liability adequacy test. [IFRS 4 para 33]

Presentation

10 IFRS 4 does not specify how insurance contracts should be presented in the primary statements. Appropriate presentation will depend on the accounting policies the insurer uses under its local GAAP.

Disclosure

11 Disclosure is particularly important for information relating to insurance contracts as insurers can continue to use local GAAP accounting policies. The diversity of local

GAAP would result in difficulty in comparing the financial performance of insurers without extensive disclosures.

12 IFRS 4 has two main principles for disclosure which require an insurer to disclose:

- Information that identifies and explains the amounts in its financial statements arising from insurance contracts. [IFRS 4 para 36].
- Information that enables users of its financial statements to evaluate the nature and extent of risks arising from insurance contracts. [IFRS 4 para 38].

Explanation of recognised amounts

13 The standard expands these principles with implementation guidance and certain minimum disclosures as follows:

- Disclosure of the insurer's accounting policy for insurance contracts.
- Disclosure of the recognised assets, liabilities, income and expense arising from insurance contracts.
- Disclosure of the process used to determine the assumptions that have the greatest effect on the measurement of the recognised amounts described above and where practicable, quantified disclosures of those assumptions.
- Disclosure of the effects of changes in assumptions used to measure insurance assets and insurance liabilities, showing separately the effect of each change that has a material effect on the financial statements.
- Reconciliations of changes in insurance liabilities, reinsurance assets and, if any, deferred acquisition costs.

[IFRS 4 para 36-37].

Nature and extent of risks arising from insurance contracts

14 Disclosure required cover:

- Risk management objective and policies for mitigating risk arising from insurance contracts.
- An insurer is required to disclose information about insurance risk.
- Sensitivity to insurance risk.
- Concentrations of insurance risk.
- Actual claims compared to previous estimates (claims development).

In addition, the insurer must disclose information about credit risk, liquidity and market risk that IFRS 7 would require, except that a maturity analysis can be based on expected cash flows.

Intangible assets

Overview

An intangible asset is an identifiable non-monetary asset without physical substance. The identifiable criterion is met when the intangible asset is separable (that is, when it can be sold, transferred or licensed), or where it arises from contractual or other legal rights.

Separately acquired intangible assets

Separately acquired intangible assets are recognised initially at cost. Cost comprises the purchase price, including import duties and non-refundable purchase taxes and any directly attributable costs of preparing the asset for its intended use. The purchase price of a separately acquired intangible asset incorporates assumptions about the probable economic future benefits that may be generated by the asset.

Internally generated intangible assets

The process of generating an intangible asset is divided into a research phase and a development phase. No intangible assets arising from the research phase may be recognised. Intangible assets arising from the development phase are recognised when the entity can demonstrate:

- Technical feasibility.
- Intention to complete the developments.
- Ability to use or sell the intangible asset.
- How the intangible asset will generate probable future economic benefits (for example, the existence of a market for the output of the intangible asset or for the intangible asset itself).
- Availability of resources to complete the development.
- Ability to measure the attributable expenditure reliably.

Any expenditure written off during the research or development phase cannot subsequently be recognised as an intangible asset if the project meets the criteria for recognition at a later date.

The costs relating to many internally generated intangible items cannot be recognised as an intangible asset and are expensed as incurred. This includes research, start-up and advertising costs. Expenditure on internally generated brands, mastheads, customer lists, publishing titles and goodwill are not recognised as intangible assets.

Intangible assets acquired in a business combination

If an intangible asset is acquired in a business combination, both the probability and measurement criterion are always considered to be met. An intangible will therefore always be recognised, regardless of whether it has been previously recognised in the acquiree's financial statements.

Subsequent measurement

Intangible assets are amortised unless they have an indefinite useful life. Amortisation is carried out on a systematic basis over the useful life of the intangible asset. An intangible asset has an indefinite useful life when, based on an analysis of all the relevant factors, there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity.

Intangible assets with finite useful lives are considered for impairment when there is an indication that the asset has been impaired. Intangible assets with indefinite useful lives and intangible assets not yet in use are tested annually for impairment and whenever there is an indication of impairment.

Resources

Standards and interpretations
- IAS 38, 'Intangible assets'
- SIC 32, 'Intangible assets – web site costs'

PwC guidance
- Manual of Accounting chapter 15, Intangible assets

Tools, practice aids and publications
- IFRS extracts from accounts

Summary of key requirements

Objective and scope

1 The objective of IAS 38 is to set out the accounting treatment for intangible assets that are not dealt with specifically in another standard. The standard deals with recognition and measurement of intangible assets and prescribes specific disclosures that must be made about such assets.

2 IAS 38 applies to all intangible assets except:
- Intangible assets that are within the scope of another standard.
- Financial assets.
- Exploration and evaluation assets and expenditure on the development and extraction of minerals, oil, natural gas and similar non-regenerative resources.

[IAS 38 para 2].

Definition

3 Intangible assets are defined as identifiable non-monetary assets without physical substance. [IAS 38 para 8].

Identifiability

4 An intangible asset meets the identfiability criterion when:
- it is separable, that is it can be separated or divided from the entity and sold, transferred, licensed or exchanged, either individually or together with a related contract, asset or liability: or
- it arises from contractual or other legal rights, whether or not those rights are transferable or separable from the entity or from other rights and obligations.

[IAS 38 paras 12].

Recognition

5 The criteria for recognition of an intangible asset are that:
- it meets the definition of an intangible asset;
- it is probable that future economic benefits attributable to the asset will flow to the entity; and
- the asset's cost can be reliably measured.

[IAS 38 para 21].

Control

6 Control exists where an entity has the power to obtain the future economic benefits from an underlying resource and to restrict the access of others to those benefits. [IAS 38 para 13].

7 Control is usually evidenced by legally enforceable contractual or other rights, such as legal title or a licence. In the absence of legal rights, it is more difficult to demonstrate control. The entity may be able to control the future economic benefits in some other way, for example control over the benefits of know-how may be attained through secrecy.

Intangible assets acquired separately or as part of a business combination

8 The probability recognition criterion is always satisfied when intangible assets are acquired separately or as part of a business combination. This is because the price paid reflects expectations about the probability that the future economic benefits of the asset will flow to the entity. [IAS 38 paras 25, 33].

9 IFRS 3, 'Business combinations', contains an illustrative list of items acquired in a business combination that meet the definition of an intangible asset. The summarised list is as follows:
- Marketing-related intangible assets, including trademarks, internet domain names and newspaper mastheads.
- Customer-related intangible assets, including customer lists, order backlogs, customer contracts and non-contractual customer relationships.
- Artistic-related intangible assets, including copyrights for plays, books and musical works.
- Contract-based intangible assets, including licence agreements, management contracts and broadcasting rights.
- Technology-based intangible assets, including patented technology, databases and trade secrets such as secret formulas, processes or recipes. [IFRS 3 IE16-IE44].

Internally generated intangible assets

10 There will always be difficulties in distinguishing the expected future economic benefits that might be attributable to internally generated intangible assets from those expected from the business as a whole. The standard therefore sets out specific procedures that must be followed for determining whether certain internally generated intangible assets can be recognised and prohibits the recognition of internally generated goodwill, brands, mastheads, publishing titles, customer lists and similar items. [IAS 38 paras 48, 51, 63].

Research and development

11 The process of generating an intangible asset is divided into a research phase and a development phase. Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding. Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the commencement of commercial production or use. Development is more closely related to the earnings process than research. [IAS 38 para 8].

12 No intangible asset arising from the research phase may be recognised. Instead any such cost should be expensed as incurred. An asset should be recognised for costs incurred in the development phase if the entity can demonstrate all of the following:
- The technological feasibility of completing the asset so that it may be used or sold.
- The intention to complete the asset and the intention and ability to use or sell it.
- How the asset will generate future probable economic benefits, by demonstrating that there is a market for the asset's output or for the asset itself, or if the asset is to be used internally, how the asset will increase revenues or reduce costs.
- Availability of adequate technical, financial and other resources to complete the development and to use or sell the asset.

- The ability to measure reliably the expenditure on the asset during its development.

[IAS 38 paras 52, 54, 57].

Non-qualifying expenditure

13 Costs that are indistinguishable from the costs of developing the business as a whole should be expensed as incurred and include start up, training, advertising and promotion costs, relocation and reorganisation costs. [IAS 38 para 69].

Initial measurement

14 Intangible assets should be measured initially at cost. [IAS 38 para 24].

Separately acquired intangible assets

15 The cost of a separately acquired intangible asset comprises the purchase price, including import duties and non-refundable purchase taxes after deducting trade discounts and rebates. Directly attributable costs of preparing the asset for its intended use are also included. The cost can usually be measured reliably, particularly when the purchase consideration is in the form of cash or other monetary assets. [IAS 38 paras 24, 27, 26].

Intangible assets acquired as part of a business combination

16 The cost of an intangible asset that is acquired as part of a business combination is represented by the asset's fair value at the acquisition date. Fair value is the amount for which the asset could be exchanged between knowledgeable, willing parties in an arm's length transaction. [IAS 38 paras 8, 33, 34].

17 The fair value of intangible assets acquired in business combinations can normally be measured with sufficient reliability to be recognised separately from goodwill. If an intangible asset acquired in a business combination has a finite useful life, there is a rebuttable presumption that its fair value can be measured reliably. [IAS 38 para 35].

18 IFRS 3 gives a specific example of an asset that is recognised as part of a business combination as an 'in-process research and development project', if the project meets the definition of an identifiable asset and its fair value can be reliably measured. [IFRS 3 para 45]. This type of asset is singled out because there is a difference between internal research and development projects and projects acquired as part of a business combination (or otherwise acquired separately). Costs in respect of the former may be recognised as intangible assets only when certain stringent conditions are met.

Valuation methods

19 Quoted prices in an active market provide the most reliable means of estimating fair value, but where there is no active market the standard describes techniques that may be used instead. These include estimating the costs the entity avoids by owning the intangible asset and not needing to obtain licensing from another party in an arm's length transaction. Another method referred to is discounting the estimated future cash flows from the asset. [IAS 38 paras 39-41].

Internally-generated intangible assets

21 The cost of internally-generated intangibles should include all directly attributable costs incurred in the creation of the asset from the date on which the asset first met the recognition criteria. [IAS 38 para 65]. All costs incurred prior to that date should be expensed and should not be subsequently reinstated. [IAS 38 para 71].

22 Examples of directly attributable costs include the costs of materials and services used or consumed in generating the asset, employment costs of those directly involved in creating the asset, depreciation of relevant property, plant and equipment, amortisation of patents and licences utilised in creating the asset legal fees and registration fees. The costs capitalised should also include borrowing costs where relevant. [IAS 38 paras 66-67].

23 Inefficiencies and initial operating losses incurred before the asset achieves planned performance should be expensed as incurred. General, selling and administrative costs not directly attributable to the generation of the intangible asset should also be expensed when incurred. [IAS 38 para 67].

24 The cost of developing a web site should be capitalised provided the recognition criteria are satisfied. [IAS 38 paras 21-22, 57; SIC 32 para 9].

Intangible assets acquired by way of government grant

25 An intangible asset may sometimes be acquired free of charge or for a nominal amount, by way of government grant. Examples include allocations of airport landing rights and import quotas. Intangible assets such as these may be recognised either at fair value or nominal value. This is an accounting policy choice, in accordance with IAS 20, 'Accounting for government grants and disclosure of government assistance'. [IAS 38 para 44].

Exchange of intangible assets

26 An intangible asset acquired in exchange for a non-monetary asset or for a combination of monetary and non-monetary assets should be measured at fair value, unless

the exchange transaction lacks commercial substance or the fair value of neither the asset given up nor the asset received can be reliably measured. If the intangible asset is not measured at fair value, it is measured at the carrying amount of the asset given up. [IAS 38 para 45].

Subsequent expenditure

27 The nature of many intangible assets is that there are often no additions to the asset or replacements to parts of it. Therefore, most subsequent expenditure is likely to be incurred to maintain the asset and will not usually meet the criteria for recognition as an asset. Moreover, it is often difficult to attribute subsequent expenditure to a particular intangible asset rather than to the business as a whole. For this reason, most subsequent expenditure will not qualify as an asset and will be expensed as incurred. Subsequent expenditure on intangible assets is only capitalised in rare circumstances. [IAS 38 para 20].

28 Subsequent expenditure on acquired research and development is expensed as incurred until the project meets the criteria for recognition. Once the criteria are met all subsequent expenditure is capitalised. [IAS 38 para 43].

Measurement subsequent to initial recognition

29 Subsequent to initial recognition, an entity may choose to adopt the cost or revaluation model as its accounting policy. Under the cost model the intangible asset is carried at cost less any accumulated amortisation and impairment losses. Under the revaluation model the intangible asset is carried at a revalued amount. This amount is the asset's fair value at the date of valuation less subsequent accumulated amortisation and impairment losses. [IAS 38 paras 72, 74, 75].

Useful life

30 Useful life for an intangible asset is the period over which the asset is expected to be available for use by an entity or the number of production or similar units expected to be obtained from the asset by an entity. [IAS 38 para 8]. An entity should assess whether an intangible asset's useful life is finite or indefinite. If it is finite the entity should assess the length of the useful life or the number of production units constituting the useful life. An intangible asset should be deemed to have an indefinite useful life if there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity. [IAS 38 para 88].

31 Because of rapid changes in technology, computer software and many other intangible assets are susceptible to technical obsolescence and it is likely that the useful lives of such assets will be relatively short. The useful life of an asset that derives from contractual or other legal rights should not exceed the duration of those rights and may be shorter depending on whether the entity intends to use the asset for the full period of the rights. Where the rights can be renewed the useful life should include the renewal period only if there is evidence that the rights can, and will, be renewed by the entity without significant cost. [IAS 38 para 94].

Amortisation – intangibles with finite lives

32 Where an intangible asset has a finite useful life its depreciable amount should be amortised on a systematic basis over that life. Amortisation commences when the asset is available for use and ceases at the earlier of when the asset is derecognised, for example on disposal, or when it is classified as held for sale in accordance with IFRS 5, 'Non-current assets held for sale and discontinued operations'. The amortisation method should reflect the pattern of consumption of the economic benefits expected from the asset or, if the pattern cannot be reliably determined, the entity should apply the straight-line method of amortisation. Amortisation is recorded in the income statement, unless it is permitted or required to be included in the carrying amount of another asset. [IAS 38 para 97].

33 A variety of amortisation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include straight-line method, the diminishing balance method and the unit of production method. [IAS 38 para 98].

34 The residual value of an intangible asset with a finite useful life in most situations should be assumed to be zero, unless there is either a commitment by a third party to purchase the asset at the end of its useful life. Where there is an active and continuing market for the intangible asset, its residual value can be determined by reference to that market. [IAS 38 para 100].

35 The consumption of a revalued asset with a finite useful life is reflected through an amortisation charge. An element of the revaluation surplus may be transferred to retained earnings in each period, being that part of the amortisation charge in respect of the revaluation uplift on the asset. When the asset is sold or scrapped, the balance in the revaluation reserve in respect of that asset is transferred to retained earnings. [IAS 38 para 87].

Review of useful lives, amortisation methods and residual values

36 The useful life, residual value, and amortisation method for an intangible asset with a finite life should be reviewed at least at each financial year end. Changes should be accounted for as a change in accounting estimate, that is

prospectively, in accordance with IAS 8, 'Accounting policies, changes in accounting estimates and errors'. [IAS 38 para 104].

Indefinite lived intangibles

37 The useful life of an indefinite lived intangible asset should also be reviewed each accounting period and if this reveals that the useful life has become finite, the change should be accounted for as a change in estimate. This change in the useful life is furthermore an indication that an asset may be impaired. [IAS 38 paras 109-110].

Impairment

38 Entities should assess at each reporting date whether there is any indication that an intangible asset is impaired. Wherever indicators of impairment exist, a review for impairment should be carried out. [IAS 36 paras 8-9]. Where impairment is identified, the asset should be written down to its recoverable amount.

39 Indefinite lived intangible assets and intangible assets not yet available for use are tested for impairment annually, whether or not there is any indication of impairment. [IAS 36 para 10].

Derecognition of intangible assets

40 Where an intangible asset is disposed of or where no future economic benefits are expected from its use or disposal it should be derecognised. Gains and losses arising on derecognition should be calculated as the difference between the asset's net disposal proceeds and its carrying amount and should be recognised in the income statement. [IAS 38 paras 112-113].

Disclosure

41 An entity should disclose, in its accounting policies, the measurement bases used for determining the gross carrying amount. For each class of intangible asset it should be stated whether useful lives are indefinite or finite and amortisation methods or useful lives for intangible assets with finite lives should be disclosed. [IAS 38 para 118].

42 The gross carrying amount and accumulated amortisation at the beginning and end of the period should be disclosed, and a reconciliation of the carrying amount of each class of intangible asset at the beginning and end of the period should also be given. The line item of the income statement in which amortisation is included should also be disclosed. [IAS 38 para 118].

43 Restrictions over intangible assets and the carrying amounts affected, the amount of intangible assets pledged as security and the amount of commitments for the acquisition of intangible assets should be disclosed. [IAS 38 para 122].

44 The carrying amount of indefinite lived intangible assets should be disclosed together with the reasons supporting the assessment of an indefinite life. The factors that contributed to determining that the asset has an indefinite life should also be disclosed. [IAS 38 para 122].

45 A description, the carrying amount and remaining amortisation period of any intangible asset that is material to the entity's financial statements should be given. [IAS 38 para 122].

46 For intangible assets acquired by way of government grant and initially recorded at fair value, details should be given of the fair value initially recorded, the carrying amounts and whether they are measured under the cost model or the revaluation model. [IAS 38 para 122].

47 The aggregate amount of research and development expenditure recognised as an expense in the period should be disclosed. [IAS 38 para 126].

48 Entities are encouraged, but not required, to describe any fully amortised intangible asset that is still in use and any significant intangible assets that have not been recognised because they did not meet the recognition criteria or were acquired or generated before IAS 38 was effective. [IAS 38 para 128].

Interim financial reporting

Overview

There is no IFRS requirement for an entity to publish interim financial statements. However, a number of countries either require or recommend their publication, in particular for public companies.

IAS 34, 'Interim financial reporting', applies where an entity publishes an interim financial report in accordance with IFRS. IAS 34 sets out the minimum content that an interim financial report should contain and the principles that should be used in recognising and measuring the transactions and balances included in that report.

Entities may either prepare full IFRS financial statements (conforming to the requirements of IAS 1) or condensed financial statements. Condensed reporting is the more common approach. Condensed financial statements include a condensed balance sheet, a condensed income statement (if presented separately), a condensed statement of comprehensive income, a condensed cash flow statement, a condensed statement of changes in equity and selected note disclosures.

An entity generally uses the same accounting policies for recognising and measuring assets, liabilities, revenues, expenses and gains and losses at interim dates as those to be used in the current-year annual financial statements.

There are special measurement requirements for certain costs that can only be determined on an annual basis (for example, items such as tax that is calculated based on a full-year effective rate), and the use of estimates in the interim financial statements. An impairment loss recognised in a previous interim period in respect of goodwill, or an investment in either an equity instrument or a financial asset carried at cost, is not reversed.

As a minimum, current period and comparative figures (condensed or complete) are disclosed as follows:

- Balance sheet – as of the current interim period end with comparatives for the immediately preceding year end.
- Statement of comprehensive income (and, if presented separately, income statement) – current interim period, financial year to date and comparatives for the same preceding periods (interim and year to date).
- Cash flow statement and statement of changes in equity – financial year to date with comparatives for the same year to date period of the preceding year.
- Explanatory notes.

IAS 34 sets out criteria to determine what information should be disclosed in the interim financial statements. These include:

- Materiality to the overall interim financial statements.
- Unusual or irregular items.
- Changes since previous reporting periods that have a significant effect on the interim financial statements (of the current or previous reporting financial year).
- Relevance to the understanding of estimates used in the interim financial statements.

The overriding goal is to ensure that an interim financial report includes all information that is relevant to understanding an entity's financial position and performance during the interim period.

Resources

Standards and interpretations

- IAS 34, 'Interim financial reporting'
- Improvements to IFRSs 2010
- IFRIC 10, 'Interim financial reporting and impairment'
- ISRE 2410, 'Review of interim financial information performed by the independent auditor of the entity'

PwC guidance

- Manual of Accounting chapter 31, Interim reports

Tools practice aids and publications

- IFRS extracts from accounts
- Illustrative interim financial information for existing IFRS preparers 2010

Summary of key requirements

1 Although there is no requirement under IFRS for entities to publish interim financial reports, a number of territories around the world either require or recommend their publication, often stipulating that they should be prepared in accordance with IFRS. IAS 34, 'Interim financial reporting', applies where an entity publishes an interim financial report in accordance with IFRS. It encourages publicly traded entities to prepare interim reports at least as of the end of the first half of their financial year. [IAS 34 para 1].

2 The objective of IAS 34 is to set out the minimum content that an interim financial report should contain and the principles that should be used in recognising and measuring the transactions and balances included in that report.

3 IAS 34 recommends that interim financial reports are published within 60 days of the period end, although local legislative requirements may mandate a different timescale. [IAS 34 para 1(b)].

Content

4 Under IAS 34, entities may either prepare full IFRS financial statements (as published in their annual report),

or condensed financial statements. Condensed reporting is the more common approach.

5 IAS 34 requires that the interim financial report should contain, as a minimum:

- A condensed statement of financial position (also commonly referred to as a balance sheet) at the end of the interim period.
- A condensed statement of comprehensive income for the interim period reported and the year to date (for example, the second quarter and the half year to date), presented as either a condensed single statement or a condensed separate income statement immediately followed by a condensed statement of comprehensive income.
- A condensed statement of cash flows for the year to date.
- A condensed statement of changes in equity for the year to date.
- Selected explanatory notes.
- Basic and diluted earnings per share, for the interim period reported (only if the entity is required to present earnings per share in accordance with IAS 33, ‘Earnings per share’).

[IAS 34 paras 8, 11, 20 as amended by IAS 1 (revised)].

6 The condensed primary statements should contain, as a minimum, the main headings and sub-totals that were included in the entity’s most recent full financial statements. [IAS 34 para 10]. Best practice would be to include the same categories and line items as in the annual financial statements.

7 IAS 34 requires that comparative information is given for all primary statements (condensed or complete). Balance sheet comparative information is required to be given for the last year end. Comparative information for the statement of comprehensive income (and income statement, if presented separately) is required to be given for the equivalent reporting period in the previous year and the equivalent year-to-date in the previous year (where different). Equity movements and cash flow comparative information is required only for the equivalent year-to-date period in the previous year. [IAS 34 para 20].

8 The entity’s annual financial statements give a comprehensive picture of the entity’s state of affairs at the most recent year end, and, therefore, the interim financial report should be read in conjunction with them. It is not necessary to give relatively insignificant updates to information already reported. The selected explanatory notes to the interim report should explain significant events and transactions that have occurred during the interim period. [IAS 34 para 15]. IAS 34 contains no requirement for a separate management commentary.

9 As a minimum, the following information is required by IAS 34 to be included in the notes to a condensed interim financial report:

- A statement that the accounting policies and methods of computation used in the interim financial report are the same as those used in the most recent annual financial statements or, if this is not the case, a description of the nature and effect of the change.
- Explanatory comments about seasonality or cyclicality of interim operations.
- The nature and amount of any items affecting assets, liabilities, equity, net income or cash flows that are unusual because of their size, nature or incidence.
- The nature and amount of changes in estimates of amounts reported in prior periods, either interim periods within the current financial year or in prior financial years, where those have a material impact in the current interim period.
- Issuances, repurchases and repayments of debt and equity securities.
- Dividends paid (aggregate or per share) separately for ordinary shares and other shares.
- Companies disclosing segmental information in their annual reports under IFRS 8, ‘Operating segments’, should disclose segmental information, including revenues from external customers, intersegment revenues, segment result; total assets for which there has been a material change from the amount disclosed in the last annual financial statements, changes in segments or in the basis of measurement of segment profit since the last annual financial statements and a reconciliation of segment results to the entity’s result before tax and discontinued operations, separately identifying and describing material items.
- Material events that have occurred subsequent to the end of the interim period that have not been reflected in the interim financial report.
- The effect of changes in the reporting entity’s composition during the interim period, including business combinations, acquisition or disposal of subsidiaries and long-term investments, restructurings and discontinued operations. For business combinations the detailed information required to be disclosed by IFRS 3, ‘Business Combinations’ is required.
- Changes in contingent liabilities and contingent assets since the end of the last annual reporting period.

[IAS 34 para 16].

10 The interim financial report should contain a statement that it is in compliance with IAS 34. The report should not be described as complying with IFRS unless it complies with all of the requirements of IFRS. [IAS 34 paras 3, 19].

Recognition and measurement

11 Although condensed interim financial reports prepared in accordance with IAS 34 are not required to comply with the full requirements of IAS 1 (revised), 'Presentation of financial statements', they are required to be prepared in accordance with certain of the fundamental principles that underpin IAS 1. These fundamental principles include the preparation of the financial statements on a going concern basis, using the accruals basis, offsetting, applying consistent accounting policies that comply with IFRS, materiality and aggregation. [IAS 1 (revised) para 4].

12 The interim financial report should be prepared using the same accounting policies as were applied in the preparation of the most recent annual financial statements. There is an exception where the entity plans or is required to change an accounting policy before the year end. In this case the accounting policy that will be applied in the next annual financial statements should be used in preparing the interim financial report and disclosure of the nature and impact of the change in accounting policy should be disclosed. [IAS 34 para 28]. The prior interim periods of the current year and the comparable interim periods of the prior year should be restated. [IAS 34 para 43].

13 For the purposes of the interim financial report, the interim period should be treated as a discrete period and the entity should apply the same criteria at the interim balance sheet date as it does at its year end when considering the accounting treatment of transactions. Assets and liabilities should be carried in the interim balance sheet only where they meet the definition of an asset or a liability at the interim balance sheet date. [IAS 34 para 29].

14 Revenue that is received seasonally, cyclically or occasionally within a financial year is not anticipated or deferred at the interim date if such treatment would not be appropriate at the year end. [IAS 34 para 37]. Highly seasonal businesses are encouraged to include financial information for the 12 months ending on the interim reporting date, with comparatives for the prior 12 month period. [IAS 34 para 21]. Costs that are incurred unevenly during the year are only anticipated or deferred at the interim date if such treatment would also be appropriate at the year end. [IAS 34 para 39].

15 There are special requirements for measuring the interim income tax expense, which is accrued based on a full-year effective rate applied to the pre-tax income of the interim period. Appendix B to the standard contains examples of applying the recognition and measurement criteria for a number of items including; payroll taxes, planned maintenance and overhaul, provisions, year-end bonuses, contingent lease payments, intangible assets, pensions, holiday pay, measurement of interim income tax expense, contractual purchase price changes, depreciation, inventories, foreign currency translation and impairment.

16 IFRIC 10, 'Interim financial reporting and impairment', addresses the issue of whether an impairment of goodwill or an investment recognised in an interim period may be reversed (in a subsequent interim period or in a subsequent full year accounts). IFRIC 10 concludes that an entity shall not reverse an impairment loss recognised in a previous interim period in respect of goodwill or an investment in either an equity instrument or a financial asset carried at cost. [IFRIC 10 para 8].

First-time adoption of IFRS

17 IFRS 1, 'First-time adoption of International Financial Reporting Standards', applies to interim financial reports that are presented in accordance with IAS 34 for part of the period covered by the entity's first IFRS financial statements. [IFRS 1 para 2(b)]. The first IFRS interim report should contain sufficient detail to enable users to understand the effect of the transition (including the new IFRS accounting policies), as well as the IFRS 1 reconciliations between previous GAAP and IFRS. This is likely to lead to a significantly longer report.

Auditors' review

18 IAS 34 does not require interim reports to be reviewed by auditors. However, where local legislation requires it, or where the entity has engaged the auditor to perform a review, the auditors' interim review report should be included in the interim report.

Non-GAAP information

19 Non-GAAP information encompasses alternative performance measures such as adjusted profit, as well as hypothetical, historical or forward-looking pro forma financial information, for example as a result of a business combination or disposal. IAS 34 does not deal with non-GAAP information. However, a number of regulators have issued guidelines on the disclosure of non-GAAP information. The basic principles contained in these guidelines are that:

- Information presented should be fair and balanced, and not misleading.
- Non-GAAP information should supplement and not replace the IFRS information.
- Non-GAAP information should be clearly identified and labelled as such.
- Non-GAAP information should never be given greater prominence than defined IFRS measures.
- Terms used should be defined, if not defined in IFRS.

- A reconciliation between non-GAAP and IFRS information should be disclosed.
- The presentation and disclosure of non-GAAP information should be consistent from year to year.
- An explanation of the internal use of non-GAAP measures should be given so that readers can understand the relevance of the information.

Inventories

Overview

Inventories are initially recognised at cost. Cost of inventories includes import duties, non-refundable taxes, transport and handling costs and any other directly attributable costs less trade discounts, rebates and similar items.

Inventories are valued at the lower of cost and net realisable value (NRV). NRV is the estimated selling price in the ordinary course of business, less the estimated costs of completion and estimated selling expenses.

IAS 2, 'Inventories', requires the cost for items that are not interchangeable or that have been segregated for specific contracts to be determined on an individual-item basis. The cost of other items of inventory used is assigned by using either the first-in, first-out (FIFO) or weighted average cost formula. Last-in, first-out (LIFO) is not permitted. An entity uses the same cost formula for all inventories that have a similar nature and use to the entity. A different cost formula may be justified where inventories have a different nature or use. The cost formula used is applied on a consistent basis from period to period.

Resources

Standards and interpretations

- IAS 2, 'Inventories'

PwC guidance

- Manual of Accounting chapter 20, Inventories

Tools, practice aids and publications

- IFRS extracts from accounts

Summary of key requirements

Objective and scope

1 The objective of IAS 2 is to set out the accounting treatment for inventories. It provides guidance on determining cost and its subsequent recognition as an expense. [IAS 2 para 1].

2 IAS 2 covers all inventories except for the following principal scope exemptions:

- Work-in-progress arising from construction contracts, including directly related service contracts (dealt with by IAS 11).
- Financial instruments (dealt with by IAS 32, 'Financial instruments: Presentation' and IAS 39, 'Financial instruments: Recognition and measurement').
- Biological assets related to agricultural activity and agricultural produce at the point of harvest (dealt with by IAS 41, 'Agriculture').

[IAS 2 para 2].

3 IAS 2 does not apply to the measurement of the inventories held by:

- producers of agricultural and forest products, agricultural produce after harvest, and mineral and mineral products, if they are measured at net realisable value in accordance with industry practices; or
- commodity broker-traders who measure their inventories at fair value less costs to sell.

[IAS 2 para 3].

Definition

4 Inventories are assets: held for sale in the ordinary course of business; in the process of production for sale, or in the form of materials or supplies to be consumed in production or in rendering services. [IAS 2 para 6].

5 The inventory of manufacturing entities is raw materials and consumable stores; work-in-progress and finished goods, awaiting sale. Agricultural entities hold as inventory agricultural produce harvested from biological assets. [IAS 2 para 20]. Goods purchased and held for resale with little or no conversion are typical of retail inventories. [IAS 2 para 8]. Real estate purchased for resale should be recognised as inventory. Conversely, property held for use in a production process, for rental to others or for administrative purposes, should be recognised as property, plant and equipment. [IAS 16 para 6].

Recognition

6 An entity should initially recognise inventory when it has control of the inventory, expects it to provide future economic benefits and the cost of the inventory can be measured reliably. [Framework paras 49(a), 89].

7 Assets held in an entity's premises may not qualify as inventories if they are held on consignment (that is, on behalf of another entity and where no liability to pay for the goods exists unless they are sold).

Initial measurement

8 Initial measurement of inventories is at cost. The cost of inventories includes all costs of purchase, costs of conversion and all other costs incurred in bringing the inventories to their present location and condition. The costs of purchase include the purchase price, import duties and other taxes (so far as not recoverable from the taxing authorities), transport and handling costs and other costs directly attributable to the acquisition of the inventory. Reductions are made for trade discounts, rebates and other similar items. [IAS 2 para 9 to 11].

9 Agricultural produce, such as wool, logs and grapes is the harvested product of biological assets and is recognised as inventory. [IAS 2 para 20]. The cost of

agricultural produce at initial recognition is its fair value less costs to sell at the point of harvest. [IAS 41 para 13].

Subsequent measurement

10 Subsequent to initial recognition, entities should measure inventories at the lower of cost or net realisable value (defined as the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated selling costs). [IAS 2 paras 9, 6].

11 Cost should be determined based on specific identification for goods not ordinarily interchangeable or those segregated for specific projects. Specific identification costing is not appropriate for inventories of homogeneous products, such as raw materials to be used in production and spare parts that have often been purchased at different prices. FIFO or weighted average methods may be used to determine the cost of such inventory. [IAS 2 paras 23 to 25]. LIFO is not permitted.

12 There are a number of methodologies for inventory costing, which fall within the categories of weighted average and FIFO. Many methods are specific to an entity or industry and some are complex. IAS 2 describes methods of application only very generally and any method that produces a result consistent with the principles in the standard is acceptable. Whatever application method an entity uses, it should apply that method consistently to inventories of a similar nature and use to the entity. [IAS 2 para 25].

13 Entities engaged in manufacturing goods must assign conversion costs to inventory. Conversion costs include costs directly related to producing goods, such as direct labour. They also include allocation of fixed and variable production overheads that are incurred in converting raw materials into finished goods. IFRS does not permit direct costing methods that expense all overheads. [IAS 2 paras 10, 12].

14 Fixed production overheads are recognised as part of the cost of inventories based on normal capacity. Normal capacity is the level of production that an entity expects to achieve on average over several periods. Variable production overhead costs are recognised for each unit produced, on the basis of actual production. An entity must charge unallocated overheads, such as idle capacity variances, to the cost of sales in the current period. Costs that do not contribute to bringing inventory to its present location and condition are not included. [IAS 2 para 13].

15 Capitalisation of storage costs is appropriate only if the storage is necessary in the production process prior to a further production stage. [IAS 2 para 16(b)].

16 The production process may result in more than one product being produced at the same time. IAS 2 states that allocation of costs should be made on a rational and consistent basis. It suggests, for example, that such allocation may be based on the relative sales value of each product. In other cases the production process may result, not in joint products that are each important, but rather in a main product and a relatively unimportant by-product. Where this is the case the standard notes that such by-products are often measured at their net realisable value and this value is then deducted from the total costs to give a net cost for the main product. [IAS 2 para 14].

17 Where an entity purchases inventories on deferred payment terms, the arrangement is likely to contain a financing element. The difference between the price that would have been paid for 'normal' credit terms and the actual amount paid should be recognised as an interest expense over the period of the financing. [IAS 2 para 18].

Derecognition

18 Inventory is derecognised when it is sold. It is recognised as an expense in the same period as the revenue from its sale is recognised. An entity should also derecognise inventory when it has no future economic value, for example, obsolete inventory. [IAS 2 para 34].

19 The point at which to derecognise inventory is not always straightforward. For example, where an entity supplies goods to a dealer on consignment or under sale and repurchase agreements, the entity may retain the risks and rewards of ownership and should continue to recognise the asset. [IAS 18 para 13, App paras 2(c), 5].

Impairment

20 The requirement to measure inventory at the lower of cost and net realisable value forces the recognition of impairment losses as they occur. The amount of the write-down should be determined on an item-by-item basis. Sometimes such an assessment may not be practical, in which case impairment is measured for a group of similar or related items. [IAS 2 para 28, 29].

21 The market prices of materials and supplies held for use in manufacturing may decline below cost. The entity should, however, continue to recognise the materials at cost if it expects to sell the finished products at prices above cost. [IAS 2 para 32].

22 Net realisable value should be determined based on the conditions that existed at the balance sheet date. Events after the end of the period should only be considered to the extent that they confirm conditions existing at or before the balance sheet date. [IAS 2 para 30].

23 IAS 2 requires a write-down to net realisable value taken in a prior period to be reinstated when the

conditions causing the write-down cease to exist. [IAS 2 para 33].

Presentation and disclosure

24 The total amount for inventories should be presented as a line item on the face of the balance sheet. Classification of inventory (in the balance sheet or notes) should be in a manner appropriate to the entity. The amounts for each classification should be shown. The classification chosen should be applied consistently. Common classifications mentioned in IAS 2 are merchandise, production supplies, materials, work-in-progress and finished goods. [IAS 1 paras 68, 27; IAS 2 para 37].

25 The following disclosures are required:

- Accounting policies adopted including cost formula used.
- Carrying amount of inventories and carrying amount in classifications appropriate to the entity.
- Carrying amount of inventories carried at fair value less costs to sell.
- The amount of inventories recognised as an expense during the period.
- The amount of any write-down of inventories.
- The amount reversed of a previous write-down recognised as income in the period.
- The circumstances that led to the reversal of a previous write-down.
- The carrying amount of inventories pledged as security for liabilities.

[IAS 2 para 36(a)-(h)].

Investment property

Overview

Certain properties are classified as investment properties for financial reporting purposes in accordance with IAS 40, 'Investment property', as the characteristics of these properties differ significantly from owner-occupied properties. It is the current value of such properties and changes to those values that are most relevant to users of financial statements.

Investment property is property (land or a building, or part of a building or both) held by an entity to earn rentals and/or for capital appreciation. Since 1 January 2009, this category includes such property in the course of construction or development. Any other properties are accounted for as property, plant and equipment (PPE) in accordance with IAS 16, 'Property, plant and equipment', if they are held for use in the production or supply of goods or services; or as inventory in accordance with IAS 2, 'Inventories', if they are held for sale in the ordinary course of business. Owner-occupied property does not meet the definition of investment property.

Initial measurement of an investment property is the fair value of its purchase consideration plus any directly attributable costs. Subsequent to initial measurement, management may choose as its accounting policy either to carry investment properties at fair value or at cost. The policy chosen is applied consistently to all the investment properties that the entity owns.

If the fair value option is chosen, investment properties in the course of construction or development are measured at fair value if this can be reliably measured, otherwise they are measured at cost.

Fair value is the price at which the property could be exchanged between knowledgeable, willing parties in an arm's length transaction. Changes in fair value are recognised in profit or loss in the period in which they arise.

The cost model requires investment properties to be carried at cost less accumulated depreciation and any accumulated impairment losses consistent with the treatment of PPE; the fair values of these properties is disclosed in the notes.

Standards and interpretations
- IAS 40, 'Investment property'

PwC guidance
- Manual of Accounting chapter 17

Tools, practice aids and publications
- IFRS extracts from accounts

Summary of key requirements

Objective and scope

1 IAS 40, 'Investment property', sets out the accounting treatment for investment property and the related disclosure requirements. It deals with the recognition, measurement and disclosure of investment property. SIC 15, 'Operating leases – incentives', is also relevant to investment property.

2 IAS 40's scope includes property held for capital appreciation or to earn rentals, where the property is owned by the entity or held by it under a lease accounted for as a finance lease (see definition of investment property below). [IAS 40 para 3].

3 IAS 40 also permits a property interest, such as an operating lease of land, to be treated as investment property where the property meets the definition of investment property and the lessee uses IAS 40's fair value model (see below). Where this is the case, the initial cost of the asset should be determined and recognised in accordance with IAS 17, 'Leases', as if it is held under a finance lease. It is initially recognised at the lower of the fair value of the property interest and the present value of the minimum lease payments to establish the amount recognised as a liability in accordance with IAS 17. [IAS 40 paras 6, 25].

4 The standard does not apply to biological assets related to agricultural activity (dealt with by IAS 41, 'Agriculture') or mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources. [IAS 40 paras 3, 4].

Definition of an investment property

5 Investment property is defined as property (land or a building – or part of a building – or both) held by the owner or held on a finance lease to earn rentals or for capital appreciation or both, rather than for:
- use in producing or supplying goods or services or for administrative purposes; or
- sale in the ordinary course of business. [IAS 40 para 5].

IAS 40 also permits property held by an entity under an operating lease to be treated as investment property provided that certain conditions are met (see para 2.3 above). [IAS 40 para 6].

6 The definition excludes owner-occupied property, property intended for sale in the ordinary course of business, property being constructed on behalf of third parties and property that is leased to a third party under a finance lease. However, the standard does apply to existing investment property that is being redeveloped for continued use as an investment property in the future.

7 Investment properties in the course of construction or development are within the scope of IAS 40. Where the fair value model under IAS 40 is applied, such a property is measured at fair value. However, where the fair value of the investment property under construction is not reliably measurable, the property is measured at cost until the earlier of the date construction is completed or the date at which fair value becomes reliably measurable.

Multi-purpose property

8 Separate accounting should be applied where a property is used for both investment purposes and administrative or productive purposes. One portion should be accounted for as an investment property and the other as PPE. Separate accounting can only be applied if it is possible for the portions to be sold separately (or leased separately under a finance lease). [IAS 40 para 10]. The existence of a third party lessee indicates that a separate sale or finance lease is possible.

9 The entire property is treated as investment property only if an insignificant portion is held for use in the production or supply of goods or services or for administrative purposes. [IAS 40 para 10].

Services provided to occupants of property

10 Where an entity provides ancillary services to occupants of a property owned by the entity, the property is an investment property if such ancillary services are a relatively insignificant portion of the arrangement as a whole. Where, however, such services are a more significant portion, such as in a hotel, the property is treated, not as investment property, but as an owner-occupied property. [IAS 40 paras 11, 12].

Property occupied by group members, associated companies or joint ventures

11 Where property is leased from one member of a group to another, from the group's perspective the property is not treated as an investment property in the consolidated financial statements. However, it may still qualify as an investment property in the individual financial statements of the subsidiary that is the lessor; if it meets the other conditions set out in the definition (see above). [IAS 40 para 15].

12 Property occupied by an associated company or joint venture accounted for using the equity method should be accounted for as investment property in the consolidated financial statements. Associates and joint ventures accounted for using the equity method are not part of the group and, therefore, the property is not owner-occupied from the group's perspective.

13 Property occupied by a joint venture accounted for using the proportionate consolidation method should be classified as PPE in the consolidated financial statements. This anomaly will be removed when proportionate consolidation is abolished. (See Topic summary on joint ventures).

Recognition

14 Investment property should be recognised as an asset when it is probable that the future economic benefits associated with the property will flow to the entity and the cost of the property can be reliably measured. [IAS 40 para 16].

15 An entity applies the recognition criteria to costs as they are incurred. Such costs include initial costs and costs that have been incurred subsequent to the initial recognition that are incurred in replacing or servicing a property. [IAS 40 para 17].

16 Costs of servicing a property are expensed as incurred, as they primarily comprise repairs and maintenance expenditure, although they may include the cost of replacing minor parts. Costs of replacing major parts, such as interior walls or a roof, are recognised in the carrying amount of the asset when incurred. The carrying amount of the part that has been replaced is derecognised at the same time. [IAS 40 paras 18, 19].

Measurement at recognition

17 Initially, investment property should be measured at cost. Cost is the fair value of the purchase price, including directly attributable expenditure, such as legal fees and property transfer tax. The cost of an investment property does not include start-up costs, operating losses incurred before the property achieves the planned level of occupancy or abnormal costs. For investment property under contruction not measured at fair value, borrowing costs should be included in accordance with IAS 23 (revised).

18 SIC 15, 'Operating leases – Incentives', states that where a lessor gives incentives, they should be recognised as a reduction of rental income over the lease term on a straight-line basis, unless another systematic basis is representative of the time pattern over which the benefit of the leased asset is diminished. Such incentives may not, therefore, be added to the cost of the asset. [SIC 15 paras 3, 4, 10].

19 The initial cost of a property interest held under a lease and classified as investment property is recorded at the lower of fair value and the present value of the minimum lease payments. A corresponding liability is recognised. This applies to assets leased under a finance lease and to assets leased under an operating lease, but only in the

specific circumstances described in paragraph 2.3 above. The asset recognised should be the leasehold interest in the property, not the property itself. Separate measurement of the land and buildings element is not required when the lessee's interest in both the land and building is classified as an investment property and the fair value model is adopted. Where a premium is paid for a lease, it forms part of the minimum lease payments and is treated as part of the asset's cost, but is excluded from the liability since it has already been paid. [IAS 40 paras 25, 26].

20 An exchange of assets is recognised at fair value unless (a) the exchange transaction lacks commercial substance or (b) the fair value of neither the asset received nor the asset given up is reliably measurable. If not measured at fair value for either of the reasons above, the cost is measured at the carrying amount of the asset given up. [IAS 40 paras 27 to 29].

Subsequent measurement

21 An entity has a choice of how it should measure investment property subsequent to initial recognition and measurement. It may choose either the fair value model or the cost model, but it must apply the chosen model consistently to all its investment property, with the following exceptions:

- Where a property held under an operating lease is treated as investment property, the fair value model must be used and this triggers the use of the fair value model for *all* other investment property (other than those in the next bullet point and in para 25) (see para 3 above).
- Regardless of its choice of policy for all other investment property, an entity may choose either the fair value model or the cost model for all investment property backing liabilities that pay a return linked directly to the fair value of, or returns from, specified assets including that investment property (this option is mainly applicable to insurers and similar entities).

[IAS 40 paras 30, 32A, 34].

22 A change from one model to the other should only be made if it will result in a more appropriate presentation. A change from fair value to historical cost is not likely to give a more appropriate presentation. [IAS 8 para 14] [IAS 40 para 31].

Fair value model

23 The fair value model involves measuring all investment property at fair value. Fair value is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction. [IAS 40 paras 5, 36].

24 Fair value should reflect market conditions at the end of the reporting period. The standard gives a considerable amount of guidance on determining fair value. In particular:

- Fair value is not reduced by transaction costs that may be incurred on sale or disposal. [IAS 40 para 37].
- The best evidence of fair value is given by current prices on an active market for similar property in the same location and condition and subject to similar lease and other constraints. [IAS 40 para 45].
- Fair value (market value) differs from value in use as defined in IAS 36, 'Impairment of assets'. [IAS 40 para 49].
- There is a need to avoid double-counting of investment property and separately recognised assets and liabilities. Integral equipment (such as lifts or air-conditioning) is generally included in the investment property rather than recognised separately. [IAS 40 para 50].
- Fair value does not reflect future capital expenditure, nor the related future benefits of that expenditure. [IAS 40 para 51].

Fair value not obtainable

25 There may be exceptional cases where an entity adopts the fair value model, but is unable to determine the fair value of a particular property reliably on a continuing basis. In such situations, the entity should measure that property at cost less depreciation and any impairment losses. The residual value of the property should be assumed to be zero. This basis should be applied until the property is disposed of. [IAS 40 para 53].

26 The above exception applies only where the inability to determine fair value on a continuing basis arises on the initial acquisition of an investment property, or when an existing property first becomes an investment property following completion of construction or development, or after a change of use. [IAS 40 para 53].

27 By contrast, where an existing investment property has previously been measured at fair value, the entity should continue to measure it at fair value until disposal (or until the property becomes owner-occupied or is developed for sale in the ordinary course of business), even if comparable market transactions become less frequent or market prices become less readily available. [IAS 40 para 55].

Gains and losses from changes in fair value

28 Gains or losses arising from changes in the fair value of investment property should be included in profit or loss for the period in which they arise. [IAS 40 para 35].

Implications for deferred tax

29 The fair value adjustments are likely to generate a deferred tax asset or liability, resulting from the difference between the property's carrying amount and its tax basis. SIC 21 applies to the land element of the investment property, and requires that any deferred tax asset or liability should be calculated at the tax rate applicable to the future sale of the land. [SIC 21 para 5]. This conclusion is not valid for the buildings element of investment properties that are carried at fair value. The expected manner of recovery for these buildings may be through use, through sale or through both use and sale. The deferred tax element relating to the building can be complex and would be entity specific. See the deferred tax topic summary.

Cost model

30 The cost model involves measuring investment property at cost less depreciation and any impairment losses (that is, the same as the treatment under IAS 16 for PPE), other than those properties that meet the criteria to be classified as held for sale (or are included in a disposal group that is classified as held for sale) in accordance with IFRS 5, 'Non-current assets held for sale and discontinued operations', which are accounted for in accordance with that standard. [IAS 40 para 56].

Transfers, derecognition and disposals

Transfers

31 Transfers should be made to or from investment property only when there is a change in use. Such a change should be evidenced by:

- The entity commencing owner-occupation, in the case of a transfer from investment property to owner-occupied property.
- The entity commencing redevelopment with a view to sale, for a transfer from investment property to a separate category (see also para 33 below).
- The entity ceasing to occupy the property as owner, for a transfer from owner-occupied property to investment property.
- The entity leasing out the property on an operating lease to a third party, for a transfer from inventory to investment property.

32 Where an entity decides to sell an investment property without developing it for sale, it is not transferred to inventory, but is carried as an investment property until disposal. In the same way, if an entity redevelops an existing investment property for continued use as an investment property, there is no transfer made to owner-occupied property during the redevelopment period, because there has been no change of use. [IAS 40 para 58].

33 Transfers from investment property held at fair value to owner-occupied property or to inventory should be made at fair value at the date of change in use. That fair value is the property's cost for subsequent accounting under IAS 16 or IAS 2, 'Inventories'. [IAS 40 para 60].

34 When an owner-occupied property is transferred to investment property and the entity has a policy of fair valuing investment property, IAS 16 should be applied up to the date of transfer. Any difference at that date between the carrying amount under IAS 16 and the fair value of the property should be treated in the same way as a revaluation under IAS 16. Subsequent revaluation gains and losses after the transfer would be taken to the income statement in accordance with IAS 40. [IAS 40 paras 61, 62, 35].

35 Where an entity has a policy of carrying investment property at fair value, transfers from inventory to investment property should be made at fair value at the date of transfer, with any difference between that fair value and the carrying value of the inventory being taken to profit or loss. [IAS 40 para 63].

Derecognition and disposals

36 Investment property should be derecognised either on disposal or when permanently withdrawn from use if no future economic benefits are expected from its ultimate disposal. Where parts of a property are replaced and the replacement part is capitalised the carrying amount of the replaced part is derecognised. [IAS 40 paras 66, 19].

Gains and losses on disposal

37 Gains or losses on disposal are calculated as the difference between the net disposal proceeds and the carrying amount of the asset and should be recognised in the income statement, unless IAS 17 requires otherwise on a sale and leaseback transaction. When consideration is deferred the proceeds are taken as the present value of the future receipts and the difference is recognised as interest income over the period of deferral. When any liabilities are retained after disposal, these are accounted for in accordance with IAS 37. [IAS 40 paras 69 to 71].

38 Compensation from third parties for investment property that is impaired, lost or given up should be recognised in profit or loss when it becomes receivable. [IAS 40 para 72].

Impairment

39 An investment property carried at cost, less any accumulated depreciation and any accumulated

impairment, is impaired if its carrying amount exceeds its recoverable amount. [IAS 36 para 8]. The recoverable amount of an investment property will often be the same as its fair value; however, there are some circumstances when this will not be the case. This is because market values consider only external factors, whereas value in use also takes account of entity-specific factors such as tax exemptions granted to the owner of the property.

40 Investment properties carried at cost, less any accumulated depreciation and any accumulated impairment, should be assessed for impairment in accordance with the provisions of IAS 36, 'Impairment of assets'. Properties carried at fair value are excluded from the scope of IAS 36. [IAS 36 para 2].

41 Where an impairment of an investment property is identified, the carrying value should be written down to the recoverable amount. [IAS 36 para 59]. The impairment should be charged to profit or loss.

Disclosure

42 IAS 40 contains extensive disclosure requirements, which in the case of leased properties are supplemented by those of IAS 17. There are disclosure requirements for all investment properties, whether carried at cost or at fair value. One important disclosure point is that where the cost approach is followed, the standard requires that the fair value of investment property should be given in the note disclosures. [IAS 40 paras 74 to 79].

43 In addition to this, the detailed disclosures cover measurement model adopted, the basis of distinguishing investment property, methods and assumptions for determining fair value, extent of involvement of external valuers, analysis of amounts included in profit or loss, details of restrictions on realisability of property or on remittance of income or proceeds of sale and contractual obligations in respect of buying, constructing or developing property and for repairs or enhancements. [IAS 40 para 75].

44 There are also further detailed disclosures required in respect of property carried at fair value including:

- The circumstances in which assets held under operating leases are treated as investment property.
- Details of significant adjustments to valuations, for example to avoid double-counting.
- Analysis of movements in investment property during the year.
- Details of any property carried at cost, because of difficulty in reliably determining fair value.

Similar disclosure of movements is required for properties where the entity carries them as a matter of policy at cost less depreciation and impairment. [IAS 40 paras 76 to 79].

Impairment of assets

Overview

Nearly all assets – current and non-current – are subject to an impairment test to ensure that they are not overstated on balance sheets.

The basic principle of impairment is that an asset may not be carried on the balance sheet above its recoverable amount. Recoverable amount is defined as the higher of the asset's fair value less costs to sell and its value in use. Fair value less costs to sell is the amount obtainable from a sale of an asset in an arm's length transaction between knowledgeable, willing parties, less costs of disposal. Value in use requires management to estimate the future cash flows to be derived from the asset and discount them using a pre-tax market rate that reflects current assessments of the time value of money and the risks specific to the asset.

All assets subject to the impairment guidance are tested for impairment where there is an indication that the asset may be impaired. Certain assets (goodwill, indefinite lived intangible assets and intangible assets that are not yet available for use) are also tested for impairment annually even if there is no impairment indicator.

When considering whether an asset is impaired, both external indicators (for example, significant adverse changes in the technological, market, economic or legal environment or increases in market interest rates) and internal indicators (for example, evidence of obsolescence or physical damage of an asset or evidence from internal reporting that the economic performance of an asset is, or will be, worse than expected) are considered.

Recoverable amount is calculated at the individual asset level. However, an asset seldom generates cash flows independently of other assets, and most assets are tested for impairment in groups of assets described as cash-generating units (CGUs). A CGU is the smallest identifiable group of assets that generates inflows that are largely independent from the cash flows from other CGUs.

The carrying value of an asset is compared to the recoverable amount (being the higher of value in use or fair value less costs to sell). An asset or CGU is impaired when its carrying amount exceeds its recoverable amount. Any impairment is allocated to the asset or assets of the CGU, with the impairment loss recognised in profit or loss.

Goodwill acquired in a business combination is allocated to the acquirer's CGUs or groups of CGUs that are expected to benefit from the synergies of the business combination. However, the largest group of CGUs permitted for goodwill impairment testing is the lowest level of operating segment, as defined in IFRS 8 paragraph 5, before the aggregation permitted by IFRS 8 paragraph 12.

Resources

Standards and interpretations
- IAS 36, 'Impairment of assets'

PwC guidance
- Manual of Accounting chapter 18, Impairment of assets

Tools practice aids and publications
- IFRS extracts from published accounts

Summary of key requirements

1 IAS 36, 'Impairment of assets', sets out the procedures that an entity should follow to ensure that assets are not carried at more than the amount that can be recovered through their use or sale (the 'recoverable amount'). Where assets are carried at more than their recoverable amount they are impaired, and the standard requires an impairment loss to be recognised. The standard gives guidance on when an impairment loss should be reversed and the disclosures that should be made in respect of impairment losses and reversals of such losses. [IAS 36 para 1].

2 All non-financial assets other than those covered specifically in other standards are in the scope of IAS 36. The assets scoped out are inventories, assets arising from construction contracts, deferred tax assets, assets arising from employee benefits, financial assets within the scope of IAS 39, 'Financial instruments: Recognition and measurement' , investment properties measured at fair value, certain biological assets, certain assets falling within the scope of IFRS 4, 'Insurance contracts', and non-current assets held for disposal in accordance with IFRS 5, 'Non-current assets held for sale and discontinued operations'. IAS 36 also applies to investments in subsidiaries, joint ventures and associates. [IAS 36 paras 2 to 5]. Assets in the scope of the standard would include property, plant and equipment, intangible assets and goodwill.

Impairment reviews and indicators of impairment

3 An entity should assess at each reporting date whether there is any indication that an asset may be impaired. If there is an indication then the entity should carry out an impairment test by measuring the asset's recoverable amount. The recoverable amount is the higher of the asset's fair value less costs to sell and its value in use. [IAS 36 paras 9, 6].

4 If the recoverable amount of an asset is less than its carrying amount the asset is impaired and the carrying

amount should be reduced to its recoverable amount. The reduction is an impairment loss. [IAS 36 para 59].

5 Indications that an asset may be impaired include both external and internal sources of information. External sources include a decline in the asset's market value, significant adverse changes in the technological, market, economic or legal environment in which the entity operates or in its markets, or increases in market rates of return that may materially affect the discount rate used in calculating the asset's recoverable amount. Internal sources include:

- Obsolescence or physical damage affecting the asset.
- Significant adverse changes in the extent to which, or in the way that, an asset is used or expected to be used, including plans to discontinue or reorganise the operation to which the asset belongs or to dispose of the asset.
- Deterioration in the expected level of the asset's performance.

[IAS 36 para 12].

6 Three types of asset (goodwill, intangible assets with an indefinite useful life and assets that are not yet ready for use) require an annual impairment review.

Measuring the recoverable amount

7 Recoverable amount is the higher of fair value less costs to sell (the amount for which an asset could be exchanged in an arm's length transaction) and value in use (the present value of the future cash flows expected to be derived from the asset). Impairment should be identified at the individual asset level where possible. Where the recoverable amount for an individual asset cannot be identified the recoverable amount should be calculated for the smallest cash-generating unit (CGU) to which the asset belongs. A CGU is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. [IAS 36 paras 66, 6, 68].

8 The rules for measuring recoverable amount are the same for individual assets and CGUs. In the following paragraphs the term 'asset' includes both individual assets and CGUs. [IAS 36 paras 6, 22].

Cash generating units (CGUs): general principles

9 Identifying CGUs is the first step in carrying out impairment reviews. IAS 36 provides guidance on how to establish the carrying amount of a CGU.

10 The independence of cash flows will be indicated by various factors including how management monitors the entity's operations, for example by product lines, businesses, individual locations, districts or regional areas or how management makes decisions about continuing or disposing of the entity's assets and operations. Management's analysis may not, therefore, reflect the legal structure through which the operations are conducted. [IAS 36 para 69].

11 The existence of an active market for the output of an asset, or group of assets, is evidence that cash flows are independent. Such an asset or group of assets will, therefore, be a CGU. This determination is independent of how the assets are managed internally. [IAS 36 para 70]. Examples of outputs from assets for which an active market exists include oil, gold and electricity.

12 The identification of CGUs should be consistent for each period. However, an asset that was previously part of a CGU but which is no longer utilised, should be excluded from the CGU and assessed for impairment separately. [IAS 36 para 72].

Fair value less costs to sell

13 Fair value less costs to sell (FVLCTS) is the amount obtainable from selling the asset in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal. The best indicator of FVLCTS is the price in a binding arm's length sale agreement adjusted for the expected incremental costs of disposal. The current price on an active market should be used in the absence of such an agreement. If neither a binding agreement nor an active market is available, then FVLCTS may still be derived using estimation techniques such as a discounted cash flow analysis. The discounted cash flow should incorporate assumptions that market participants would use in estimating the asset's fair value. This means that some of the restrictions imposed by IAS 36 on the assumptions inherent in the value in use calculation will not apply to a fair value less costs to sell valuation and hence the FVLCTS value may be higher.

Calculating value in use

14 Value in use is ''*the present value of the future cash flows expected to be derived from an asset or cash-generating unit*''. Calculating value in use involves the following processes:

- Estimates of the future cash flows from the asset.
- Estimating the potential variation in the amount and timing of the future cash flows.
- Selecting a pre tax discount rate that reflects the risks that a market participant would take into account.

[IAS 36 para 30].

The future cash flows to be derived from the asset include those that arise from the asset's continuing use and those that arise from its ultimate disposal.

15 Cash flows should be based on reasonable and supportable assumptions that represent management's

best estimate of the range of economic conditions that will exist over the asset's remaining useful life. The cash flows should be based upon the most recent financial budgets/forecasts that management has approved, but should exclude future estimated cash inflows or outflows expected to arise from future restructurings or from improving or enhancing the asset's performance. The cash flows should cover a maximum period of five years, unless a longer period can be justified. [IAS 36 paras 33(a) (b), 42].

16 Cash flows beyond five years should be estimated by extrapolating the projections for the first five years using a steady or declining growth rate for subsequent years, unless an increasing rate can be justified. This growth rate should not exceed the long-term average growth rate for the products, industries, or countries in which the entity operates, or for the market in which the asset is used, unless a higher rate can be justified. [IAS 36 para 33(c)].

17 The cash flows should be based on the asset's current condition. That is, they should exclude expenditure (and related inflows) associated with any planned restructuring to which the entity is not yet committed. The cash flows should also exclude any future expenditure (and related inflows) that will improve or enhance the asset's performance. [IAS 36 para 44]. The cash flows should not include cash flows from financing activities or income tax receipts or payments. [IAS 36 paras 39(c), 50].

18 The discount rate used to calculate value in use should be the pre-tax discount rate. This is consistent with the cash flows that are also pre-tax. The rate used should reflect the current market assessment of the time value of money and the risks specific to the asset for which the future cash flow estimates have not been adjusted. [IAS 36 para 55].

Allocating assets and liabilities to cash generating units (CGUs)

19 The recoverable amount of a CGU is the higher of value in use and FVLCS, as for an individual asset. They way in which the CGU is determined should be consistent with the determination of its recoverable amount.

20 The carrying amount of a CGU consists of assets that are directly and exclusively attributable to the CGU and an allocation of assets that are indirectly attributable on a reasonable and consistent basis to the CGU including corporate assets and goodwill.

21 Goodwill acquired in a business combination should be allocated to each of the acquirer's CGUs or groups of CGUs that are expected to benefit from the synergies of the combination. The allocation of goodwill is made independently of the allocation of the acquiree's other assets and liabilities. Goodwill is allocated to CGUs at the lowest level at which management monitors goodwill for internal purposes and must not be larger than an operating segment under IFRS 8, 'Operating segments'. Where goodwill has been allocated to a CGU and the entity disposes of an operation within that CGU, the goodwill attributable to the operation disposed of is included in the carrying amount of the operation when calculating the profit or loss on disposal. Similarly, an entity might reorganise its business and change the composition of one or more CGUs to which goodwill has been allocated. In such situations, the goodwill attributable to operations that are moved between CGUs is calculated on the basis of the relative fair values of those operations and the remainder of the CGUs from which the operations are transferred. [IAS 36 paras 80, 84, 86, 87].

22 Corporate assets attributable to the CGU should be allocated to the carrying amount of the CGU if they can be allocated on a reasonable and consistent basis. If, however, the corporate assets cannot be allocated to the CGU, the entity should carry out an impairment test on the CGU, excluding any allocation of corporate assets and recognise any impairment loss arising. The entity should then identify the smallest group of CGUs that includes the CGU under review and to which corporate assets can be allocated on a reasonable and consistent basis. The entity should then test that group of CGUs, including the allocated corporate assets, for impairment and recognise any impairment loss arising.

23 Liabilities that relate to the financing of the CGU and tax balances are not allocated to determine the carrying amount of the CGU as the related cash flows will be excluded from the impairment calculations.

Recognition of impairment loss

24 An impairment loss should be recognised if the recoverable amount of an asset or CGU is less than its carrying amount. The loss should be included as an expense in the income statement (and charged in arriving at profit or loss before tax), unless the asset is carried at a revalued amount, under IAS 16 or IAS 38, when it should be treated as a revaluation decrease. Where treated as a revaluation decrease the loss is charged first against any previous revaluation surplus to the extent of that surplus with the balance being recognised in the income statement as above. The future depreciation or amortisation of the impaired asset should be adjusted to reflect the revised carrying amount. [IAS 36 paras 59, 60, 63].

25 An impairment charge calculated for a CGU rather than an individual asset should be allocated to the CGU's individual assets in the following order:

- First to goodwill allocated to the CGU (or group of CGUs).

- Then to the other assets of the CGU (or group of CGUs) on a *pro rata* basis based on the carrying amount of each asset in the CGU (or group of CGUs).

[IAS 36 para 104].

26 In allocating the impairment loss to a CGU the carrying amount of each asset within the CGU should not be reduced below the highest of:

- Fair value less costs to sell.
- Value in use.
- Zero.

[IAS 36 para 105].

27 Any unallocated impairment should be reallocated to the CGU's other assets, subject to the same limits. This could result in an iterative process, continuing until the impairment loss is fully allocated or until each of the CGU's assets have been reduced to the highest of each asset's fair value less costs to sell, value in use and zero. The recognition of an impairment loss should not, however, result in the recognition of a liability, unless it meets the definition of a liability under another IFRS. [IAS 36 para 108].

Reversal of impairment loss

28 An entity should assess at each subsequent reporting date whether there is any indication that impairment losses previously recognised may have reversed. Where indicators of reversal exist, the asset's recoverable amount should be recalculated and its carrying amount should be increased to the revised recoverable amount. A reversal should be recognised only if it arises from a change in the estimates used to calculate the recoverable amount. However, an impairment of goodwill may not be reversed in any circumstances. This includes an impairment loss in respect of goodwill recognised in a previous interim period. [IAS 36 paras 114, 124; IFRIC 10 para 8].

29 The increased carrying amount of an asset due to an impairment reversal should not exceed the amount (net of depreciation or amortisation) at which the asset would be stated had the original impairment not occurred. The same principle applies to the reversal of an impairment of a CGU.

30 The reversal of an impairment loss should be recognised in profit or loss, unless the asset is carried at a revalued amount, for example under IAS 16. A reversal of an impairment loss on a revalued asset should be treated as a revaluation increase to the extent that the reversal exceeds the amount (adjusted for depreciation that would have been charged had no impairment occurred) previously charged to profit or loss.

Disclosure

31 The disclosure requirements for impairment are extensive. The disclosures are designed to enable a reader of the financial statements to understand the process and to decide whether they would have reached the same conclusion. For example, even where there is no impairment charge, the standard requires disclosure of the estimates and assumptions used to measure the recoverable amounts of CGUs that contain goodwill or indefinite lived intangibles. In certain circumstances, some sensitivity analysis to provide information on the degree of sensitivity of the value in use or FVLCS calculations to the key assumptions made. There are also extensive disclosures when an impairment charged is recorded.

Joint ventures

Overview

A joint venture is a contractual arrangement whereby two or more parties (the venturers) undertake an economic activity that is subject to joint control. Joint control is defined as the contractually agreed sharing of control of an economic activity.

Joint ventures fall into three categories: jointly controlled entities, jointly controlled operations and jointly controlled assets. The accounting treatment depends on the type of joint venture.

A jointly controlled entity involves the establishment of a separate entity, which may be, for example, a corporation or partnership. Jointly controlled entities are accounted for under IAS 31, 'Interest in joint ventures', using either proportionate consolidation or equity accounting. SIC 13, 'Jointly controlled entities – non-monetary contributions by venturers', addresses non-monetary contributions to a jointly controlled entity in exchange for an equity interest.

Jointly controlled operations and jointly controlled assets do not involve the creation of an entity that is separate from the venturers themselves. In a joint operation, each venturer uses its own resources and carries out its own part of a joint operation separately from the activities of the other venturer(s). Each venturer owns and controls its own resources that it uses in the joint operation. Jointly controlled assets involve the joint ownership of one or more assets.

Where an entity has an interest in jointly controlled operations or jointly controlled assets, it accounts for its share of the assets, liabilities, income and expenses and cash flows under the arrangement.

Resources

Standards and interpretations
- IAS 31, 'Interests in joint ventures'
- SIC 13, 'Jointly controlled entities – non-monetary contributions by venturers'

Exposure drafts and discussion papers
- ED 9, 'Joint arrangements'

PwC guidance
- Manual of Accounting chapter 28, Joint ventures

PwC views
- Comment letter on ED 9, 'Joint arrangements'

Tools practice aids and publications
- IFRS extracts from accounts

Summary of key requirements

Objective and scope

1 IAS 31, 'Interests in joint ventures', sets out the accounting for joint ventures and the related disclosure requirements. It deals with classification, accounting and disclosure for joint ventures. SIC 13, 'Jointly controlled entities – non-monetary contributions by venturers', deals with non-monetary contributions to a jointly controlled entity in exchange for an equity interest.

2 All interests in joint ventures fall within the standard's scope regardless of the structures or forms under which the joint venture activities take place, except for interests in jointly controlled entities held by venture capital organisations, mutual funds, unit trusts and similar entities, including investment-linked insurance funds. An exemption from joint venture accounting is available to those entities if the investments are measured at fair value through profit and loss. A venturer holding this type of interest must make the disclosures required by paragraphs 55 and 56. [IAS 31 para 1].

Forms of joint venture

3 A joint venture is a contractual arrangement whereby two or more parties undertake an economic activity that is subject to joint control. Joint control is the contractually agreed sharing of control over an economic activity and exists only when the strategic financial and operating decisions require the unanimous consent of all the venturers. The standard identifies three broad types of joint ventures:
- Jointly controlled operations.
- Jointly controlled assets.
- Jointly controlled entities.

[IAS 31 paras 3, 7].

Contractual arrangement

4 Activities that have no contractual arrangement to establish joint control are not joint ventures. The contractual arrangement may be evidenced in a number of ways, for example by contract, minutes of discussion, or the articles of the joint venture. [IAS 31 paras 9, 10].

5 The contractual agreement will usually address:
- The activity, duration and reporting obligations of the joint venture. [IAS 31 para 10(a)].
- The appointment of the board or equivalent governing body and the voting rights of the venturers. [IAS 31 para 10(b)].
- The capital contributions required from the parties. [IAS 31 para 10(c)].
- The sharing of the venture's output, income, expenses or results. [IAS 31 para 10(d)].

6 The contractual agreement may identify one of the parties to it as the manager of the day-to-day operations. The operator does not control the joint venture, but acts within the financial and operating policies set out in the contractual agreement. [IAS 31 para 12].

7 There may be parties to the contractual agreement who are not part of the exercise of joint control. These parties are investors and account for their interests under the equity method if they are able to exercise significant influence, or as investments in accordance with IAS 39, 'Financial instruments: Recognition and measurement', if they do not.

Jointly controlled operations

8 This involves the use of the venturers' assets and other resources rather than setting up a separate corporation, partnership or other entity. [IAS 31 para 13].

9 A venturer recognises in its financial statements:

- The assets that it controls and the liabilities that it incurs.
- The expenses that it incurs and its share of the income that it earns from the sale of goods and services by the joint operation.

[IAS 31 para 15].

Jointly controlled assets

10 Some joint ventures involve the joint control by the venturers of assets contributed to or acquired for the purposes of the joint venture. Similar to jointly controlled operations, these joint ventures do not involve establishing a separate corporation, partnership or other entity. Each venturer has control over its share of future economic benefits through its share in the jointly controlled asset. [IAS 31 paras 18, 19].

11 A venturer recognises in its financial statements in respect of its interests in jointly controlled assets,:

- Its share of jointly controlled assets, classified according to the assets' nature.
- Any liabilities that it has incurred.
- Its share of liabilities incurred jointly with other venturers.
- Any income from the sale or use of its share of the output of the joint venture, together with its share of any expenses incurred by the joint venture.
- Any expenses that it has incurred in respect of its interest in the jointly controlled asset.

[IAS 31 para 21].

Jointly controlled entities

Definition

12 A jointly controlled entity is a joint venture that involves establishing a corporation, partnership or other entity in which the venturer has an interest. It operates in the same way as other entities, except that a contractual arrangement between the venturers establishes joint control over the entity's economic activity. [IAS 31 para 24].

13 From the date when a jointly controlled entity becomes a subsidiary of a venturer, the venturer should account for its interest in accordance with IAS 27, 'Consolidated and separate financial statements'. From the date when a jointly controlled entity becomes an associate of a venturer, the investor should account for its interest in accordance with IAS 28, 'Associates'. [IAS 31 para 45].

14 In January 2008, the IASB issued a revised IAS 27, effective for annual periods beginning on or after 1 July 2009, which resulted in consequential amendments to IAS 31. As a result, when an investor ceases to have joint control over an entity and the entity becomes neither a subsidiary nor an associate, it should account for any remaining investment in accordance with IAS 39 from that date.

15 From the date when a jointly controlled entity becomes a subsidiary of an investor, the investor should account for its interest in accordance with IAS 27 (revised), and IFRS 3 (revised), 'Business combinations'.

16 From the date when a jointly controlled entity becomes an associate of an investor, the investor should account for its interest in accordance with IAS 28, 'Investments in associates'. [IAS 31 (amended) para 45].

17 On the loss of joint control, the investor must measure at fair value any investment retained in the former jointly controlled entity. The investor must recognise in profit or loss any difference between:

(a) the fair value of any retained investment and any proceeds from disposing of the part interest in the jointly controlled entity; and
(b) the carrying amount of the investment at the date when joint control is lost. [IAS 31 (amended) para 45].

18 When an investment ceases to be a jointly controlled entity and is accounted for under IAS 39, the fair value of the investment when it ceases to be a jointly controlled entity is regarded as its fair value on initial recognition as a financial asset. [IAS 31 (amended) para 45A].

19 If an investor loses joint control of an entity, the investor must account for all amounts recognised in other comprehensive income in relation to that entity on the

same basis required as if the jointly controlled entity had directly disposed of the related assets or liabilities.

20 Thus, if a gain or loss previously recognised in other comprehensive income would be reclassified to profit or loss on the disposal of the related assets or liabilities, the investor reclassifies the gain or loss from equity to profit or loss (as a reclassification adjustment) when the investor loses joint control of the entity. [IAS 31 (amended) para 45B].

Required accounting

21 A venturer's interest in a jointly controlled entity should be recognised using proportionate consolidation or the equity method. [IAS 31 paras 30, 38].

22 The requirement to use the proportionate consolidation or equity methods to account for jointly controlled entities also applies to investors that do not have subsidiaries, but do have investments in jointly controlled entities. The financial statements prepared by these investors are known as 'economic interest', financial statements. 'Economic interest' financial statements differ from 'separate' financial statements in which investments in jointly controlled entities are measured at cost or in accordance with IAS 39, 'Financial instruments: recognition and measurement' (see 'Separate financial statements' below).

Exemptions from proportionate consolidation and equity accounting

23 There are exceptions to the application of the prescribed methods of accounting for interests in jointly controlled entities (that is, proportionate consolidation or the equity method). The first exception is in respect of interests in jointly controlled entities classified as held for sale in accordance with IFRS 5. The second is in respect of venturers that are exempt under IAS 27 from the requirement to prepare consolidated financial statements (see below). The third is in respect of entities that are exempt under either IAS 28 or IAS 31 from the requirement to prepare 'economic interest' financial statements (see below). [IAS 31 para 2].

24 IAS 27, 'Consolidated and separate financial statements', exempts certain parents, that are wholly or partially owned by another entity and that have both investments in subsidiaries and jointly controlled entities from the requirement to prepare consolidated financial statements and, therefore, to consolidate and proportionately consolidate or equity account respectively those subsidiaries and jointly controlled entities, provided that certain specified conditions apply. IAS 31 additionally exempts venturers, that are wholly or partially owned by another entity and that only have investments in jointly controlled entities (and that, therefore, do not prepare consolidated financial statements), from the requirement to proportionately consolidate or equity account those jointly controlled entities if similar conditions apply. Such entities may present separate financial statements as their only financial statements. [IAS 27 para 10; IAS 31 paras 2(c), 6].

Proportionate consolidation

25 When proportionate consolidation is used, the standard requires the use of one of two reporting formats for proportionate consolidation: either the line-by-line basis or separate line items. [IAS 31 paras 30, 34]. The line-by-line basis involves combining the investor's share of each of the assets, liabilities, income and expense of the jointly controlled entity with the similar items, line by line, in the investor's financial statements. The separate basis involves including separate line items for its share of each of the assets, liabilities, income and expense of the jointly controlled entity.

Equity method

26 IAS 31 permits the use of the equity method as an alternative treatment for accounting for jointly controlled entities. It does not recommend the use of the equity method as it states that proportionate consolidation better reflects the substance and economic reality of the venturer's interests in a jointly controlled entity. [IAS 31 para 38, 40]. The key proposal in ED 9, 'Joint arrangements', issued in September 2007, is the removal of the option for proportionate consolidation for jointly controlled entities, which will converge IFRS with US GAAP.

Non-monetary contributions contributed in exchange for an equity interest

27 Gains and losses on transfers of assets in exchange for an equity interest in a jointly controlled entity should be recognised to the extent of the interests of the other venturers. This requirement is suspended when any of the following circumstances occurs; the significant risks and rewards of ownership of the contributed non-monetary assets have not been transferred to the joint venture, the gain or loss cannot be reliably measured or the transaction lacks commercial substance. [SIC 13 para 5]. If any of these exceptions applies the gain or loss is unrealised and is not recognised in profit or loss, unless the following paragraph also applies.

28 If the venturer receives additional consideration in the form of cash or dissimilar non-monetary assets, the appropriate portion of the gain on the transaction should be recognised by the venturer in profit or loss.

29 Unrealised gains or losses on non-monetary assets contributed to jointly controlled entities are eliminated against the underlying assets under the proportionate consolidation method or against the investment under the equity method. They are not shown as deferred gains or losses in the balance sheet. [SIC 13 para 7].

30 IAS 27 (revised) is applicable for accounting periods beginning on or after 1 July 2009. It specifies that when control of a subsidiary is lost, any retained interest should be re-measured to its fair value with any resulting gain or loss recognised in the income statement. (See separate topic summary IAS 27 (revised), 'Consolidated and separate financial statements'). As such, when a business/subsidiary is contributed to a joint venture in exchange for a jointly-controlled interest, a gain or loss is recognised on the portion retained in addition to the gain or loss on the portion no longer owned.

31 The interaction between SIC 13 and IAS 27 (revised) is currently unclear and IAS 27 (revised) did not amend or supersede SIC 13. Upon adoption of IAS 27 (revised), SIC 13 should no longer be analogised to when a subsidiary/business is contributed to an entity in exchange for shares where control, significant influence or a financial asset is retained. However, if a subsidiary/business is contributed to a joint venture in exchange for a jointly-controlled interest, the conflict between IAS 31/SIC 13 and IAS 27 (revised) remains. The IASB plans to address the interaction between SIC 13 and IAS 27 (revised) in its project on joint ventures. Until such time, entities should adopt a policy and consistently apply either SIC 13/IAS 31 or IAS 27 (revised) when dealing with contributions of a subsidiary of business to jointly-controlled entities.

Separate financial statements

32 IAS 31 cross-refers to paragraphs 38 to 43 of IAS 27, 'Consolidated and separate financial statements', as that standard specifies the accounting and disclosures required for interests in jointly controlled entities in a venturer's 'separate' financial statements. IAS 27 requires that such investments should be accounted for either at cost or in accordance with IAS 39. [IAS 31 para 46].

33 Separate financial statements are the investor's own financial statements in which investments are accounted for on the basis of the direct equity interest. The term direct equity interest means at cost or in accordance with IAS 39. Jointly controlled entities are not proportionately consolidated or equity accounted in separate financial statements. [IAS 31 para 3, 5].

34 IAS 27 and IAS 31 do not mandate which entities produce separate financial statements, but specify the accounting and disclosures required when an entity elects, or is required, by local regulations, to present separate financial statements. Where separate financial statements are produced, they are presented in addition to consolidated financial statements or 'economic interest' financial statements. Investors that are exempt from the requirement to consolidate, proportionately consolidate or equity account their investments may present separate financial statements as their only financial statements (see para 2.16 above). [IAS 27 paras 8, 10; IAS 31 paras 6, 47].

Transactions between a venturer and a joint venture

35 When a venturer contributes or sells assets to a joint venture and where the assets are retained by the joint venture, the venturer should recognise only the proportion of the gain or loss that is attributable to the interests of the other venturers. [IAS 31 para 48].

36 When a venturer purchases assets from a joint venture, the venturer should not recognise its share of the profit or loss of the joint venture from the transaction, until it resells the assets to an independent third party. [IAS 31 para 49].

37 The full amount of any loss is recognised if the transaction provides evidence of a reduction in the net realisable value of current assets or an impairment loss. [IAS 31 paras 48, 49].

Disclosure

38 IAS 31 sets out a number of detailed disclosures including:

- The aggregate amounts of current assets, long-term assets, current liabilities, long-term liabilities, income and expenses related to the investor's interests in joint ventures, where the line-by-line reporting format for proportionate consolidation or the equity method has been used in reporting interests in jointly controlled entities.
- A listing and description of interests in significant joint ventures and the proportion of ownership interest in jointly controlled entities.
- The method used to recognise interests in jointly controlled entities.
- Contingencies and capital commitments relating to the joint ventures.

[IAS 31 paras 54 to 57].

39 There are reduced disclosures for an entity accounting for its interests in joint ventures at fair value through profit or loss. A listing and description of interests in significant joint ventures, the proportion of ownership interest in jointly controlled entities and any commitments relating to the joint ventures need only be disclosed. [IAS 31 paras 1, 55, 56].

Leasing

Overview

A lease gives one party (the lessee) the right to use an asset over an agreed period of time in return for payment to the lessor. Leasing is an important source of medium- and long-term financing; accounting for leases can have a significant impact on lessees' and lessors' financial statements.

Leases are classified as finance or operating leases at inception, depending on whether substantially all the risks and rewards of ownership transfer to the lessee. Under a finance lease, the lessee has substantially all of the risks and reward of ownership. All other leases are operating leases. Leases of land and buildings are considered separately under IFRS.

Under a finance lease, the lessee recognises an asset held under a finance lease and a corresponding obligation to pay rentals. The lessee depreciates the asset.

The lessor recognises the leased asset as a receivable. The receivable is measured at the 'net investment' in the lease – the minimum lease payments receivable, discounted at the internal rate of return of the lease, plus the unguaranteed residual which accrues to the lessor.

Under an operating lease, the lessee does not recognise an asset and lease obligation. The lessor continues to recognise the leased asset and depreciates it. The rentals paid are normally charged to the income statement of the lessee and credited to that of the lessor on a straight-line basis.

Linked transactions with the legal form of a lease are accounted for on the basis of their substance – for example, a sale and leaseback where the seller is committed to repurchase the asset may not be a lease in substance if the 'seller' retains the risks and rewards of ownership and substantially the same rights of use as before the transaction.

Equally, some transactions that do not have the legal form of a lease are in substance leases if they are dependent on a particular asset that the purchaser can control physically or economically.

Standards and interpretations
- IAS 17, 'Leases'
- IAS 40, 'Investment property'
- IFRIC 4, 'Determining whether an arrangement contains a lease'
- SIC 15, 'Operating leases – Incentives'
- SIC 27, 'Evaluating the substance of transactions involving the legal form of a lease'

Exposure drafts and discussion papers
- Discussion paper on leases – preliminary view on leases

PwC Views
- PwC Comment letter on the IASB's discussion paper on leases – preliminary view on leases

PwC guidance
- Manual of Accounting chapter 19, Lease accounting

Tools, practice aids and publications
- IFRS extracts from accounts

Summary of key requirements

Classification

1 All leases must be classified at inception as either finance or operating leases. Lease classification depends on whether the lessor or lessee has the risks and rewards of the leased asset, not the legal form of the transaction.

In substance, a finance lease is a financing transaction that enables the lessee to effectively acquire an asset, although they may not get legal title to it. The following are examples of situations that, individually or in combination, would normally lead to a lease being classified as a finance lease:
- Ownership is transferred to the lessee at the end of the lease term.
- The lessee has an option to buy the leased asset at the end of the lease term, priced so that it is reasonably certain at inception that the lessee will exercise the option.
- The lease term is for the majority of the economic life of the asset.
- At inception, the fair value of the asset isn't significantly more than the present value of the minimum lease payments.
- The leased assets are specialised and only the lessee can use them without major modifications.

Additional indicators that a lease may be a finance lease include the following:
- If the lessee can cancel the lease, it bears any losses of the lessor that arise.
- The lessee benefits from fluctuations in the fair value of the residual, for example, by receiving rent rebates of most of the sales proceeds at the end of the lease.
- The lessee can continue the lease for a secondary period for below-market rent.

2 An operating lease does not have the commercial effect of financing the acquisition of an asset. Leases which do not meet the definition of a finance lease are operating leases

3 If the terms and conditions of the lease are changed, this is a new lease for accounting purposes.

4 The risks and rewards of the land element and buildings element of a lease of land and buildings must be considered separately. If leased land and buildings meet the definition of investment property under IAS 40, even if the land would normally be classified as an operating lease it can be measured and recognised as a finance lease, provided that the investment property is subsequently measured at fair value.

5 Leases are classified and, for finance leases, measured, at inception, which is the earlier of the agreement date and when the parties were committed to the principal provisions of the lease. On 'commencement' – when the lessee can use the leased asset – a finance lease gives rise to an asset (the leased asset) and an obligation to pay future rentals for the lessee.

Finance leases: lessee accounting

6 The amount recognised as an asset and liability is the lower of:

- the fair value of the leased asset, and
- the present value of the minimum lease payments.

To calculate the present value, the minimum lease payments are discounted at the interest rate implicit in the lease, that is, the rate that makes the sum of the minimum lease payments and the residual value equal to the fair value of the leased asset plus initial direct costs. In practice, the lessee will need to estimate this rate using estimated costs and residual values. If this isn't possible, the lessee should use its incremental borrowing rate – the rate it would have to pay on a similar lease or on borrowings over a similar term with similar security.

7 The leased asset should be depreciated over the shorter of the lease term and its useful life. If it is reasonably certain that title will pass to the lessee at the end of the lease term, the asset is depreciated over its useful life.

8 Lease rentals are split into two components – an interest charge and the reduction in the lease receivable.

Finance leases: lessor

9 The lessor recognises a finance lease receivable for the amount due under the finance lease, measured at the 'net investment' in the lease. This is calculated as the minimum lease payments, including any residual value guaranteed by the lessee or a third party, discounted at the interest rate implicit in the lease**,** plus any unguaranteed residual value which accrues to the lessor.

10 Lease rentals are allocated between a reduction in the receivable and finance income so that finance income recognised represents a constant percentage rate of return on the net investment.

11 Manufactures and dealers often also act as lessors. Manufacture/dealer lessors have two forms of income on entering into a lease – the profit on sale and finance income. They record revenue on a leased asset at the lower of the asset's fair value or the present value of the minimum lease payments. To prevent excessive income being recognised on sale, a market interest rate is used.

Operating leases

12 Lessees do not capitalise operating leases. Lease payments, excluding any payments for services such as insurance, are recognised on a straight line basis over the lease term unless there is a systematic way to spread the cost that is more representative of the benefit to the user. Lease costs must be charged to profit or loss even when the lessee is not using the asset, for example, if leased commercial premises are being fitted out.

13 The lessor continues to recognise the leased asset as property, plant and equipment and depreciates it as normal. Rentals are taken to profit or loss on a straight line basis, unless there is another systematic basis that is more representative.

Operating lease incentives

14 Lessors sometimes provide incentives for lessees to enter into operating leases. Incentives include rent free or below-market rent periods, upfront cash payments to the lessee, directly paying the lessee's costs, for example, relocation, or settling their liabilities.

Whatever the form of an incentive, it should be taken into account as part of the overall consideration paid by the lessee to the lessor for the leased asset. Therefore a lessee should spread incentives received over the lease term on a straight line basis (rarely, another systematic basis may be more appropriate). In effect this reduces the cost of the rentals taken to profit or loss, so that the aggregate consideration reflects the true rental cost to the lessee.

The lessor recognises incentives paid as a reduction of rental income.

Sale and leaseback

15 Sale and leaseback transactions are a way of releasing cash and are an alternative to borrowing. The vendor sells (or leases) an asset but retains use of the asset by entering into a lease with the buyer. The accounting treatment depends on the substance of the transaction, taking into account whether the leaseback is a financing or operating

lease, and whether the sale proceeds and lease rentals are on an arm's length basis.

16 A sale and finance leaseback is in substance a financing transaction. The seller does not recognise any profit on the sale – the difference between the sales proceeds and the carrying value of the asset is deferred and amortised to the income statement over the lease term. Further rules apply if the sale and/or the leaseback is not at an arm's length price.

17 If the leaseback is classified as an operating lease, then any gain is recognised immediately if the sale and leaseback terms clearly are at fair value. Otherwise, the sale and leaseback are accounted for as follows:

- If the sale price is above the fair value:
  - the difference between fair value and carrying amount is recognised immediately; but
  - the excess of proceeds over fair value should be deferred and amortised over the period for which the asset is expected to be used.
- If the sale price is below the fair value, the difference between sale price and carrying amount should be recognised immediately except that, if a loss arising is compensated by future rent at below market price, it should be deferred and amortised in proportion to the rent payments over the period for which the asset is expected to be used.

[IAS 17 para 61].

Transactions with the legal form but not the substance of a lease (SIC 27)

18 Some transactions with the legal form of a sale and leaseback include a commitment for the seller to repurchase the asset. Where the repurchase price is not market value, it will normally be the original sale price plus costs and a lender's return, and the substance of the transaction is a collateralised borrowing. Where this is the case, the transaction would not be accounted for as a sale and leaseback.

19 Other leaseback arrangements are put in place to obtain tax advantages for the lessee, which are shared with a lessor through a fee. As the commercial substance does not convey the use of an asset to the lessee, the transaction is not accounted for as a lease.

Transactions which don't have the legal form of a lease

20 Under IFRIC 4, arrangements that are not legally a lease are accounted for as leases if:

- fulfilment of the arrangement is dependent on the use of a specific asset; and
- the arrangement conveys the right to use a specific asset.

Per IFRIC 4, the right to use the asset is the right to control the use of the asset. The purchaser has the right to control the asset if the arrangement meets any of these conditions:

- The purchaser does not pay either a market price or a fixed price per unit. There is only a remote possibility that a third party will take more than an insignificant amount of the asset's output.
- If the purchaser can obtain or control more than an insignificant amount of the asset's output, either:
  - it can operate or direct the operation of the asset; or
  - it can control physical access to the asset.

21 The parties to the arrangement must each assess whether it contains a lease at its inception. The arrangement is re-assessed if there is a change in terms or if the contract is renewed or extended, unless this was included in the original terms.

22 Whether the arrangement contains a lease is also re-assessed if there is a substantial change to the asset used in the arrangement, or if there is a change in whether or not the fulfilment of the arrangement depends on a specific asset.

23 If the arrangement contains a lease, the lease element of the arrangement is accounted for under IAS 17 and is classified either as a finance or an operating lease.

24 The 'lease' payments must be split out from the other payments under the arrangement, based on the relative fair values of the lease and the other elements. If this is impractical, for a finance lease the purchaser measures the asset and liability at the fair value of the leased asset, accruing interest at the incremental borrowing rate. For an operating lease, all payments under the arrangement are treated as lease payments including the payments for non-lease elements but are disclosed separately from other payments that are purely lease payments.

Disclosure

25 For any type of lease, both lessees and lessors must disclose:

- A general description of their leasing arrangements, including how contingent rents are determined, if there are renewal terms, purchase options or escalation clauses, and if the leases impose any restrictions on the lessee.
- Contingent rents received/paid.

26 Operating lease lessees and lessors must disclose the future minimum lease payments payable/receivable under non-cancellable leases in total and receivable in less than 1 year, 1 to 5 years, and more than 5 years.

27 For finance leases, lessees must disclose:

- The net carrying amount at the balance sheet date for each class of asset.
- A reconciliation between the total minimum lease payments and their present value.

28 Operating lease lessees must disclose:

- The total of non-cancellable minimum lease payments payable within 1 year, in 1 to 5 years and in more than 5 years.
- Contingent rent, minimum lease and sublease payments recognised as an expense in the period.

29 Lessees must disclose for any type of lease:

- the total future minimum lease payments receivable under non-cancellable sub-leases.

30 For finance leases, lessors must disclose:

- A reconciliation between the gross investment in the lease at the balance sheet date, and the present value of the minimum lease payments.
- The gross investment in the lease and the present value of the minimum lease payments for the periods less than 1 year, 1 to 5 years, and more than 5 years.
- Unearned finance income.
- The unguaranteed residual values of leased assets.
- The accumulated allowance for uncollectible minimum lease payments.

Operating segments

Overview

The IASB issued IFRS 8, 'Operating segments', in November 2006 as part of convergence with US GAAP. IFRS 8 is similar to the US standard SFAS 131. It replaces IAS 14. It is effective for periods beginning on or after 1 January 2009, with earlier application permitted.

All entities with listed or quoted equity or debt instruments or that are in the process of obtaining a listing or quotation of debt or equity instruments in a public market are required to disclose segment information.

Operating segments are components of an entity, identified based on internal reports on each segment that are regularly used by the entity's chief operating decision-maker (CODM) to allocate resources to the segment and to assess its performance.

Operating segments are separately reported if they meet the definition of a reportable segment. A reportable segment is an operating segment or group of operating segments that exceed the quantitative thresholds set out in the standard. An entity may, however, disclose any additional operating segment if it chooses to do so.

All reportable segments are required to provide a measure of profit and assets in the format viewed by the CODM, as well as disclosure of the revenue from customers for each group of similar products and services, revenue by geography and dependence on major customers. Other detailed disclosures of performance and resources are required if the CODM reviews these amounts. A reconciliation of the totals of revenue, profit and loss, assets and other material items reviewed by the CODM to the primary financial statements is required.

Resources

Standards and interpretations

- IFRS 8, 'Operating segments'

PwC guidance

- Manual of Accounting chapter 10, Segment reporting

Tools practice aids and publications

- A practical guide to IFRS 8 for investment funds
- A practical guide to segment reporting
- IFRS 8 flyer Segment reporting – an opportunity to explain the business

Summary of key requirements of IFRS 8

Objective and scope

1 IFRS 8, 'Operating segments', applies to entities whose equity or debt instruments are publicly traded (or that are in the process of issuing equity or debt instruments in a public market). It applies for periods beginning on or after 1 January 2009, with earlier adoption permitted.

2 IFRS 8's objective is set out in a core principle, which requires an entity to disclose information that enables users of the financial statements to evaluate the nature and financial effects of the business activities and the economic environments through the eyes of management ('management approach').

3 This principle is clear that the standard is primarily a disclosure standard. How segmental information is measured is not prescribed in detail (beyond requiring that it be based on information reported to the CODM) but the standard includes requirements for reconciliations from segmental information to figures in the income statement and balance sheet and for disclosure of explanations of how segments are identified and how segmental measures have been determined.

Identification and definition of operating segments

4 Operating segments are identified based on internal reports on each segment that are regularly used by the entity's CODM to allocate resources to the segment and to assess its performance.

5 An operating segment is defined as a component of an entity:

- that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the entity);
- whose operating results are regularly reviewed by the entity's CODM to make decisions about allocating resources to the segment and to assess its performance; and
- for which discrete financial information is available.

[IFRS 8 para 5].

6 The definition of an operating segment includes a component of an entity that sells mainly or wholly to other operating segments if the entity is managed in that way. Thus, for example, in a vertically integrated operation, an oil producing operation that sells wholly to another component that refines the oil, could be a separate operating segment if it is managed as such. [IFRS 8 App A paras 79, 80].

Reportable segments

7 Reportable segments are those operating segments or aggregations of operating segments for which segment information must be separately reported. Aggregation of one or more operating segments into a single reportable segment is permitted (but not required) where certain conditions are met, the principal condition being that the operating segments should have similar economic characteristics. Once aggregation has been considered, single operating segments or aggregations of operating segments (where permitted) must be treated as reportable segments where they exceed certain quantitative thresholds that are based on a comparison of segment revenues, profit or loss and assets with the comparable figures for all segments. (An entity is allowed, however, to report segment information for smaller operating segments or aggregations of operating segments if it wishes to do so.) [IFRS 8 para 11].

8 The quantitative thresholds above for which reportable segments should be disclosed are:

- Revenue (external and intersegment) is ten per cent or more of total revenue (external and intersegment) of all operating segments.
- The absolute amount of the segment's reported profit or loss is ten per cent or more of the greater of the combined reported profit of all segments that did not report a loss and the combined loss of all segments that reported a loss.
- The segment's assets are ten per cent or more of the combined assets of all operating segments.

[IFRS 8 para 13].

9 The amounts reported in respect of each reportable segment should be the measures reported to the CODM for the purpose of allocating resources to the segment and for assessing its performance. Amounts required to be disclosed are:

- A measure of profit or loss and total assets.
- A measure of liabilities (if such an amount is regularly provided to the CODM).
- Each of the following if it is included in the measure of profit or loss reported to the CODM or is regularly provided to the CODM, even if not included in that measure of segment profit or loss.
  - Revenue from external customers.
  - Revenue from transactions with the entity's other operating segments (inter-segment revenue).
  - Interest revenue.
  - Interest expense.
  - Depreciation and amortisation.
  - Material items of income and expense separately disclosed under IAS 1 (revised) paragraph 97 ('exceptional items').
  - Share of results of associates and joint ventures accounted for using the equity method.
  - Income tax.
  - Material non – cash items other than depreciation and amortisation.

[IFRS 8 para 23].

10 Interest may be reported net if a majority of a segment's result is from interest and the CODM uses net interest to assess performance and make decisions about resource allocation, but the fact that net interest has been reported must be disclosed. [IFRS 8 para 23].

11 Each of the following also has to be disclosed if it is included in the measure of segment assets reported to the CODM or is regularly provided to the CODM, even if not included in that measure of segment assets:

- The amount of investments in associates and joint ventures that are equity accounted.
- The amount of additions to non-current assets other than financial instruments, deferred tax assets, post employment benefit assets and rights arising under insurance contracts.

[IFRS 8 para 24].

12 Reconciliations should be given from total segment revenues, segment profit or loss, segment total assets to the entity's total revenues, profit or loss before tax and total assets. If an entity regularly reports segment liabilities to the CODM a reconciliation of segment liabilities to total liabilities should also be given. Other material segment items that are disclosed should also be reconciled to the corresponding amount for the entity. [IFRS 8 para 28].

13 Additional information should be given about the entity as a whole if this information has not already been given as part of the segment disclosures for reportable segments. The information relates to an entity's products and services and its geographical areas. It need not be given if it is unavailable and the cost to develop it would be excessive (but if that is the case that fact should be disclosed). The information should be based on the financial information used to produce the entity's financial statements and is as follows:

- Revenues from external customers for each product or service or group of similar products and services.
- Revenues from external customers attributed to (i) the entity's country of domicile; and (ii) all foreign countries in total from which the entity derives revenues. Revenue from each individual country that is material should be separately disclosed. The basis for attributing revenue from external customers to individual countries should be disclosed.
- Non-current assets other than financial instruments, deferred tax assets, post employment benefit assets and rights arising under insurance contracts located (i) in the entity's country of domicile; and (ii) in all foreign

countries in total in which the entity holds assets. If assets located in an individual foreign country are material those assets should be separately disclosed.
- Sub-totals of geographical information may be given in addition to the above.

[IFRS 8 para 33].

14 Additional information should be given about the extent of an entity's reliance on major customers (although the names of those customers are not required to be disclosed). This applies where revenue from transactions with a single external customer are ten per cent or more of an entity's revenues. [IFRS 8 para 34].

15 A description is required of factors used in identifying an entity's reportable segments, including the basis of organisation. The types of products and services from which each reportable segment derives its revenues should also be disclosed. [IFRS 8 para 22].

16 An entity should also provide an explanation of the measures of segment profit or loss and segment assets and liabilities for each reportable segment. This should include as a minimum:
- The basis of accounting for transactions between reportable segments.
- The nature of any differences between the reportable segment profit or loss and the entity's profit or loss before tax and discontinued operations if these are not apparent from the reconciliations required by the standard. This explanation might include the basis of allocating central items and details of any differences between accounting policies used for reporting segments and those used for reporting the entity's total performance.
- The nature of any differences between the reportable segment assets and the entity's total assets if these are not apparent from the reconciliations required by the standard.
- The nature of any differences between the reportable segment liabilities (if reported) and the entity's total liabilities if these are not apparent from the reconciliations required by the standard.
- The nature of any changes from prior periods in the measurement methods used for determining reported segment profit or loss and the effect of the changes.
- The nature of any asymmetrical allocations to reportable segments. For example, an entity might allocate depreciation to a segment's profit or loss without allocating the related assets to the segment's assets.

[IFRS 8 para 27].

17 Where an entity changes its reportable segments comparative information should be restated to the new basis, unless the information is unavailable and the cost to develop it would be excessive. An entity should disclose whether or not comparative information has been restated. If comparative information has not been restated for this reason the information for the current year should be disclosed on both the old and new bases, unless the information is unavailable and the cost to develop it is excessive. [IFRS 8 paras 29, 30].

Presentation of financial statements

Overview

The IASB issued IAS 1 (revised), 'Presentation of financial statements', in September 2007 to replace the existing IAS 1 (2005) for annual periods beginning on or after 1 January 2009 (with early adoption permitted).

The objective of financial statements is to provide information that is useful in making economic decisions. The objective of IAS 1 (revised) is to ensure comparability of presentation of that information with the entity's financial statements of previous periods and with the financial statements of other entities.

Financial statements are prepared on a going concern basis unless management intends either to liquidate the entity or to cease trading, or has no realistic alternative but to do so. An entity prepares its financial statements, except for cash flow information, under the accrual basis of accounting.

A complete set of financial statements comprises a statement of financial position (or 'balance sheet'), a statement of comprehensive income, a statement of changes in equity, a statement of cash flows (collectively described as the primary financial statements) and explanatory notes (including accounting policies).

There is no prescribed format for the financial statements. However, there are minimum disclosures to be made in the financial statements as well as in the notes. The implementation guidance to IAS 1 (revised) contains illustrative examples of acceptable formats.

Financial statements disclose corresponding information for the preceding period (comparatives), unless a standard or interpretation permits or requires otherwise.

Where entities prepare a separate income statement and statement of comprehensive income under IAS 1 (revised), the revised standard requires the income statement to be presented immediately before the statement of comprehensive income.

Where entities are in breach of banking covenants at year end, they should usually present the bank borrowings as current liabilities under IAS 1 (revised). Provided the breach causes the entity to lose the unconditional right to avoid settling within 12 months, and the breach has not been waived by the lender before the year end, the whole borrowing is a current liability at the balance sheet date. Even where covenant waivers are subsequently received from the lender, and where borrowings have been restructured in the following year, the financial statements must present the borrowings based on their contractual maturity at year end. A post year end waiver is a non-adjusting post balance sheet event under IAS 10.

Statement of financial position (balance sheet)

The statement of financial position presents an entity's financial position at a specific point in time. Subject to meeting certain minimum presentation and disclosure requirements, management may use its judgement regarding the form of presentation, such as whether to use a vertical or a horizontal format, which sub-classifications to present and which information to disclose on the face of the statement or in the notes.

The following items, as a minimum, are presented on the face of the balance sheet:

- Assets – property, plant and equipment; investment property; intangible assets; financial assets; investments accounted for using the equity method; biological assets; deferred tax assets; current tax assets; inventories; trade and other receivables; and cash and cash equivalents.
- Equity – issued capital and reserves attributable to the owners of the parent; and minority interest.
- Liabilities – deferred tax liabilities; current tax liabilities; financial liabilities; provisions; and trade and other payables.
- Assets and liabilities held for sale – the total of assets classified as held for sale and assets included in disposal groups classified as held for sale; and liabilities included in disposal groups classified as held for sale in accordance with IFRS 5, 'Non-current assets held for sale and discontinued operations'.

Current and non-current assets and current and non-current liabilities are presented as separate classifications in the statement, unless presentation based on liquidity provides information that is reliable and more relevant.

Statement of comprehensive income

The statement of comprehensive income presents an entity's performance over a specific period. Entities have a choice of presenting this in a single statement or as two statements. The statement of comprehensive income under the single-statement approach includes all items of income and expense and includes each component of other comprehensive income classified by nature. Under the two statement approach, all components of profit or loss are presented in an income statement, followed immediately by a statement of comprehensive income. This begins with the total profit or loss for the period and displays all components of other comprehensive income.

Items to be presented in statement of comprehensive income

The following items, as a minimum, are presented in the statement of comprehensive income:

- Revenue.

- Finance costs.
- Share of the profit or loss of associates and joint ventures accounted for using the equity method.
- Tax expense.
- Post-tax profit or loss of discontinued operations aggregated with any post-tax gain or loss recognised on the measurement to fair value less costs to sell (or on the disposal) of the assets or disposal group(s) constituting the discontinued operation.
- Profit or loss for the period.
- Each component of other comprehensive income classified by nature.
- Share of the other comprehensive income of associates and joint ventures accounted for using the equity method.
- Total comprehensive income.

Profit or loss for the period and total comprehensive income are allocated in the statement of comprehensive income to the amounts attributable to minority interest and to the owners of the parent.

Additional line items or sub-headings are presented in this statement when such presentation is relevant to an understanding of the entity's financial performance.

Material items

The nature and amount of items of income and expense are disclosed separately where they are material. Disclosure may be in the statement or in the notes. Such income/expenses may include items such as restructuring costs; write-downs of inventories or property, plant and equipment; litigation settlements; and gains or losses on disposals of non-current assets.

Tax on components of other comprehensive income

An entity presents each component of other comprehensive income in the statement either (i) net of its related tax effects, or (ii) before its related tax effects, with the aggregate tax effect of these components shown separately.

Statement of changes in equity

The following items are presented in the statement of changes in equity:

- Total comprehensive income for the period, showing separately the total amounts attributable to owners of the parent and to minority interest.
- For each component of equity, the effects of retrospective application or retrospective restatement recognised in accordance with IAS 8, 'Accounting policies, changes in accounting estimates, and errors'.
- Amounts of transactions with owners in their capacity as owners, showing separately contributions by and distributions to owners.
- For each component of equity, a reconciliation between the carrying amount at the beginning and the end of the period, separately disclosing each change.

The above requirement has been amended, for periods beginning on or after 1 July 2009, to require the presentation of each item of other comprehensive income in the statement of changes in equity, although the IASB is proposing to further amend this requirement to clarify that this disclosure can be given in the notes.

Statement of cash flows

Cash flow statements are addressed in a separate topic summary dealing with the requirements of IAS 7.

Notes to the financial statements

The notes are an integral part of the financial statements. Notes provide information additional to the amounts disclosed in the 'primary' statements. They include accounting policies and critical accounting estimates and judgements.

Resources

Standards and interpretations

- IAS 1, 'Presentation of financial statements'
- Improvements to IFRSs 2010

Exposure drafts and discussion papers

- Clarification of statement of changes in equity
- Discussion paper: Preliminary views on financial statement presentation

PwC views

- PwC response to preliminary views on financial statement presentation

PwC guidance

- Manual of Accounting chapter 4, Presentation of financial statements.

Tools, practice aids and publications

- IFRS extracts from accounts

Summary of key requirements

Objective and scope

1 The objective of IAS 1 (revised) is to prescribe the basis for presentation of general purpose financial statements to ensure comparability. The standard specifies that the purpose of financial statements is to provide information that is useful in making economic decisions. The standard sets out requirements for the presentation of financial

statements with guidance on the structure and minimum disclosures required. [IAS 1 (revised) para 1]. The standard applies to all general purpose financial statements prepared under IFRS. [IAS 1 (revised) para 2].

Content

2 IAS 1 (revised) requires that a complete set of financial statements comprises the following:

- Statement of financial position.
- Statement of comprehensive income.
- Statement of changes in equity.
- Statement of cash flows.
- Notes, comprising a summary of significant accounting policies and other explanatory notes.

[IAS 1 (revised) para 10].

Comparative information in respect of the previous period is disclosed for all amounts reported in respect of the current period. In addition, if retrospective adjustments have been made (because of policy changes or corrections of errors), an additional statement of financial position is presented as at the beginning of the earliest comparative period. [IAS 1 (revised) para 10(f)].

Statements of cash flow are dealt with separately by IAS 7, 'Statement of cash flows', and are discussed in a separate topic summary.

Overall considerations

Fair presentation

3 Financial statements must 'present fairly' the financial position, financial performance and cash flows of an entity. Application of IFRSs (defined as also including IASs, IFRIC and SIC interpretations) is presumed to result in a fair presentation. Financial statements should be described as complying with IFRS only where they comply with all of the requirements of IFRSs. A 'true and fair override' of IFRS is required in *extremely* rare cases where compliance with IFRS would conflict with the objective of financial statements set out in the IASB's Framework for the preparation and presentation of financial statements ('Framework'). IAS 1 sets out additional disclosure requirements in such circumstances. [IAS 1 (revised) paras 15, 16, 19, 20].

Other considerations

4 Financial statements should be prepared on a going concern basis, unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. An entity should prepare its financial statements, except for cash flow information, under the accruals basis of accounting. [IAS 1 (revised) paras 25, 27].

5 Comparatives are required to be presented for all amounts reported in current financial statements. Comparative narrative and descriptive information must be included when it helps a reader understand the current period financial statements. Entities must retain the presentation and classification of items from one period to the next unless:

- It is apparent, following a significant change in the nature of operations or a review of the financial statements, that another presentation or classification is more appropriate.
- A change in presentation is required by a standard or interpretation.

[IAS 1 (revised) paras 38, 45].

6 When the presentation or classification of items is amended, the comparative amounts should be reclassified unless the reclassification is impracticable (that is, cannot be done, after *"making every reasonable effort to do so"*). Additional disclosures are required when such a reclassification of comparatives takes place. Similarly, additional disclosures are required when comparatives are not restated following a change in presentation. [IAS 1 (revised) paras 41, 42].

7 Each material class of similar items should be presented separately, unless immaterial. Offsetting of assets and liabilities, or of income and expenses, is not permitted, unless expressly permitted or required by a standard or interpretation. [IAS 1 (revised) paras 29, 32].

Statement of financial position

8 The statement of financial position (also commonly referred to as the balance sheet) presents an entity's financial position at a specific point in time. Subject to meeting certain minimum presentation and disclosure requirements, management may use its judgement regarding the form of presentation, such as whether to use a vertical or a horizontal format, which sub-classifications to present, and which information to disclose on the face of the statement or in the notes.

Line items

9 As a minimum, the face of the statement includes the following line items:

(a) Property, plant and equipment.
(b) Investment property.
(c) Intangible assets.
(d) Financial assets, excluding amounts shown under (e), (h) and (i).
(e) Investments accounted for using the equity method.
(f) Biological assets.
(g) Inventories.
(h) Trade and other receivables.
(i) Cash and cash equivalents.

(j) Total of assets held for sale and assets included in disposal groups.
(k) Trade and other payables.
(l) Provisions.
(m) Financial liabilities, excluding amounts shown under (k) and (l).
(n) Liabilities and assets for current tax.
(o) Deferred tax liabilities and deferred tax assets.
(p) Liabilities included in disposal groups.
(q) Minority interest, presented within equity.
(r) Issued capital and reserves attributable to the owners of the parent.

[IAS 1 (revised) para 54].

10 Additional line items, headings and sub-totals should be presented when relevant to understanding the entity's financial position. [IAS 1 (revised) para 77].

Current/non-current distinction

11 Current and non-current assets, and current and non-current liabilities, must be shown as separate classifications on the face of the balance sheet, except when a liquidity presentation provides information that is reliable and more relevant. A liquidity presentation is likely to be more appropriate in entities that do not have a clearly identifiable operating cycle (for example, financial institutions). [IAS 1 (revised) para 60].

12 An asset that is expected to be realised, or is held for sale or consumption in the normal course of the company's operating cycle is a current asset even though it may not be realised within 12 months of the balance sheet date. Similarly, a liability that is in respect of an operating cost and that will be settled in the normal course of the entity's operating cycle is a current liability, regardless of the settlement date. [IAS 1 (revised) paras 66, 69].

13 Deferred tax assets and liabilities should always be classified as non-current, where an entity adopts the current/non-current presentation. [IAS 1 (revised) para 56].

14 The standard gives additional guidance on classifying liabilities that are refinanced or rescheduled after the balance sheet date, but before the financial statements are authorised for issue. Additional guidance is also given in respect of liabilities subject to a borrowing covenant that has been breached. [IAS 1 (revised) paras 72 to 76].

Statement of comprehensive income

15 The statement of comprehensive income is presented as a single statement or split into two statements: an income statement, displaying all components of profit or loss, immediately followed by a statement of comprehensive income that begins with the total of profit or loss for the period and displays all components of other comprehensive income. [IAS 1 (revised) paras 10, 81].

16 The statement of comprehensive income presents an entity's financial performance showing all items of income and expense over a specific period of time. Subject to certain minimum requirements, management may use its judgement regarding the form of presentation, such as which sub-classifications to present, and which information to disclose on the face of the statement or in the notes.

17 As a minimum, the face of the statement includes the following line items:

- Revenue.
- Finance costs (the IFRIC has clarified that finance income and finance costs should be shown separately on the face).
- Share of the profit or loss of associates and joint ventures accounted for using the equity method.
- Tax expense.
- A single amount comprising the total of:
  - the post-tax profit or loss of discontinued operations; and
  - the post-tax gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation.
- Profit or loss.
- Components of other comprehensive income.
- Share of other comprehensive income of associates and joint ventures accounted for using the equity method.
- Total comprehensive income.

[IAS 1 (revised) para 82].

18 The following are shown on the face of the statement as allocations of the profit or loss and total comprehensive income respectively:

- Profit or loss attributable to minority interest.
- Profit or loss attributable to owners of the parent.
- Total comprehensive income attributable to minority interest.
- Total comprehensive income attributable to owners of the parent.

[IAS 1 (revised) para 83].

19 Additional line items, headings and sub-totals are presented when relevant to understanding the entity's financial performance. Items are not presented as extraordinary, either on the face of the statement or in the notes. [IAS 1 (revised) paras 16, 85].

20 Entities present an analysis of expenses recognised in profit or loss using either the 'nature of expenses' method (a 'natural analysis' of expenses) or the 'cost of sales' method (a 'functional analysis' of expenses). Entities are

encouraged to present this analysis on the face of the statement, but it may be disclosed in the notes. Where an entity elects to use the 'cost of sales' method for analysing expenses, additional information on the nature of expenses must be disclosed, including depreciation and amortisation expense and employee benefits expense. [IAS 1 (revised) para 99].

21 Where items of income and expense are material, their nature and amount are disclosed separately. Disclosure may be on the face of the statement or in the notes. Such income/expenses may include items such as restructuring costs, write-downs of inventories or plant and equipment, litigation settlements, and gains or losses on disposals of non-current assets. [IAS 1 (revised) paras 97, 98].

22 An entity presents each component of other comprehensive income in the statement either (i) net of its related tax effects, or (ii) before its related tax effects, with the aggregate tax effect of these components shown separately. Whichever presentation is adopted, an entity must disclose the tax related to each component of other comprehensive income. [IAS 1 (revised) para 90].

23 An entity discloses reclassification adjustments relating to components of other comprehensive income. (Reclassification adjustments occur when amounts recognised previously in other comprehensive income are reclassified to profit or loss. Such a reclassification would occur, for example, on derecognition of an available-for-sale asset, when unrealised gains recognised previously in other comprehensive income are reclassified to profit or loss.). [IAS 1 (revised) para 92].

Statement of changes in equity

24 The statement of changes in equity presents a reconciliation of equity items between the beginning and end of the period.

25 An entity should present a statement of changes in equity showing on the face of the statement:

- Total comprehensive income for the period, showing separately the total amounts attributable to owners of the parent and to minority interest.
- For each component of equity, the effects of retrospective application or retrospective restatement recognised in accordance with IAS 8, 'Accounting policies, changes in accounting estimates and errors'.
- The amounts of transactions with owners acting in their capacity as owners, showing separately contributions by and distributions to owners.
- For each component of equity, a reconciliation between the carrying amount at the beginning and the end of the period, separately disclosing each change.

[IAS 1 (revised) para 106].

25.1 The above requirement has been amended, for periods beginning on or after 1 July 2009, to require the presentation of each item of other comprehensive income in the statement of changes in equity, along with profit or loss and transactions with owners. However, the IASB is proposing to further amend this requirement to clarify that the disclosure of each item of other comprehensive income can be given in the notes.

Dividends

26 An entity discloses the amount of dividends recognised as distributions to owners during the period and the related amount per share. This disclosure may be given on the face of the statement of changes in equity or in the notes to the financial statements.

Notes to the financial statements

27 The notes are an integral part of the financial statements. They provide additional information to that disclosed on the face of the primary statements. Information presented in an entity's statement of financial position, statement of comprehensive income, statement of changes in equity and statement of cash flows should be cross-referenced to the relevant notes wherever possible. [IAS 1 (revised) para 113].

28 IAS 1 (revised) requires that the notes to the financial statements disclose various matters, including details of significant accounting policies. Entities must disclose the judgements that management has made in the process of applying the accounting policies and that have the most significant effect on the amounts recognised in the financial statements (for example, in determining whether financial assets are held to maturity investments). In addition, entities must disclose information regarding key assumptions about the future and other key sources of estimation uncertainty at the balance sheet date that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year. A further required disclosure is the amount of dividends proposed or declared but not recognised. [IAS 1 (revised) paras 117-136].

29 IAS 1 (revised) also requires entities to disclosure information that will enable users of its financial statements to evaluate the entity's objectives, policies and processes for managing capital. [IAS 1 (revised) para 134].

Non-GAAP information

30 Non-GAAP information encompasses alternative performance measures such as adjusted profit, as well as hypothetical, historical or forward-looking *pro forma* financial information, for example as a result of a business combination or disposal. IAS 1 (revised) does not deal with

non-GAAP information. However, a number of regulators have issued guidelines on the disclosure of non-GAAP information. The basic principles contained in these guidelines are that:

- Information presented should be fair and balanced, and not misleading.
- Non-GAAP information should supplement and not replace the IFRS information.
- Non-GAAP information should be clearly identified and labelled as such.
- Non-GAAP information should never be given greater prominence than defined IFRS measures.
- Terms used should be defined, if not defined in IFRS.
- A reconciliation between non-GAAP and IFRS information should be disclosed.
- The presentation and disclosure of non-GAAP information should be consistent from year to year.
- An explanation of the internal use of non-GAAP measures should be given so that readers can understand the relevance of the information.

Property, plant and equipment (including borrowing costs)

Overview

Property, plant and equipment (PPE) is recognised when the cost of an asset can be reliably measured and it is probable that the entity will obtain future economic benefits from the asset.

PPE is measured initially at cost. Cost includes the fair value of the consideration given to acquire the asset (net of discounts and rebates) and any directly attributable cost of bringing the asset to working condition for its intended use (inclusive of import duties and non-refundable purchase taxes).

Directly attributable costs include the cost of site preparation, delivery, installation costs, relevant professional fees and the estimated cost of dismantling and removing the asset and restoring the site (to the extent that such a cost is recognised as a provision). Classes of PPE are carried at historical cost less accumulated depreciation and any accumulated impairment losses (the cost model), or at a revalued amount less any accumulated depreciation and subsequent accumulated impairment losses (the revaluation model). The depreciable amount of PPE (being the gross carrying value less the estimated residual value) is depreciated on a systematic basis over its useful life.

Subsequent expenditure relating to an item of PPE is capitalised if it meets the recognition criteria.

PPE may comprise parts with different useful lives. Depreciation is calculated based on each individual part's life. In case of replacement of one part, the new part is capitalised to the extent that it meets the recognition criteria of an asset, and the carrying amount of the parts replaced is derecognised.

The cost of a major inspection or overhaul of an item occurring at regular intervals over the useful life of the item is capitalised to the extent that it meets the recognition criteria of an asset. The carrying amounts of the parts replaced are derecognised.

The IFRIC published IFRIC 18, 'Transfer of assets from customers', in January 2009. It clarifies the accounting for arrangements where an item of PPE that is provided by the customer is used to provide an ongoing service.

Borrowing costs

IAS 23 requires borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset to be capitalised.

Resources

Standards and interpretations

- IAS 16, 'Property, plant and equipment'
- IAS 23, 'Borrowing costs'
- IFRIC 1, 'Changes in existing decommissioning, restoration and similar liabilities'

PwC guidance

- Manual of Accounting chapter 16, Property, plant and equipment

Tools practice aids and publications

- IFRS extracts from accounts
- A practical guide to capitalisation of borrowing costs

Summary of key requirements – property, plant and equipment

Objective and scope

1 Property plant and equipment are tangible assets that an entity holds for its own use or for rental to others that the entity expects to use during more than one period. [IAS 16 para 6]. Property, plant and equipment could be constructed by the reporting entity or purchased from other entities. [IAS 16 para 22].

2 IAS 16 sets out principles for recognition of property, plant and equipment, measurement at recognition and measurement after recognition. Principles are also included for depreciation, impairment and derecognition of property, plant and equipment. [IAS 16 para 1].

3 IAS 16 applies to accounting for property, plant and equipment, but its scope excludes:

- Property, plant and equipment classified as held for sale in accordance with IFRS 5, 'Non-current assets held for sale and discontinued operations'.
- Biological assets related to agricultural activity (dealt with by IAS 41, 'Agriculture').
- The recognition and measurement of exploration and evaluation assets (dealt with by IFRS 6, 'Exploration for and evaluation of mineral resources').
- Mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources.
- Property, plant and equipment held for sale (dealt with by IFRS 5, 'Non-current assets held for sale and discontinued operations').

However, the standard does apply to property, plant and equipment used to develop or maintain the assets described in bullet points two and three above. [IAS 16 para 3].

4 An entity that chooses the cost model for investment property in accordance with IAS 40, 'Investment property',

has to measure that property in accordance with IAS 16 [IAS 16 para 5].

Recognition

5 An item of property, plant and equipment should be recognised as an asset when it is probable that future economic benefits associated with the asset will flow to the entity and the cost of the item can be reliably measured. [IAS 16 para 7].

6 After initial recognition of the costs of an item of property, plant and equipment an entity should add subsequent costs to the cost of the item when those costs meet the conditions for recognition set out in the standard. Examples are given of costs of replacing components of an asset or costs of carrying out regular major inspections. In such situations the remaining carrying amount of the replaced component or cost associated with the previous major inspection is written off when the subsequent costs are capitalised. [IAS 16 paras 13, 14].

Initial measurement

7 Property, plant and equipment should initially be measured at cost. [IAS 16 para 15]. Cost is the fair value of consideration given for the asset. [IAS 16 para 6]. This applies equally to assets purchased from a third party and to assets constructed by the entity itself.

8 The cost of an item of property, plant and equipment comprises the purchase price and 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. The cost also includes estimated costs of dismantling and removing the asset and restoring the site on which it is located (see below). Trade discounts and rebates are deducted in arriving at cost. Directly attributable costs include costs such as:

- Employee benefit costs arising directly from the construction or acquisition of the item of property, plant and equipment.
- Costs of site preparation.
- Initial delivery and handling costs.
- Installation and assembly costs.
- Costs of testing whether the asset is functioning properly after deducting net proceeds of sale from items produced while testing.
- Professional fees.

[IAS 16 paras 16, 17].

9 The cost may also include transfers from equity of gains/losses on qualifying cash flow hedges (basis adjustment) that are directly related to the acquisition of property, plant and equipment.

10 Directly attributable costs do *not* include administration and other general overheads. The standard also lists other costs that are not directly attributable. These costs include various types of start-up costs, initial operating losses, relocation and reorganisation costs and costs incurred when the asset is capable of operating as management intends, but has not yet been brought into use or is operating at less than full capacity. [IAS 16 paras 19, 20].

11 The cost of an item of property, plant and equipment is the cash price equivalent at the recognition date. Where consideration is deferred beyond normal credit terms, cost should be discounted to present value. Where an item is acquired through exchange for another non-monetary asset, the cost of the item acquired is measured at fair value unless the transaction lacks commercial substance or neither the fair value of the asset received nor the fair value of the asset given up can be reliably measured. If the acquired item is not measured at fair value, the cost of the asset acquired is measured at the amount of the asset given up. [IAS 16 paras 23, 24].

12 Borrowing costs that are directly attributable to the acquisition, production or construction of a qualifying asset are capitalisation – see Summary of key requirements – IAS 23 (revised), 'Borrowing costs' below.

Decommissioning and site restoration costs

13 When an entity purchases or constructs an asset, it may take on a contractual or statutory obligation to decommission the asset or restore the asset site to certain minimum standards or both, at the end of the asset's life. These costs should be capitalised at the date on which the entity becomes obligated to incur them. [IAS 16 paras 16,18; IAS 37 App C Example 3].

14 The amount capitalised as part of the asset's cost will be the amount estimated to be paid, discounted to the date of initial recognition. The related credit is recognised in provisions.

15 There may be significant changes in the initial (and subsequent) estimates of decommissioning costs of an asset, particularly where asset lives are long. These changes in estimate may be due to changes in legislation, technology, timing of the decommissioning and or management's assumptions.

16 An entity that uses the cost model (see below) records changes in the existing liability and changes in the discount rate adjusting the cost of the related asset in the current period. The asset is assessed for impairment if there is an indication that the asset may not be fully recoverable. [IFRIC 1 para 5].

17 An entity using the revaluation model (see below) accounts for changes effectively through the revaluation reserve. Any decrease in the liability that results in a carrying amount lower than the cost that would have been

recognised had the asset been measured under the cost model should be recognised in profit or loss immediately. [IFRIC 1 para 6].

Measurement subsequent to initial recognition

18 An entity has two options for subsequent measurement. The asset is carried at cost less any subsequent accumulated depreciation and impairment losses under the cost model. [IAS 16 para 30]. An asset is carried at revalued amount, less any subsequent accumulated depreciation and impairment losses under the revaluation model. [IAS 16 para 31].

19 Where a policy of revaluation is adopted, revaluations must be kept up to date, that is they must be made with sufficient regularity that the carrying amount does not differ materially from fair value at the balance sheet date. Where an item of property, plant and equipment is revalued the whole of the class of asset to which that asset belongs must be revalued. [IAS 16 paras 31, 36]. Examples of separate classes of asset include land, land and buildings, machinery, ships, aircraft, motor vehicles, furniture and fixtures and office equipment. [IAS 16 para 37].

Revaluation model: basic requirements

20 The basis of revaluation is the asset's fair value at the date of revaluation. [IAS 16 paras 6, 31].

21 The fair value of land and buildings is its market value. [IAS 16 para 32]. A professionally qualified valuer normally undertakes the valuation. Disclosure should be made of whether or not the revaluation was performed by an independent valuer. [IAS 16 para 77(b)].

22 The same basic rule for revaluations applies to plant and equipment. [IAS 16 para 32]. However, the practical difficulties of obtaining a market value for plant and equipment are recognised in IAS 16. Valuation at depreciated replacement cost is allowed when there is no real market value measure, for instance because of the specialised nature of the assets and because they are rarely sold. [IAS 16 para 33].

23 Except as noted below, revaluation surpluses must be credited to other comprehensive income and accumulated in equity as a revaluation surplus. A revaluation surplus should be recognised in profit or loss only to the extent that it reverses a revaluation decrease on the same asset previously recognised in profit or loss. [IAS 16 para 39].

24 Where there is a revaluation decrease, it should be recognised in profit or loss except to the extent that it reverses a revaluation surplus on the same asset that is held in other comprehensive income. In this case, that element is charged to other comprehensive income and reduces the revaluation surplus accumulated in equity. [IAS 16 para 40].

Depreciation

25 Each part of an item of property, plant and equipment that has a cost that is significant in relation to the total cost of the item should be depreciated separately**.** The depreciable amount of an asset (or of each significant part thereof), that is the cost or revalued amount less residual value, should be depreciated on a systematic basis over its useful life. The method of depreciation should reflect the pattern in which the economic benefits are expected to be consumed. The depreciation charge should be recognised in full in profit or loss unless it, or part of it, is included in the cost of another asset (such as inventory). [IAS 16 paras 43, 50, 60, 48].

26 For revalued assets an element of the revaluation surplus may be transferred to retained earnings in each period, being that part of the depreciation charge in respect of the revaluation uplift on the asset. [IAS 16 para 41]. Thus, the additional depreciation is systematically treated as realised over the estimated remaining life of the asset.

27 Useful lives and residual values should be reviewed at least at each year end and revised where expectations are significantly different from previous estimates. The depreciation charge should then be adjusted for current and future periods. [IAS 16 para 51].

28 The residual value of an item of property, plant and equipment is based on the estimated amount that an entity would currently obtain from the asset's disposal, less estimated selling costs, if the asset were already of the age and in the condition expected at the end of its useful life. Thus, residual values take account of changes in prices up to the balance sheet date, but not of expected future changes. The standard notes that the residual value of an asset may increase to an amount equal to or greater than its carrying amount. The asset's depreciation charge is zero, in these circumstances unless the residual value decreases below the asset's carrying amount. [IAS 16 paras 6, 54].

29 Depreciation methods should be reviewed at least at each year end. Where the expected pattern of consumption of the future economic benefits has changed significantly from previous estimates, the method should be changed to reflect the new pattern. Any such change is a change of estimate, accounted for by adjusting the charge for current and future periods. [IAS 16 para 61].

Impairment

30 Impairments should be accounted for in accordance with IAS 36, 'Impairment of assets'. [IAS 16 para 63]. An

impairment loss under the revaluation model is treated as a revaluation decrease (see para 24) to the extent of previous revaluation surpluses. Any loss that takes the asset below historical depreciated cost is recognised in the income statement. [IAS 36 para 60]. Where there is a reversal of an impairment loss, the amount of the reversal that can be recognised is restricted to increasing the carrying value of the asset to the carrying value that would have been recognised had the original impairment not occurred. That is, after taking account of normal depreciation that would have been charged had no impairment occurred. [IAS 36 para 117].

Compensation for impairment losses

31 Compensation may be received in the form of reimbursements from insurance companies, governmental indemnities related to expropriated assets or involuntary relocation or conversion of items of property, plant and equipment that have been impaired. Compensation from third parties is recorded in the income statement when the compensation becomes receivable. [IAS 16 para 65]. Impairments or losses of items of property, plant and equipment, related claims for or payments of compensation from third parties, and any subsequent purchase or construction of replacement assets, are separate economic events and should be accounted for as such. [IAS 16 para 66].

Derecognition

32 An item of property, plant or equipment is derecognised when it is disposed of or where no future economic benefits are expected from its use or disposal. Gains and losses arising on derecognition should be calculated as the difference between the net disposal proceeds and the carrying amount of the asset. Such gains or losses should be recognised in the income statement, but they should not be classified as revenue. When a revalued asset is sold or scrapped, the balance in the revaluation reserve in respect of that asset may be transferred to retained earnings by means of a reserve transfer. [IAS 16 para 41].

Disclosure

33 An entity should disclose, in its accounting policies, the measurement bases used for determining gross carrying amount. Depreciation methods and useful lives (or depreciation rates) should also be disclosed. [IAS 16 paras 73-74].

34 There should be detailed numerical disclosures about the balances (gross carrying amount and accumulated depreciation and impairment) of each class of property, plant and equipment at the beginning and end of the year, and the movements in the carrying amount during the year for all periods presented. [IAS 16 para 73]. Many entities prefer to present separate tabulations of gross assets and accumulated depreciation, with each separately reconciled.

35 Restrictions over the property, plant and equipment, the amount of expenditure relating to assets under construction and the amount of commitments for the acquisition of property, plant and equipment are required disclosures. Any compensation from third parties in relation to property, plant and equipment is disclosed separately on the face of the income statement or in the notes. [IAS 16 para 74].

36 The following disclosures are required in respect of property, plant and equipment carried at revalued amounts;

- the effective date of the revaluation;
- whether an independent valuer was involved;
- the methods and significant assumptions used in estimates;
- how much of fair values were determined directly by reference to an active market or were estimated using valuation techniques;
- for each class of property, plant and equipment, the carrying amount that would have been recognised had the assets been carried under the cost model; and
- the revaluation surplus, indicating the movement for the period and any restrictions on the distribution of the balance to shareholders.

[IAS 16 para 77].

37 A lessee of property, plant and equipment leased under a finance lease should provide additional disclosures, including the net carrying amount for each class of property, plant and equipment held under finance leases. [IAS 17 para 31(a)].

Summary of key requirements – borrowing costs

Objective and scope

38 IAS 23 deals with the accounting treatment of borrowing costs and excludes from its definition the actual or implied cost of equity, including preferred capital not classed as a liability. [IAS 23 para 3].

39 IAS 23 requires capitalisation of borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset. Other borrowing costs should be recognised as an expense in the period incurred. [IAS 23 paras 8 to 9].

40 Borrowing costs may include:

- Interest expense calculated using the effective interest rate method as described in IAS 39, 'Financial instruments: Recognition and measurement'.
- Finance charges in respect of finance leases recognised in accordance with IAS 17, 'Leases'.
- Exchange differences arising from foreign currency borrowings to the extent that they are regarded as adjustments to interest costs.

[IAS 23 para 6].

41 A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. [IAS 23 para 5]. Financial assets, and inventories that are manufactured, or otherwise produced, over a short period of time, are not qualifying assets. Assets that are ready for their intended use or sale when acquired are not qualifying assets. [IAS 23 para 7].

42 Where borrowings are taken out specifically to finance a qualifying asset the amount of the borrowing costs eligible for capitalisation is the actual borrowing costs incurred less investment income on the temporary investment of the borrowings. [IAS 23 para 12].

43 Where funds are borrowed generally and used to obtain a qualifying asset, the amount of borrowing costs eligible for capitalisation is determined by applying a capitalisation rate to the expenditure on the asset. The capitalisation rate is the weighted average of the borrowing costs applicable to the borrowings that are outstanding in the period, other than borrowings made specifically to obtain a qualifying asset. The amount of general borrowing costs capitalised in a period should not exceed the amount of borrowing costs incurred in that period. [IAS 23 para 14].

44 Capitalisation of borrowing costs should commence when:

- expenditures for the asset are being incurred;
- borrowing costs are being incurred; and
- activities that are necessary to get the asset ready for its intended use or sale are in progress.

[IAS 23 para 17].

45 Capitalisation should be suspended when active development of the asset is interrupted for extended periods. Capitalisation should cease when substantially all the activities necessary to prepare the asset for its intended use are complete. An asset is normally ready for use when physical construction is completed even though standard administrative work might still continue. [IAS 23 paras 20, 22, 23].

46 In certain situations, construction of an asset is completed in parts and each completed part can be used whilst the remainder is still under construction. In this case capitalisation of borrowing costs on that part should cease when substantially all the activities necessary to prepare that part for its intended use are complete. [IAS 23 para 24].

47 The financial statements should disclose:

- The amount of borrowing costs capitalised in the period.
- The capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation.

[IAS 23 para 26].

Provisions, contingent liabilities and contingent assets

Overview

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'. A provision falls within the category of liabilities and is defined as ''*a liability of uncertain timing or amount*''.

Recognition and initial measurement

A provision is recognised when: the entity has a present obligation to transfer economic benefits as a result of past events; it is probable (more likely than not) that such a transfer will be required to settle the obligation; and a reliable estimate of the amount of the obligation can be made.

The amount recognised as a provision is the best estimate of the expenditure required to settle the obligation at the balance sheet date, measured at the expected cash flows discounted for the time value of money. Provisions are not recognised for future operating losses.

A present obligation arises from an obligating event and may take the form of either a legal obligation or a constructive obligation. An obligating event leaves the entity no realistic alternative to settling the obligation. If the entity can avoid the future expenditure by its future actions, it has no present obligation, and no provision is required. For example, an entity cannot recognise a provision based solely on the intent to incur expenditure at some future date or the expectation of future operating losses (unless these losses relate to an onerous contract).

An obligation does not generally have to take the form of a 'legal' obligation before a provision is recognised. An entity may have an established pattern of past practice that indicates to other parties that it will accept certain responsibilities and as a result has created a valid expectation on the part of those other parties that it will discharge those responsibilities (that is, the entity is under a constructive obligation).

If an entity has an onerous contract (the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it), the present obligation under the contract is recognised as a provision. Impairments of any assets dedicated to the contract are recognised before making a provision.

Restructuring provisions

There are specific requirements for restructuring provisions. A provision is recognised when there is: (a) a detailed formal plan identifying the main features of the restructuring; and (b) a valid expectation in those affected that the entity will carry out the restructuring by starting to implement the plan or by announcing its main features to those affected.

A restructuring plan does not create a present obligation at the balance sheet date if it is announced after that date, even if it is announced before the financial statements are approved. No obligation arises for the sale of an operation until the entity is committed to the sale (that is, there is a binding sale agreement).

The provision only includes incremental costs necessarily resulting from the restructuring and not those associated with the entity's ongoing activities. Any expected gains on the sale of assets are not considered in measuring a restructuring provision.

Reimbursements

An obligation and any anticipated recovery are presented separately as a liability and an asset respectively; however, an asset can only be recognised if it is virtually certain that settlement of the obligation will result in a reimbursement, and the amount recognised for the reimbursement should not exceed the amount of the provision. The amount of any expected reimbursement is disclosed. Net presentation is permitted only in the income statement.

Subsequent measurement

Management performs an exercise at each balance sheet date to identify the best estimate of the expenditure required to settle the present obligation at the balance sheet date, discounted at an appropriate rate. The increase in provision due to the passage of time is recognised as interest expense.

Contingent liabilities

Contingent liabilities are possible obligations whose existence will be confirmed only on the occurrence or non-occurrence of uncertain future events outside the entity's control, or present obligations that are not recognised because: (a) it is not probable that an outflow of economic benefits will be required to settle the obligation; or (b) the amount cannot be measured reliably.

Contingent liabilities are not recognised but are disclosed and described in the notes to the financial statements, including an estimate of their potential financial effect and uncertainties relating to the amount or timing of any outflow, unless the possibility of settlement is remote.

Contingent assets

Contingent assets are possible assets whose existence will be confirmed only on the occurrence or non-occurrence of uncertain future events outside the entity's

control. Contingent assets are not recognised. When the realisation of income is virtually certain, the related asset is not a contingent asset; it is recognised as an asset.

Contingent assets are disclosed and described in the notes to the financial statements, including an estimate of their potential financial effect if the inflow of economic benefits is probable.

Resources

Standards and interpretations
- IAS 37, 'Provisions, contingent liabilities and contingent assets'
- IFRIC 1, 'Changes in existing decommissioning, restoration and similar liabilities'
- IFRIC 5, 'Rights to interests arising from decommissioning, restoration and environmental rehabilitation funds'
- IFRIC 6, 'Liabilities arising from participating in a specific market – Waste electrical and electronic equipment'

Exposure drafts and discussion papers
- Exposure draft on proposed amendments to IAS 37

PwC views
- PwC comment letter on the exposure draft of proposed amendments to IAS 37

PwC guidance
- Manual of Accounting chapter 21, Provisions and contingencies

Tools practice aids and publications
- Straight away 12, IASB proposes significantly different measurement model for non-financial liabilities
- IFRS extracts from accounts

Summary of key requirements

Objective and scope

1 The objective of IAS 37, 'Provisions, contingent liabilities and contingent assets', is to ensure that appropriate recognition criteria and measurement bases are applied to provisions, contingent liabilities and contingent assets and that sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount. The IAS defines a provision as *''a liability of uncertain timing or amount''*. [IAS 37 para 10]. Certain IFRIC interpretations, IFRIC 1, IFRIC 5 and IFRIC 6 provide additional guidance on provisions.

2 The IAS covers provisions, contingent liabilities and contingent assets, but excludes those that relate to executory contracts (except where these are onerous). The rules do not apply to contingent liabilities assumed by an acquirer in a business combination, which are dealt with by IFRS 3 or IFRS 3 (revised), 'Business combinations', or to provisions that are covered by more specific standards (for example, those that relate to construction contracts, income taxes, leases (with the exception of onerous operating leases), employee benefits, insurance contracts and revenue recognition). The rules also do not apply to items such as depreciation, impairment of assets or doubtful debts that are adjustments to the carrying amounts of assets. [IAS 37 paras 2, 3 to 7].

3 IAS 37 does not apply to liabilities resulting from financial instruments (including guarantees) that are within the scope of IAS 39, 'Financial instruments: Recognition and measurement'. [IAS 37 para 2].

Recognition

4 IAS 37 sets out three main criteria that must be met to recognise a provision. These criteria, which are essentially those established in the Framework for liabilities generally, are as follows:
- an entity has a present obligation (legal or constructive) as a result of a past event;
- it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
- a reliable estimate can be made of the amount of the obligation.

[IAS 37 paras 14].

5 An entity will normally be able to determine a range of possible outcomes sufficient to enable it to make a reliable estimate of an obligation. [IAS 37 para 25].

6 Provisions arise from a number of different types of events. The more common of these arise from obligations in relation to: manufacturer's standard warranties, site decommissioning, refunds, guarantees, onerous contracts, outstanding litigation and business restructuring. Provisions can be distinguished from other liabilities such as trade payables and accruals because there is uncertainty about the timing or amount required in settlement. [IAS 37 para 11].

Present obligation

7 In rare cases it is not clear whether there is a present obligation. In these cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the balance sheet date. [IAS 37 para 15].

Constructive obligations

8 A constructive obligation is defined as an obligation that derives from an entity's actions where, by an established pattern of past practice or as a result of published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities. [IAS 37 para 10].

Past events

9 A past event that leads to a present obligation is called an obligating event. This is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling the obligation. [IAS 37 paras 10, 17].

10 Only liabilities that exist at the balance sheet date can be recognised. Where an entity can avoid future expenditure by its future actions, it does not have a present obligation and a provision cannot be recognised. [IAS 37 paras 18, 19]. Therefore, the rules prohibit provisions for future repairs and maintenance of own assets and for future costs, unless they relate to an onerous contract (see para 30 below).

11 The identification of past events where settlement is enforceable under a legal agreement (legal obligations), such as a lease and warranties, is usually straight-forward.

12 The existence of laws and regulations, however, do not automatically imply an obligating event. An entity aware of a particular law that would affect its future operations may choose to avoid its impact by closing that line of business or making changes to its operations. [IAS 37 para 19].

13 Past events and the actions of management that raise valid expectations in other parties, give rise to constructive obligations. [IAS 37 para 17(b)]. For example, an entity may publish its intention as a good corporate citizen to clean up site contamination, raising a valid expectation that it will do so. Management does not need to specifically identify the 'expectant' party; rather it must communicate its intentions, and as a result cannot avoid meeting the obligation.

14 A past event, such as site contamination that does not give rise to a legal obligation immediately, may do so at a later date when, for example, legislation is enacted, or is virtually certain to be enacted, that obliges the entity to rectify the existing damage. An obligation may also arise when the entity publicly accepts responsibility for rectification (see para 2.13) in a way that creates a constructive obligation. [IAS 37 paras 21, 22].

15 A board decision does not give rise to a constructive obligation at the balance sheet date, unless that decision has been communicated before the balance sheet date in sufficient detail to create a valid expectation in other parties that the entity will discharge the obligation or the entity has started to implement the decision before the balance sheet date. [IAS 37 para 20].

Probable outflow of economic benefits

16 For a liability to qualify for recognition there must be not only a present obligation, but also the probability of an outflow of economic benefits to settle that obligation. An outflow of resources or other event is regarded as probable if the event is more likely than not to occur. [IAS 37 para 23]. The more-likely-than-not interpretation suggests that a likelihood assessed at above 50 per cent qualifies for recognition. Many provisions relate to complex fact patterns for which assessments of likelihood are judgmental and not susceptible to precise determination.

17 Where there are a number of similar obligations (for example, product warranties) the probability that an outflow will be required in settlement is determined by considering the class of obligations as a whole. Although the likelihood of outflow for any one item may be small, it may well be probable that some outflow of resources will be needed to settle the class of obligations as a whole. If that is the case, a provision is recognised (if the other recognition criteria are met). [IAS 37 para 24].

Measurement on initial recognition

18 The amount recognised as a provision should be the best estimate of the expenditure required to settle or transfer the present obligation at the balance sheet date. The best estimate should take account of any risks and uncertainties. [IAS 37 paras 36, 42]. Required disclosures in IAS 37 (see below) will help a reader of the financial statements to understand the uncertainties inherent in such estimates.

19 The best estimate may be based on information that produces a range of amounts. Where each point within that range is equally likely, the mid-point of the range is used. Where a provision relates to a large population of items, an expected value measurement is used, where all possible outcomes are weighted by their associated probabilities. [IAS 37 para 39]. This methodology is well accepted and produces a sensible result for a population of numerous items, each with similar characteristics, but other methods might give acceptable measures as the number or homogeneity of the items reduces.

20 Where a single obligation is being measured, the individual most likely outcome may be the best estimate of the liability. However, even in such a case, the entity considers other possible outcomes. Where other possible

outcomes are either mostly higher or mostly lower than the most likely outcome, the best estimate may be a higher or lower amount. [IAS 37 para 40].

Future events

21 Events such as changes in technology and new legislation may affect the amount required to settle a liability. These events should be reflected in the measurement of a provision if there is sufficient objective evidence that they will occur. [IAS 37 para 48].

Discounting

22 Where the effect of the time value of money is material, the amount of a provision should be the present value of the expenditures expected to be required to settle the obligation. [IAS 37 para 45]. Where discounting is used, the increase in the carrying amount of the provision from period to period as a result of the passage of time is recognised as a borrowing cost.

23 The discount rate should be a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the liability. It should not reflect risks for which future cash flow estimates have been adjusted. [IAS 37 para 47].

Gains from expected disposal of assets

24 Gains from expected asset disposals (for example, as part of a restructuring) should not be taken into account in measuring a provision. [IAS 37 para 51].

Assets arising from provision

25 When an obligation recognised as a provision (for example, decommissioning costs) gives access to future economic benefits then an asset should also be recognised. Otherwise, the provision should be charged immediately to the income statement. [IAS 37 App C Example 3; IAS 16 para 16].

Subsequent measurement and use of provisions

26 The measurement rule must be reapplied at each balance sheet date. The estimate of the liability should therefore be updated at each balance sheet date. [IAS 37 para 59].

27 IAS 37 puts important constraints on the utilisation of provisions. Provisions are to be used only for the expenditures for which they were established, and reversed when they are no longer required for that particular expenditure. [IAS 37 paras 59, 61]. They cannot be held as a general provision to be applied against some other unrelated expenditure. Where the initial provision was charged to expense, any subsequent reversal is credited to the same line in the income statement in accordance with the principle of consistency. [IAS 1 (revised) para 45]. However, where the provision had initially been recognised as part of the cost of an asset (for instance, as in the case of site restoration costs), the reversal should reduce the asset's carrying amount, allowing for any accumulated depreciation or amortisation and accretion of discount. IFRIC 1 'Changes in existing decommissioning, restoration and similar liabilities', provides additional guidance.

Reimbursements

28 A liability and any expected reimbursement (for example, insurance recoveries) should be shown gross in the balance sheet. The asset resulting from the reimbursement should only be recognised when it is virtually certain that reimbursement will be received if the entity settles the obligation and it should not exceed the amount of the provision. However, in the income statement, the expense relating to settlement of the liability and the reimbursement may be presented net. [IAS 37 paras 53, 54].

Decommissioning, restoration and environmental rehabilitation funds

29 IFRIC 5 clarifies that entities with obligations to pay for decommissioning costs having interests in decommissioning, restoration and environmental rehabilitation funds should recognise their obligations (provision) and their interests in the fund separately, unless they have no liability even if the fund fails to pay. [IFRIC 5 paras 7 to 9].

Specific applications

Future operating losses/onerous contracts

30 Provisions should not be recognised for future operating losses (although assets may have to be written down for impairment). [IAS 37 paras 63, 65]. However, a provision should be recognised if an entity has a contract that is onerous. An onerous contract is one in which the unavoidable costs of meeting the obligations under it exceeds the economic benefits expected to be received. [IAS 37 paras 10, 66]. The key difference between future losses and onerous contracts is that in the case of onerous contracts there is a past obligating event, which is not the case with other expected future losses.

31 The provision for an onerous contract should represent the least net cost of exiting from the contract, that is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it. [IAS 37 para 68].

32 Specific assets might be dedicated to a particular contract, in which case before a separate provision for an

onerous contract can be made, it is necessary to recognise any impairment loss for those assets in accordance with the rules set out in IAS 36, 'Impairment of assets'. [IAS 37 para 69].

Restructuring activities

33 IAS 37 defines a restructuring as a programme that is:

- planned and controlled by management; and
- materially changes either the scope of a business or the manner in which that business is conducted.

[IAS 37 para 10].

34 The characteristics of an obligating event for a restructuring are specified in IAS 37 as:

- a detailed formal plan identifying at least five specified key features of the plan and its implementation; and
- a valid expectation on the part of those affected, either by starting to implement the plan or announcing its main features to those affected by it, such as customers, suppliers, employees or trade unions.

[IAS 37 paras 72, 73].

35 Considerable judgement is required to determine whether an obligating event has occurred. All the available evidence must be assessed to determine whether a plan is detailed enough to create a valid expectation in others. IAS 37 does not specify the maximum period that may elapse either prior to the implementation or to completion of the plan. However, plans that are to be executed quickly will raise the expectation of management's commitment to the restructure, whilst a long delay before the restructuring commences or an unreasonably long time frame for the restructuring will make it unlikely that a valid expectation has been raised in those affected. [IAS 37 para 74].

36 Both the formal plan condition and the valid expectation condition referred to in paragraph 2.34 above must be met as at the balance sheet date before a restructuring provision is recognised. A management or even a board decision taken before the balance sheet date, coupled with implementation or announcement after the balance sheet date and before the financial statements are finalised, are not sufficient to recognise a provision. The latter case would require disclosures under IAS 10, 'Events after the reporting period', as a non-adjusting subsequent event. [IAS 37 para 75].

37 IAS 37 provides important guidance on what is included in a restructuring provision. Qualifying expenditures are restricted to those incurred as a direct consequence of the restructuring, which are those costs that necessarily result from the restructuring and are not associated with the ongoing activities of the entity. Restructuring provisions do not include, for example, retraining or relocation costs of continuing staff, marketing or investments in new systems and distribution networks. Nor do they include future operating losses up to the date of the restructuring (unless they relate to an onerous contract) or gains from the expected future disposal of assets. [IAS 37 paras 80 to 83].

Sales of businesses

38 No obligation arises from an operation's sale until the entity is committed to the sale, that is, there is a binding sale agreement. [IAS 37 para 78].

Provisions for waste management costs

39 IFRIC 6 clarifies when certain producers of electrical goods have to recognise a liability for the cost of waste management for historical electrical and electronic equipment supplied to private households. It concludes, based on the fact pattern considered, that the event giving rise to the liability for such costs, and so its recognition, is participation in the market during a measurement period (that is, a period in which market shares are determined for the purpose of allocating waste management costs). [IFRIC 6 para 9].

Other

40 Appendix C to IAS 37 illustrates how to apply the standard using a number of examples. These examples include warranties, contaminated land, decommissioning costs, sales refunds, training costs, guarantees and maintenance costs.

Contingent liabilities

41 A contingent liability is:

- a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the entity's control; or
- a present obligation that arises from past events but is not recognised because: it is not probable that an outflow of economic benefits will be required to settle the obligation; or the amount of the obligation cannot be measured reliably.

[IAS 37 paras 10, 27-30].

42 A contingent liability should not be recognised, but should be disclosed, unless the possibility of an outflow of economic benefits is remote. [IAS 37 paras 27, 28].

43 Note that a present obligation that probably requires an outflow of economic resources is not a contingent liability. A provision should be recognised and disclosures given in respect of the obligation.

Contingent assets

44 Contingent assets are possible assets that arise from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the entity's control. [IAS 37 para 10].

45 The accounting treatment of contingent assets will depend on the probability of future benefits. [IAS 37 paras 31 to 35]. For example, where the inflow of economic benefits:

- is not probable – no asset is recognised or disclosed;
- is probable, but not virtually certain – no asset is recognised, but disclosure is required; and
- is virtually certain – the asset is recognised on the balance sheet].

[IAS 37 paras 31, 37, 89].

Presentation and disclosure

46 An entity is required to present provisions as a line item on the face of the balance sheet. [IAS 1 (revised) para 54(l)].

Provisions

47 An entity discloses in the notes to the financial statements:

- for each class of provision, carrying amounts at the beginning and end of the period, additions, amounts used, unused amounts reversed and adjustments due to discount reversal or changes in the discount rate. Comparative information is not required.
- a brief description of the obligation, timing and uncertainty of outflows and expected reimbursements including the amount of any asset recognised.

[IAS 37 paras 84, 85].

Contingent liabilities

48 Unless the possibility of any outflow is remote, an entity discloses, for each class of contingent liability, a brief description of the nature of the contingency and, where practicable, an estimate of its financial effect, the uncertainties relating to the amount and timing of any outflow and the possibility of any reimbursement. Where any of the above information is not disclosed because it is impracticable that fact should be stated. [IAS 37 paras 86, 91].

Contingent assets

49 Where an inflow of economic benefits is probable an entity discloses a brief description of the nature of the contingent assets and where practicable an estimate of their financial effect. Where any of the above information is not disclosed because it is impracticable that fact should be stated. [IAS 37 paras 89, 91].

Seriously prejudicial exemption

50 In extremely rare cases disclosure of some or all of the above information may seriously prejudice the entity's position in a dispute with other parties. IAS 37 allows an entity to omit the disclosures in such situations. However, the entity is then required to disclose the general nature of the dispute and the fact that the information has not been disclosed giving the reasons for the non-disclosure. [IAS 37 para 92].

Related-party disclosures

Overview

Disclosures are required in respect of an entity's transactions with related parties. Related parties include:

- Subsidiaries.
- Fellow subsidiaries.
- Associates.
- Joint ventures.
- The entity's and its parent's key management personnel (including close members of their families).
- Parties with control/joint control/significant influence over the entity (including close members of their families, where applicable).
- Post-employment benefit plans.

However, they exclude, for example, finance providers and governments in the course of their normal dealings with the entity.

The name of the ultimate parent entity is disclosed if it is not mentioned elsewhere in information published with the financial statements. The names of the immediate and the ultimate controlling parties (which could be an individual or a group of individuals) are disclosed irrespective of whether there have been transactions with those related parties.

Where there have been related-party transactions, management discloses the nature of the relationship, the amount of transactions, and outstanding balances and other elements necessary for a clear understanding of the financial statements (for example, volume and amounts of transactions, amounts outstanding and pricing policies). The disclosure is made by category of related parties and by major types of transaction. Items of a similar nature may be disclosed in aggregate, except when separate disclosure is necessary for an understanding of the effects of related-party transactions on the reporting entity's financial statements.

Disclosures that related-party transactions were made on terms equivalent to those that prevail for arm's length transactions are made only if such terms can be substantiated.

Resources

Standards and interpretations

- IAS 24, 'Related-party disclosures'
- Amendment to IAS 24, 'Related-party disclosures'

PwC guidance

- Manual of Accounting chapter 29, Related-party disclosures

Tools practice aids and publications

- Straight away 5: Guidance on amendment to IAS 24, Related party disclosures

Summary of key requirements

Objective and scope

1 The objective of IAS 24, 'Related-party disclosures', is to ensure that financial statements disclose the information necessary to draw attention to the possibility that the financial position and profit or loss may have been affected by the existence of related parties and by transactions and outstanding balances with such parties. [IAS 24 para 1].

2 IAS 24 applies in identifying related party relationships and transactions and balances with related parties. It is also applied in determining when disclosure of such transactions and balances is required and what form the disclosure should take. There is no exemption from disclosing related party transactions and balances in the separate financial statements of a parent, venturer or investor and in the financial statements of subsidiaries. In consolidated financial statements, intra-group related party transactions are eliminated and are, therefore, not disclosed. [IAS 24 paras 2-4].

Related parties

3 A party is related to an entity if:

(a) The party, directly or indirectly through one or more intermediaries:
  1. Controls, is controlled by, or is under common control with, the entity (this includes parents, subsidiaries and fellow subsidiaries).
  2. Has an interest in the entity that gives it significant influence over the entity.
  3. Has joint control over the entity.

(b) The party is an associate of the entity (as defined in IAS 28, 'Investments in associates').

(c) The party is a joint venture in which the entity is a venturer (as defined in IAS 31, 'Interests in joint ventures').

(d) The party is a member of key management of the entity or its parent. Key management includes executive and non-executive directors.

(e) The party is a close family member of an individual related to an entity under categories (a) or (d). Close family members of an individual are those who may be expected to influence, or be influenced by, that individual in their dealings with the entity.

(f) The party is an entity that is controlled, jointly controlled or significantly influenced by, or in which significant voting power belongs directly or indirectly to, an individual referred to in categories (d) or (e).

(g) The party is a post-employment benefit plan for the benefit of the entity's employees, or of any entity that is a related party of the entity.

[IAS 24 para 9].

4 IAS 24 specifies that the following are not necessarily related parties:

- Entities that have a director or other member of key management in common.
- Two venturers simply because they share joint control over a joint venture.
- Providers of finance, trade unions, public utilities and government departments and agencies, simply by virtue of their normal dealings with an entity.
- A customer, supplier, franchisor, distributor or general agent with which an entity transacts a significant volume of business, merely by virtue of the resulting economic dependence.

[IAS 24 para 11].

Related-party transactions

5 A related-party transaction is a transfer of resources, services or obligations between related parties, regardless of whether a price is charged. Related-party transactions include:

- Purchases and sales of goods, property or other assets.
- Rendering or receiving of services.
- Leases.
- Transfers of research and development.
- Transfers under licence agreements and finance arrangements.
- Provision of guarantees or collateral.
- Settlement of liabilities on behalf of the entity or by the entity on behalf of another party.
- Participation by a parent or subsidiary in a defined benefit plan that shares risks between group entities.

[IAS 24 paras 9, 20].

Disclosures

6 Disclosures required by IAS 24 include:

- The name of the entity's parent and, if different, the ultimate controlling party. If neither the parent nor the ultimate controlling party prepare financial statements available for public use then the name of the next most senior parent that does prepare such financial statements should also be disclosed.
- The aggregate of key management compensation showing the split between: short-term employee benefits, post-employment benefits, other long-term benefits, termination benefits and share-based payment.
- If there have been transactions between related parties, an entity should disclose the nature of the relationship and details of the transactions and outstanding balances. As a minimum such details should include:
- The amount of the transaction.
- The amount of outstanding balances, including their terms and conditions, whether they are secured and the nature of consideration to be provided.
- Details of guarantees given or received.
- Provisions for bad and doubtful debts and the expense recognised during the period in respect of balances with related parties.
- Any other information necessary for an understanding of the potential effect of the relationship on the financial statements.

[IAS 24 paras 12, 16, 17].

7 A statement that a transaction was made on arm's length terms may only be made if it is capable of substantiation. [IAS 24 para 21].

8 The related party disclosures are made separately for different categories of related parties. Items of a similar nature may be aggregated, except when separate disclosure is required to explain the effects of related party transactions on the entity's financial statements. [IAS 24 paras 18, 22].

9 In November 2009 the IASB published an amendment to IAS 24 on relationships with the state. This amendment reduced the disclosure requirements for some entities that are related because they are each state-controlled or significantly influenced by the state. It also clarified and removed inconsistencies in the definition of a related party.

Revenue and construction contracts

Overview

Revenue is measured at the fair value of the consideration received or receivable. When the substance of a single transaction indicates that it includes separately identifiable components, revenue is allocated to these components by reference to their fair values. It is recognised for each component separately by applying the recognition criteria below. For example, when a product is sold with a subsequent service, revenue is allocated initially to the product component and the service component; it is recognised separately thereafter when the criteria for revenue recognition are met for each component.

Revenue – IAS 18

Revenue arising from the sale of goods is recognised when an entity transfers the significant risks and rewards of ownership and gives up managerial involvement usually associated with ownership and control, if it is probable that economic benefits will flow to the entity and the amount of revenue and costs can be measured reliably.

Revenue from the rendering of services is recognised when the outcome of the transaction can be estimated reliably. This is done by reference to the stage of completion of the transaction at the balance sheet date, using requirements similar to those for construction contracts. The outcome of a transaction can be estimated reliably when: the amount of revenue can be measured reliably; it is probable that economic benefits will flow to the entity; the stage of completion can be measured reliably; and the costs incurred and costs to complete can be reliably measured.

Examples of transactions where the entity retains significant risks and rewards of ownership and revenue is not recognised are when:

- The entity retains an obligation for unsatisfactory performance not covered by normal warranty provisions.
- The receipt of revenue from a particular sale is contingent on the buyer in turn obtaining revenue from its sale of the goods.
- The buyer has the power to rescind the purchase for a reason specified in the sales contract and the entity is uncertain about the probability of return.
- When the goods are shipped subject to installation and that installation is a significant part of the contract.

Interest income is recognised using the effective interest rate method. Royalties are recognised on an accruals basis in accordance with the substance of the relevant agreement. Dividends are recognised when the shareholder's right to receive payment is established.

Construction contracts – IAS 11

A construction contract is a contract specifically negotiated for the construction of an asset, or combination of assets, including contracts for the rendering of services directly related to the construction of the asset (such as project managers and architects services). Such contracts are typically fixed-price or cost-plus contracts.

Revenue and expenses on construction contracts are recognised using the percentage-of-completion method. This means that revenue, expenses and therefore profit are recognised gradually as contract activity occurs.

When the outcome of the contract cannot be estimated reliably, revenue is recognised only to the extent of costs incurred that it is probable will be recovered; contract costs are recognised as an expense as incurred. When it is probable that total contract costs will exceed total contract revenue, the expected loss is recognised as an expense immediately.

The IASB published IFRIC 15, 'Agreements for construction of real estate', in July 2008. This interpretation clarifies which standard (IAS 18, 'Revenue', or IAS 11, 'Construction contracts') should be applied to particular transactions. It is likely to mean that IAS 18 will be applied to a wider range of transactions. This interpretation is effective for non-EU accounting periods beginning on or after 1 January 2009, or 1 January 2010 in the EU with earlier adoption permitted.

Government grants – IAS 20

Government grants are recognised when there is reasonable assurance that the entity will comply with the conditions related to them and that the grants will be received.

Grants related to income are recognised in profit or loss over the periods necessary to match them with the related costs that they are intended to compensate. The timing of such recognition in profit or loss will depend on the fulfilment of any conditions or obligations attaching to the grant.

Grants related to assets are either offset against the carrying amount of the relevant asset or presented as deferred income in the balance sheet. Profit or loss will be affected either by a reduced depreciation charge or by deferred income being recognised as income systematically over the useful life of the related asset.

Resources

Standards and interpretations
- IAS 18, 'Revenue'
- IFRIC 13, 'Customer loyalty programmes'
- IFRIC 15, 'Agreements for the construction of real estate'
- IFRIC 18, 'Transfer of assets from customers'
- SIC 27, 'Evaluating the substances of transactions involving the legal form of a lease'
- SIC 31, 'Revenue – Barter transactions involving advertising services'
- Improvements to IFRSs 2010

Exposure drafts and discussion papers
- Discussion paper on preliminary views on revenue recognition in contracts with customers

PwC guidance
- Manual of Accounting chapter 9, Revenue and construction contracts

Tools practice aids and publications
- IFRS extracts from accounts

Summary of key requirements – IAS 18

Objective and scope

1 The issue of revenue recognition is fundamental to the reporting of performance. IAS 18, 'Revenue', governs the accounting for revenue. Revenue arises in the course of an entity's ordinary activities and is referred to by a variety of different names including sales, turnover, fees, interest, dividends, royalties and rents. The objective of IAS 18 is to prescribe the accounting treatment of revenue arising from certain types of transactions and events. IAS 18 identifies the primary issue as determining when to recognise revenue and sets out the criteria that should be used for determining whether or not revenue should be recognised.

2 The standard applies to accounting for revenue from the following:
- Sale of goods.
- Rendering of services.
- Use by others of an entity's assets that gives rise to interest, royalties or dividends.

[IAS 18 para 1].

3 The sale of goods includes goods manufactured for sale and purchased for resale, but does not include construction contracts that should be accounted for in accordance with IAS 11, 'Construction contracts'. Where services rendered are directly related to construction contracts, for example, services rendered by project managers and architects, they are also dealt with under IAS 11, rather than under IAS 18. [IAS 18 para 3, 4].

4 The standard excludes from its scope revenue arising from certain items that are dealt with by more specific standards, including lease agreements (IAS 17), dividends from equity-accounted investments (IAS 28), insurance contracts within the scope of IFRS 4, changes in the fair value of financial assets and liabilities or their disposal (IAS 39) and changes in value of other current assets. It also excludes from its scope revenue arising from changes in the fair value of biological assets relating to agricultural activity, initial recognition of biological assets or agricultural produce (IAS 41) and the extraction of mineral ores. [IAS 18 para 6].

Definition of revenue

5 Revenue is defined as the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity, when those inflows result in increases in equity, other than increases relating to contributions from equity participants. [IAS 18 para 7].

6 Revenue includes only inflows of economic benefits that belong to the entity and it, therefore, excludes amounts collected on behalf of and paid or payable to others, such as value added tax or amounts collected on behalf of a principal by the entity as agent. In the latter situation, the revenue attributable to the entity is the commission earned, not the gross receipts that are due to the principal. [IAS 18 para 8].

Identifying the transaction

7 Whilst most transactions are straightforward exchanges, some may involve a number of elements. For example, a product sold with an undertaking to provide an after-sales service. In such situations, it is necessary to allocate the consideration received between the different elements of the transaction. In this example, part of the consideration would be attributed to the servicing element and recognised as revenue over the period of the service obligation, the remainder would be recognised on the transfer of risks and rewards of the product.

8 Other transactions may be even more complex. An example is a sale with a repurchase commitment. The standard makes it clear that all aspects of the transaction or the whole of a series of transactions that together constitute, in substance, one transaction, must be considered together. In the case of a sale with a repurchase commitment, the standard notes that the repurchase commitment effectively negates the original sale. [IAS 18 para 13].

Timing of recognition

Sale of goods

9 Revenue from the sale of goods should be recognised when all of the following conditions are satisfied:

- The entity has transferred to the buyer the significant risks and rewards of ownership.
- The entity does not retain either the continuing managerial involvement normally associated with ownership or effective control over the goods.
- The amount of revenue can be reliably measured.
- It is probable that the economic benefits associated with the transaction will flow to the entity.
- The costs incurred or to be incurred in respect of the transaction can be reliably measured.

[IAS 18 para 14].

10 The standard notes that transfer of the significant risks and rewards of ownership normally occurs when legal title or possession passes to the buyer. This is the case with most retail sales, but in other situations the transfer of significant risks and rewards may pass at a different time. [IAS 18 para 15].

11 The standard provides examples of circumstances in which the transfer of significant risks and rewards has not taken place and, thus, revenue is not recognised. [IAS 18 para 16].

12 Where significant risks and rewards have passed and the entity retains only insignificant risks and rewards of ownership, revenue is recognised. [IAS 18 para 17].

13 Revenue is recognised only when it is probable that the economic benefits associated with the transaction will flow to the entity. In some cases, it may not be probable until the consideration is received or until an uncertainty is removed. When an uncertainty arises about the collectability of an amount already included in revenue, the uncollectable amount or the amount in respect of which recovery has ceased to be probable is recognised as an expense and not as an adjustment to revenue. [IAS 18 para 18].

Rendering of services

14 When the outcome of a transaction that involves the rendering of services can be reliably estimated, revenue from the transaction should be recognised by reference to the stage of completion of the transaction at the balance sheet date. Reliable estimation of the outcome of a transaction is possible when all the following conditions are met:

- The amount of revenue can be reliably measured.
- It is probable that the economic benefits associated with the transaction will flow to the entity.
- The stage of completion of the transaction can be reliably measured at the balance sheet date.
- The costs incurred and the costs to complete can be reliably measured.

[IAS 18 para 20].

15 Revenue recognition by reference to the stage of completion of a transaction is known as the 'percentage of completion' method. The method recognises revenue according to work done, that is, in the accounting period in which services are performed. As such, it gives a fairer reflection of performance than if revenue recognition is deferred until the end of the contract, which could be in a different period from that in which the majority of the services are rendered. This is the method used in IAS 11, 'Construction contracts', and IAS 18 notes that the requirements of IAS 11 are generally applicable to recognising revenue and costs for a transaction that involves the rendering of services. [IAS 18 para 21]. IAS 11 contains more detailed guidance than IAS 18 relating to contract revenue and contract costs and is discussed more fully from paragraph 2.39 below.

16 As for sale of goods, IAS 18 notes that revenue is only recognised when it is probable that the economic benefits associated with the transaction will flow to the entity. Once revenue has been recognised any uncertainty that arises subsequently and that requires provision to be made against amounts due to the entity, is recognised as an expense and not as a reduction of revenue. [IAS 18 para 22].

17 A reliable estimate of the revenue to be received can generally be made when the entity has agreed with the other party:

- Each party's enforceable rights regarding the services to be performed.
- The amount of the consideration.
- The manner and terms of settlement.

[IAS 18 para 23].

18 The entity should have an effective system for monitoring and reporting progress on each contract and should revise its estimates of the outcome of the contract as it progresses in the light of performance to date. Progress of the contract and the stage of completion should be assessed regularly to measure the value of services rendered. A number of different methods may be used, including:

- Surveys of work performed.
- The amount of the services performed to date as a percentage of total services to be performed.
- The proportion of costs incurred compared to estimated total costs of the transaction.

[IAS 18 para 24].

19 In determining costs to date, only costs incurred in providing services should be included and only costs that reflect services performed or to be performed are included in the estimate of total costs of the transaction. [IAS 18 para 24].

20 Where progress payments or advances are received from customers these may not reflect services performed, but rather may be payments in respect of work still to be performed. [IAS 18 para 24].

21 Where services are provided by an indeterminate number of acts over a specified period of time, revenue is, as a practical matter, recognised on a straight-line basis over that period, unless there is evidence that another method gives a better reflection of work performed. For example, revenue from a contract to provide maintenance services for a six-month period would normally be reflected on a straight-line basis over the six months. Where, however, in such a contract there is one (or more) specific act of the contract that is much more significant than any other, revenue is recognised in line with completion of that act. [IAS 18 para 25].

22 If the outcome of a contract for providing services cannot be reliably estimated, revenue should only be recognised to the extent of costs incurred that are recoverable. [IAS 18 para 26]. This may be the situation in the early stages of a contract for providing services. Where the outcome of a contract cannot be reliably estimated and it is uncertain as to whether costs incurred to date can be recovered, such costs should be expensed as incurred. If, at a later date, recovery of such costs becomes probable their recovery is recognised as revenue rather than by reversing the original write off of the costs. [IAS 18 para 28].

Interest, royalties and dividend

23 Revenue from the use by others of the entity's assets, in the form of interest, royalties or dividends, should be recognised when:

- It is probable that the economic benefits associated with the transaction will flow to the entity.
- The amount of the revenue can be reliably measured.

[IAS 18 para 29].

24 Interest should be recognised using the effective interest method as set out in IAS 39, 'Financial instruments: Recognition and measurement'. [IAS 18 para 30].

25 When an interest bearing security is purchased, any accrued interest is allocated when received between pre-acquisition and post-acquisition periods. Only the latter is recognised as revenue with the former amount – the pre-acquisition element – being treated as a reduction in the cost of the investment. [IAS 18 para 32].

26 Dividends are recognised as income in profit or loss when the right to receive payment is established. [IAS 18 para 32].

27 Royalty revenue normally arises in accordance with the terms of a royalty agreement (for example, five per cent of sales made by the other party) and should be recognised on that basis, unless the agreement's substance is such that another systematic and rational basis is more appropriate. [IAS 18 para 33].

Measurement of revenue

28 Revenue should be measured at the fair value of the consideration received or receivable. This is normally agreed between the entity and the purchaser of goods or services, or the user of the asset. Consideration is net of trade discounts and volume rebates allowed by the entity. [IAS 18 para 9, 10].

29 Fair value is defined as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. [IAS 18 para 7].

30 Where consideration is deferred, it should be discounted to present value. The discount rate to be used is whichever of the following is the more clearly determinable:

- The prevailing rate for a similar instrument of an issuer with a similar credit rating.
- A rate of interest that discounts the nominal value of the instrument to the current cash sales price of the goods or services.

[IAS 18 para 11].

31 The difference between the fair value (that is, present value) and the nominal amount of the consideration is recognised as interest revenue on a time apportionment basis that takes account of the effective yield on the asset (the receivable). [IAS 18 para 11].

32 When goods or services are exchanged for similar goods or services, the exchange is not treated as generating revenue. Examples might include swaps of advertising by e-businesses (as dealt with by SIC 31, 'Revenue – Barter transactions involving advertising services').

33 By contrast, when goods or services are exchanged for dissimilar goods or services, the transaction gives rise to revenue. The amount of revenue is measured at the fair value of goods or services received, adjusted for any cash or cash equivalents received or paid. If the fair value of goods or services received cannot be reliably measured, the revenue is measured at the fair value of goods or services given up by the entity, again adjusted for any

cash or cash equivalents received or paid. [IAS 18 para 12].

Disclosure

34 The standard requires disclosure of:

- The accounting policy for revenue recognition, including the methods adopted for determining the stage of completion of transactions that involve rendering services.
- The amounts of each significant category of revenue recognised in the period, including:
- Sale of goods.
- Rendering of services.
- Interest.
- Royalties.
- Dividends.
- The amount of revenue recognised from exchanges of goods and services in each of the significant categories of revenue.

[IAS 18 para 35].

35 Any contingent liabilities, such as warranties, claims, penalties or possible losses, or contingent assets should also be disclosed in accordance with IAS 37, 'Provisions, contingent liabilities and contingent assets'. [IAS 18 para 36].

Detailed guidance

36 The standard gives detailed guidance on specific types of transactions that give rise to revenue. These include bill and hold sales, goods shipped subject to conditions, orders for which payment is received in advance, servicing fees included in the price of a product, financial service fees and franchise fees. [IAS 18 Appendix].

37 IFRIC 13, 'Customer loyalty programmes', deals with 'award credits', (for example, arrangements where customers earn points when they spend a certain amount at the store). IFRIC 13 applies to all entities that grant award credits as part of a sales transaction, including awards that can be redeemed for goods and services not supplied by the entity. This includes schemes as diverse as those offered by supermarkets, airlines, telecommunications operators, hotels and credit card issuers. Such transactions are accounted for as multiple element transactions, and as such, the fair value of the consideration received or receivable in respect of the initial sale is allocated between the award credits and the other components of the sale. Additionally, the interpretation requires the fair value of a population of award credits to take into consideration the proportion of incentives expected to be redeemed.

38 IFRIC 15, 'Agreements for the construction of real estate', gives guidance on whether contracts for the construction of real estate fall into the scope of the revenue standard (IAS 18) or the construction contracts standard (IAS 11). This guidance was intended to address diversity in practice in the real estate industry. However, the guidance can also be applied by analogy within other industries if it is unclear which standard should be applied. [IFRIC 15 para BC6]. IAS 11 applies when the agreement meets the definition of a construction contract set out in paragraph 3 of IAS 11. An agreement for the construction of real estate meets the definition of a construction contract when the buyer is able to specify the major structural elements of the design of the real estate before construction begins and/or specify major structural changes once construction is in progress (whether or not it exercises that ability). [IFRIC 15 para 11].

Summary of key requirements – IAS 11

Objective and scope

39 The objective of IAS 11 is to set out the accounting treatment for revenue and costs associated with construction contracts. This includes guidance on allocating costs and revenue between accounting periods. [IAS 11 Objective].

40 The primary accounting issue is the allocation of revenues and costs to the different accounting periods in which the contract work is performed. Construction contract accounting also applies to contracts for rendering services that are directly related to the construction of an asset, contracts for the destruction of assets, contracts for the restoration of assets and to contracts for the restoration of the environment following the demolition or removal of assets. The concepts of IAS 11 are also applied to the recognition of revenue and expenses for contracts for services that extend over more than one accounting period. [IAS 11 paras 4, 5, Objective; IAS 18 para 21].

Definition

41 A construction contract is defined in IAS 11 as a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose and use. In many cases, the date of commencement of a construction contract and the date of its completion fall into different accounting periods. [IAS 11 paras 3, Objective].

42 Construction contract work in progress (WIP) balances represent those costs incurred in respect of construction contracts as at the balance sheet date that will be recovered in future periods. [IAS 11 para 27].

Types of contract

43 Construction contracts may be fixed price contracts or cost plus contracts. Fixed price contracts are those where the parties agree a fixed price for the contract or a fixed rate per unit of output, which in some cases may be subject to cost escalation clauses. Cost plus contracts are those where the contractor is reimbursed for allowable costs, plus a percentage of those costs or a fixed fee. [IAS 11 paras 6, 3].

Aggregation and disaggregation of contracts

44 A single contract may cover the construction of a number of assets. The construction of each asset should be treated as a separate contract where:

- Separate proposals have been submitted for each asset.
- Each asset has been the subject of separate negotiations and the contractor and customer have each been able to accept or reject that part of the contract relating to each asset.
- The costs and revenues of each asset can be identified.

[IAS 11 para 8].

45 A group of contracts, whether with a single customer or a number of customers, should be combined where:

- The contracts have been negotiated as a single package.
- The contracts are so closely interrelated that they are, in substance, part of a single contract with an overall profit margin.
- The contracts are performed concurrently or in a continuous sequence.

[IAS 11 para 9].

Contract revenue

46 Contract revenue comprises the initial amount of revenue agreed in the contract and variations in contract work, claims and incentive payments, to the extent that it is probable that they will result in revenue and can be reliably measured. [IAS 11 para 11].

47 A variation is a modification of the original construction contract that may lead to an increase or decrease in the amount of work (costs) and contract revenue. Variations include changes in specification or design, the method or manner of performance, facilities, equipment, materials, site and period for completion. [IAS 11 para 13]. Many variations are unpriced, with the change agreed first and price adjustments negotiated later.

48 A claim relates to additional amounts sought by the contractor as compensation for cost overruns. [IAS 11 para 14].

Contract costs

49 Contract costs comprise costs that relate directly to the contract, costs attributable to contract activity in general that can be allocated to the contract and such other costs as are specifically chargeable to the customer under the contract's terms. [IAS 11 para 16].

50 Direct costs may include labour costs (including site supervision), materials, depreciation of plant and equipment used on the contract, costs of moving plant, equipment and materials to and from the site, hire of such plant and equipment, design costs, rectification and guarantee work and claims from third parties. Indirect costs may include insurance, design and technical assistance not directly related to a specific contract and construction overheads, such as costs of preparing and processing wages and salaries of construction personnel. Borrowing costs related to specific contracts should also be included where these have been capitalised in accordance with IAS 23 (revised), 'Borrowing costs'. Overhead costs should be allocated on a systematic and consistent basis. [IAS 11 paras 17,18].

51 Certain types of cost cannot be allocated to a contract and are, therefore, excluded. Examples of such costs are:

- Selling costs.
- General administration costs that are not reimbursable under the contract.
- Research and development costs that are not reimbursable under the contract.
- Depreciation of plant and equipment that is not used on a particular contract.

[IAS 11 para 20].

Initial recognition and measurement

52 Construction contract work in progress should be recognised from the date on which it becomes probable that the contract will be obtained and, thus, economic benefits will flow to the entity. [Framework para 89]. Costs incurred after that date in respect of the contract should, therefore, be included in work in progress. Costs of securing a contract are included only if they can be separately identified and measured reliably and it is probable that the contract will be obtained. [IAS 11 para 21].

Subsequent recognition and measurement

53 When the outcome of a construction contract can be reliably estimated, revenue and costs (as defined above) related to the contract should be recognised by reference to the stage of completion at the balance sheet date. [IAS 11 para 22].

54 In the case of a fixed price contract a reliable estimate of the outcome is possible when:

- The total contract revenue can be reliably measured.
- It is probable that the economic benefits will flow to the entity.
- Both costs to complete and the stage of completion at the balance sheet date can be reliably measured.
- The contract costs can be clearly identified and measured reliably so that actual costs incurred can be compared with prior estimates.

[IAS 11 para 23].

55 In the case of a cost plus contract a reliable estimate of the outcome is possible when:

- It is probable that the economic benefits will flow to the entity.
- The contract costs, whether or not specifically reimbursable, can be clearly identified and measured reliably.

[IAS 11 para 24].

Stage of completion

56 The method used to determine the stage of completion will depend on the contract's nature. A consistent approach should be taken to the revenue recognition of similar contracts. The more common methods are:

- Surveys of work performed.
- The proportion of costs incurred for work performed to date compared to the total estimated contract costs. (Costs incurred that relate to future work to be performed should be excluded from costs incurred for work performed to date in determining the stage of completion.)
- The proportion of physical work performed to date compared to total construction work.
- The proportion of services performed to date as a percentage of total services to be performed (in the case of contracts for services).

[IAS 11 para 30].

No reliable estimate possible

57 When the outcome of a contract cannot be estimated reliably, but the contract overall is expected to be profitable, revenue should be recognised to the extent of recoverable costs. In such circumstances, contract costs should be recognised in the period in which they are incurred. [IAS 11 para 32].

Expected losses

58 Any expected loss on a contract should be recognised as an expense immediately. [IAS 11 para 36].

Disclosure

59 Entities should disclose the gross amount due from customers for contract work as an asset. This amount is the net of:

- costs incurred plus recognised profits; and
- the sum of recognised losses and progress billings.

for all contracts where the amount in the first bullet point exceeds the amount in the second bullet point. [IAS 11 paras 42, 43].

60 Entities should also disclose the gross amount due to customers for contract work as a liability. This amount is the net of the sums in the two bullet points above where the amount in the second bullet exceeds the amount in the first bullet point. [IAS 11 paras 42, 44].

61 Amounts invoiced to customers, but not received at the balance sheet date should be included in trade receivables. There is no specific requirement in the standard to disclose the amount separately.

62 The other disclosures that should be given in respect of construction contracts are as follows:

- contract revenue recognised as revenue in the period;
- details of methods used to determine contract revenue; and
- details of methods used to determine stage of completion.

[IAS 11 para 39(a)(b)(c)].

63 For contracts in progress at the balance sheet date disclosure should be made of:

- contract costs incurred and recognised profits (less recognised losses) to date;
- advances received; and
- retentions.

[IAS 11 para 40(a)(b)(c)].

64 Retentions are the amounts of progress billings that are not paid until conditions specified in the contract have been met with respect to the satisfactory construction of the asset. [IAS 11 para 41].

Service concession arrangements

Overview

There is no specific IFRS that applies to public-to-private service concession arrangements for delivery of public services. SIC 29, 'Service concession arrangements: Disclosures', contains disclosure requirements in respect of public-to-private service arrangements but does not specify how they are accounted for. As a result, IFRIC issued an interpretation (IFRIC 12) on service concession arrangements in November 2006. The interpretation clarifies how IFRS should be applied by a private sector entity in accounting for public-to-private service concession arrangements.

IFRIC 12 applies to public-to-private service concession arrangements in which the public sector body (the grantor) controls and/or regulates the services provided with the infrastructure by the private sector entity (the operator). The regulation also addresses to whom the operator should provide the services and at what price. The grantor controls any significant residual interest in the infrastructure.

As the infrastructure is controlled by the grantor, the operator does not recognise the infrastructure as its property, plant and equipment; nor does the operator recognise a finance lease receivable for leasing the public service infrastructure to the grantor, regardless of the extent to which the operator bears the risk and rewards incidental to ownership of the assets.

The operator recognises a financial asset to the extent that it has an unconditional contractual right to receive cash irrespective of the usage of the infrastructure.

The operator recognises an intangible asset to the extent that it receives a right (a licence) to charge users of the public service.

Under both the financial asset and the intangible asset models, the operator accounts for revenue and costs relating to construction or upgrade services in accordance with IAS 11, 'Construction contracts'. The operator recognises revenue and costs relating to operation services in accordance with IAS 18, 'Revenue'. Any contractual obligation to maintain or restore infrastructure, except for upgrade services, is recognised in accordance with IAS 37, 'Provisions, contingent liabilities and contingent assets'.

IFRIC 12 is applicable for accounting periods beginning on or after 1 January 2008. Earlier application is permitted. The change in accounting policy is accounted for retrospectively, except when this is impractical, in which case special transition rules apply.

Resources

Standards and interpretations

- IFRIC 12, 'Service concession arrangements'

PwC guidance

- Manual of Accounting chapter 33, Service concession arrangements

Summary of key requirements

Objectives and scope

1 IFRIC 12's objective is to establish general principles on recognising and measuring the obligations and related rights in service concession arrangements. A feature of service concession arrangements is the public service nature of the obligation undertaken by the operator. The infrastructure or its output must be available to the public, irrespective of the identity of the party that operates it.

2 The scope of IFRIC 12 is limited to the accounting by operators for public-to-private service concession arrangements in which the public sector (grantor):

- controls or regulates what services the operator must provide with the infrastructure, to whom it must provide them, and at what price; and
- controls – through ownership, beneficial entitlement or otherwise – any significant residual interest in the infrastructure at the end of the arrangement's term.

[IFRIC 12 para 5(a)(b)].

3 Infrastructure used in a public-to-private service concession arrangement for its entire useful life is within the scope of IFRIC 12 if the above conditions are met. [IFRIC 12 para 6].

4 The interpretation applies to both infrastructure that the operator constructs or acquires from a third party and existing infrastructure to which the grantor gives the operator access. [IFRIC 12 para 7].

5 IFRIC 12 does not address accounting by grantors.

Accounting for service concession arrangements

Treatment of operator's rights over the infrastructure

6 Public service infrastructure should not be recognised as property, plant and equipment of the operator because the contractual arrangement does not convey the right to control the infrastructure to the operator. The operator has access to operate the infrastructure to provide the public service on the grantor's behalf in accordance with the contract's terms. [IFRIC 12 para 11]. This applies whether the infrastructure is constructed or acquired by the

operator or is provided by the grantor for the purposes of the concession.

Revenue and expense recognition

7 Under the terms of contractual arrangements within the scope of this Interpretation, the operator acts as a service provider. The operator constructs or upgrades infrastructure (construction or upgrade services) used to provide a public service and operates and maintains that infrastructure (operation services) for a specified period of time.

8 The operator accounts for revenue and costs relating to construction or upgrade services in accordance with IAS 11, 'Construction contracts'. [IFRIC 12 para 14]. IAS 11 requires revenue from construction or upgrade services to be measured at the fair value of the consideration received or receivable. The nature of the consideration determines its subsequent accounting treatment (see para 2.10 below).

9 The operator accounts for revenue and costs relating to operation services in accordance with IAS 18, 'Revenue'. [IFRIC 12 para 20].

10 If the operator performs more than one service (that is, construction or upgrade services and operation services) under a single contract or arrangement, consideration received or receivable should be allocated by reference to the relative fair values of the services delivered, when the amounts are separately identifiable.

Recognition and measurement of arrangement consideration

11 Given that the operator is neither permitted to recognise the infrastructure nor a lease of the infrastructure, the asset the operator recognises is the consideration it receives from the grantor in exchange for providing construction or upgrade services. The consideration may be rights to a financial asset or an intangible asset. [IFRIC 12 para 15].

Recognition of a financial asset

12 The operator recognises a financial asset to the extent that it has an unconditional contractual right to receive cash or another financial asset from, or at the direction of, the grantor for the construction or upgrade services. This applies even if payment is contingent on the operator ensuring that the infrastructure meets specified quality or efficiency requirements. [IFRIC 12 para 16].

13 The financial asset is built up from day one and continues to build up until construction activity ceases. It is initially recorded at the fair value of the consideration received or receivable for the construction services. The asset is amortised as the operator provides the public service and receives cash from the grantor during the operation phase. IFRIC 12 requires the financial asset to be accounted for and disclosed in accordance with the financial instruments standards IAS 32, 'Financial Instruments: Presentation'; IAS 39, 'Financial instruments: Recognition and measurement'; and IFRS 7, 'Financial instruments, Disclosures'.

Recognition of an intangible asset

14 The operator recognises an intangible asset to the extent that it receives a right (a licence) to charge users of the public service. Consistent with the recognition of a financial asset, the intangible asset is set up as the operator recognises revenue, being the fair value of the construction services provided during the construction phase. That is, the intangible asset is built up from day one and continues to build up until the construction activity ceases.

15 The asset is accounted for in accordance with IAS 38, 'Intangible assets', at cost, that is at the fair value of the construction services provided. [IFRIC 12 para 26]. The intangible asset is amortised over its expected useful life, which for a service concession arrangement is the concession period. Amortisation should commence when the asset is available for use, that is, at the point in time when the operator exercises its rights under the licence to charge users.

16 If the operator is paid for the construction services partly by a financial asset and partly by an intangible asset it is necessary to account separately for each component of the operator's consideration. The consideration received or receivable for both components should be recognised initially at the fair value of the consideration received or receivable. [IFRIC 12 para 18].

Replacement and maintenance expenditure

17 The operator may have contractual obligations it must fulfil as a condition of its licence to maintain the infrastructure to a specified level of serviceability or to restore the infrastructure to a specified condition before it is handed over to the grantor at the end of the service arrangement.

18 To the extent that the operator is required to undertake major maintenance expenditure at a certain point in time for which it is specifically reimbursed by the grantor, it is treated as a revenue generating activity and revenue and costs are recognised when the expenditure is undertaken.

19 To the extent that the operator is required to maintain or restore infrastructure, except for upgrade services, during the concession period, the obligation is recognised and measured in accordance with IAS 37, 'Provisions,

contingent liabilities and contingent assets', that is, at the best estimate of the expenditure that would be required to settle the present obligation at the balance sheet date. [IFRIC 12 para 21].

Items provided to the operator by the grantor

20 If the grantor provides other items to the operator that the operator can keep or deal with as it wishes, they are not treated as government grants as defined in IAS 20, 'Accounting for government grants and disclosure of government assistance'. They are recognised as assets of the operator, measured at fair value on initial recognition together with a liability for unfulfilled obligations. [IFRIC 12 para 27].

Disclosures

21 The disclosure requirements relating to service concession arrangements are contained in SIC 29 and apply to both the grantor and the operator, although IFRIC 12 only applies to accounting by the operator.

22 SIC 29's disclosure requirements are in addition to those in other standards that may apply to certain aspects of service concession arrangements, such as IAS 16, 'Property, plant and equipment', IAS 17, 'Leases', and IAS 38, 'Intangible assets'. IFRS 7, 'Financial instruments; Disclosures', also applies where an operator recognises a financial asset. [IFRIC 12 para 23].

Share-based payment

Overview

Share-based payment transactions are transactions in which entities receive goods or services as consideration for either:

- equity instruments of the entity (or the entity's parent or another entity within the same group) – 'equity-settled share-based payment'; or
- cash or other assets, where the amount is based on the price or value of the entity's shares – 'cash-settled share-based payment'.

The most common application is to employee share schemes, such as share option schemes. However, entities sometimes also pay for other expenses such as professional fees, and for the purchase of assets, by means of share-based payment.

The accounting treatment under IFRS 2 is based on the fair value of the instruments. Both the valuation of and the accounting for awards can be difficult, due to the complex models that need to be used to calculate the fair value of options and also due to the variety and complexity of schemes. In addition, the standard requires extensive disclosures. The result generally is to reduce reported profits, especially in entities that use share-based payment extensively as part of their remuneration strategy.

All transactions involving share-based payment are recognised as expenses or assets over any vesting period.

Equity-settled share-based payment transactions are measured at the grant date fair value for employee services; and, for non-employee transactions, at the fair value of the goods or services received at the date on which the entity recognises the goods or services. If the fair value of the goods or services cannot be estimated reliably – such as employee services and circumstances in which the goods or services cannot be specifically identified – the entity uses the fair value of the equity instruments granted. Under IFRIC 8, 'Scope of IFRS 2', management needs to consider if there are any unidentifiable goods or services received or to be received by the entity, as these also have to be measured in accordance with IFRS 2.

Equity-settled share-based payment transactions are not re-measured once the grant date fair value has been determined.

The treatment is different for cash-settled share-based payment transactions: cash-settled awards are measured at the fair value of the liability. The liability is re-measured at each balance sheet date and at the date of settlement, with changes in fair value recognised in the income statement.

Resources

Standards and interpretations

- IFRS 2, 'Share-based payment'
- Amendment to IFRS 2, 'Share-based payment – Vesting conditions and cancellations'
- Amendments to IFRS 2 – Group cash-settled share-based payment transactions

PwC guidance

- Manual of Accounting chapter 12, Share-based payment

Tools practice aids and publications

- IFRS extracts from accounts
- A practical guide to share-based payments

Summary of key requirements

Objective and scope

1 IFRS 2's objective is to specify the financial reporting for share-based payment transactions. The standard requires the effects of share-based payment transactions to be reflected in an entity's profit or loss and balance sheet, including expenses related to share options granted to employees. [IFRS 2 para 1].

2 The standard applies to all share-based payment transactions, of which there are three broad types:

- *Equity-settled share-based payment transactions* – Transactions in which an entity receives goods or services (including employee services) as consideration for its own equity instruments. Such transactions include employee share option and share incentive plans.
- *Cash-settled share-based payment transactions* – Transactions in which an entity acquires goods or services by incurring liabilities (typically to be settled in cash) and where the amount paid is based on the price or value of the entity's shares or other equity instruments. Typical examples include 'phantom' share schemes, share appreciation rights and certain long-term incentive schemes.
- Transactions in which either party may *choose* settlement in the form of cash (or other assets) or the entity's equity instruments.

[IFRS 2 para 2].

3 There are few exclusions from IFRS 2's scope. These relate to transactions that are dealt with in more detail by other standards, namely IFRS 3, 'Business combinations', (for example in relation to shares issued as consideration for a business combination) and IAS 32, 'Financial instruments: Disclosure and presentation' and IAS 39, 'Financial instruments: Recognition and measurement' (for

example in relation to net-settled contracts such as commodity contracts). Transactions with employees in their capacity as shareholders rather than in consideration for employee services are also outside the standard's scope.

Recognition of share-based payment transactions

4 The goods or services acquired in a share-based payment transaction should be recognised when they are received. For an equity-settled transaction, the corresponding entry is within equity. For cash-settled transactions a liability is recognised. [IFRS 2 para 7].

Measurement of equity-settled share-based payment transactions

5 IFRS 2's measurement objective is to determine the fair value of the goods or services acquired by an entity. However, if the fair value of goods and services themselves cannot be measured reliably, the standard requires indirect measurement by reference to the fair value of the equity instruments granted. [IFRS 2 para 10].

6 For situations where the indirect method of valuation is used, the standard requires that the fair value of the equity instrument is measured as follows:

- For transactions with parties other than employees, fair value is measured on the date at which an entity obtains goods or the counterparty renders services. Measurement by reference to the fair value of the equity instruments granted applies only in the rare cases where the fair value of the goods and services cannot be estimated reliably.
- For transactions with employees (including others providing similar services), fair value is determined by reference to the fair value of the equity instrument granted (the standard notes that it is typically not possible to reliably estimate the fair value of services received by employees). The measurement date is the grant date (defined as the date at which the entity and counterparty have a shared understanding of the terms and conditions of the arrangement). As explained above, the fair value is not subsequently re-measured for an equity-settled award.

[IFRS 2 paras 11, 13].

7 Ideally, the fair value of an equity instrument is based on market prices. However, market prices for many equity instruments are not available. Where this is the case, IFRS 2 requires a valuation technique to be used, incorporating all factors and assumptions that knowledgeable, willing market participants would consider in setting the price. [IFRS 2 paras 16, 17].

8 As mentioned above, the measurement requirements for equity-settled share-based payment transactions were extended with the publication IFRIC 8, 'Scope of IFRS 2'. The interpretation requires entities to recognise any unidentified goods and services within their financial statements. Unidentified goods and services arise where the fair value of the equity instruments granted is greater than the fair value of the goods and services received. An example is given of shares issued to parties from a particular section of the community (historically disadvantaged individuals) where no consideration is received, but intangible benefits arise such as enhancement of corporate image, increases in the customer base, attraction and retention of employees or improving or maintaining the entity's ability to tender for contracts.

9 IFRS 2 considers that there may be rare circumstances where the fair value of an equity instrument cannot be estimated reliably. In these circumstances, the standard proposes a pragmatic solution. In the absence of a reliable measure of fair value, an entity should measure the equity instruments granted at their intrinsic value, that is, the difference between market price and exercise price. The intrinsic value should be re-measured at each reporting date and at the date the equity instruments are settled (that is, they are exercised, forfeited or lapsed in the case of options, or they vest or are forfeited in the case of shares). [IFRS 2 para 24(a)].

Group situations

10 IFRIC 11, 'IFRS 2 – Group and treasury share transactions', addresses how a subsidiary should account for rights over parent company shares issued to its employees. The accounting for such share-based payment arrangements hinges around which entity grants the award and which entity has an obligation to provide the employees with equity instruments.

11 Unlike the exposure draft D17, IFRIC 11 does not address the accounting within the parent entity where the parent grants rights over its equity instruments to the employees of its subsidiary. D17 indicated that the parent entity would debit its investment in subsidiary and credit equity for the equity instrument it has granted. There is no indication that this accounting would be inappropriate, therefore, we believe it should continue to be applied.

12 While IFRIC 11 provides guidance in relation to equity-settled share-based payment awards in group situations, it does not give guidance for cash-settled share-based payment awards that will be settled by an entity that does not employ the employees who receive the awards. In June 2009 the IASB issued 'Amendments to IFRS 2, Share-based payment – Group cash-settled share-based payment transactions' to address this issue. The amendments apply for periods beginning on or after 1 January 2010.

13 The amendments address the accounting in the separate financial statements of a subsidiary when its suppliers/employees will receive cash payments from the parent that are linked to the price of the equity instruments of an entity in the group. The parent, and not the entity, has the obligation to deliver cash. The amendments state that the entity should measure the goods and services received based on a cash-settled share-based payment. However, since the entity has no obligation, the corresponding credit would be recorded in equity.

Vesting conditions

14 Vesting conditions are conditions that must be satisfied before a counterparty becomes unconditionally entitled to equity instruments or a payment under a share-based payment arrangement. Where equity instruments vest immediately, in the absence of evidence to the contrary, an entity should presume that they represent consideration for goods already received or services already rendered. Therefore, on the date on which options are granted the entity should recognise the goods or services received in full. However, if there is a specified period of service over which an award vests, the goods or services should be recognised over that vesting period. [IFRS 2 paras 14, 15].

15 No distinction is drawn in IFRS 2 between vesting periods during which counterparties, such as employees, have to satisfy specific performance conditions and vesting periods during which there are no particular requirements other than to remain in the entity's employment. The recent amendment to IFRS 2, 'Vesting conditions and cancellations', clarifies that vesting conditions are either service or performance conditions. Performance conditions require the counterparty to complete a specified period of service and specified performance targets. Any condition other than a service or performance condition, such as a requirement to save (in a save as you earn plan) or a requirement to hold shares (in a matching share award), is defined as a non-vesting condition. [Amendment to IFRS 2 Appendix A]. Non-vesting conditions should be incorporated into the fair value of an award and ignored if the non-vesting condition is not met. The amendment is applicable for periods beginning on or after 1 January 2009 and should be applied retrospectively.

16 The impact of vesting conditions on the amounts recognised in the financial statements will vary depending on whether any of those conditions relate to the market price of the entity's equity instruments. Such conditions, which IFRS 2 defines as 'market conditions', are taken into account when determining the fair value of the equity instruments granted, so they are ignored for the purposes of estimating the number of equity instruments that will vest (the treatment of non-vesting conditions is the same). For vesting conditions other than market conditions, an entity should recognise the goods or services it has acquired during the vesting period based on the best available estimate of the number of equity instruments expected to vest. It should revise that estimate, if necessary, when subsequent information indicates that the number of equity instruments expected to vest differs from previous estimates. Finally, on vesting, the entity should revise the estimate to equal the number of equity instruments that ultimately did vest, although, as noted above, the impact of market conditions and non-vesting conditions on the number of instruments that vested is ignored. Furthermore, no change is made to the estimate of fair value at the relevant measurement date. [IFRS 2 paras 19 to 21].

Modifications and cancellations

17 IFRS 2 gives guidance where the terms and conditions of an equity instrument are modified or cancelled before the vesting date. An example is the re-pricing of options. Any incremental value in a modified award should be calculated as the difference between the fair value of the re-priced option and the fair value of the original option at the date of re-pricing. This incremental value should then be recognised as an expense over the remaining vesting period. This is in addition to the amount in respect of the original option grant, which is recognised over the remainder of the original vesting period. The guidance on cancellations is dependent on whether other compensation is given to the counterparty. However, unless another equity instrument is granted (in which case the modification principles are used) an entity should account for a cancellation as an acceleration of vesting and recognise immediately the amount that otherwise would have been recognised over the remainder of the vesting period. [IFRS 2 paras 26 to 29].

18 Another example of where the terms and conditions of an equity instrument are modified is following a business combination. In such situations, the acquirer will need to determine an allocation of the services provided for the equity instrument between pre- and post-acquisition services. IFRS 3 (revised), 'Business combinations', provides guidance in this area. Where post-acquisition services are required, an award that was originally granted by the newly acquired entity will be treated as a new award from the acquirer's perspective and will therefore, need to be fair valued at the date of acquisition by the acquirer. [IFRS 3 (revised) paras B56 to B62].

Cash-settled share-based payment transactions

19 Similar to equity-settled share-based payment transactions, expenses in respect of cash-settled share-

based payment transactions should be recognised over the period during which goods are received or services are rendered and measured at the fair value of the liability. However, as mentioned above, unlike equity-settled transactions, the fair value of the liability should be re-measured at each reporting date until settled. Changes in fair value are recognised in the statement of comprehensive income. [IFRS 2 para 30].

20 Unlike equity-settled share-based payment transactions, the credit entry in respect of a cash-settled share-based payment transaction is presented as a liability. [IFRS 2 para 7].

Share-based payment transactions with alternative methods of settlement

21 Sometimes either the reporting entity or the counterparty has a choice as to whether a share-based payment transaction is settled in cash or equity instruments.

22 Where the counterparty has the choice of settlement method, the standard concludes that the reporting entity has issued a compound financial instrument, comprising a debt component (the counterparty's right to demand payment in cash) and an equity component (the counterparty's right to demand settlement in equity instruments). There are detailed rules on the valuation and subsequent treatment of the instrument's debt and equity components. [IFRS 2 paras 35 to 40].

23 Where the reporting entity has the choice, the transaction should be treated as cash-settled if the option to settle in equity has no commercial substance or if the entity has a past practice or a stated policy of settling in cash. Otherwise, the transaction should be treated as equity-settled. Adjustments will then be necessary if the actual method of settlement does not match the previously anticipated method of settlement, or when the entity elects the settlement method with a higher fair value. [IFRS 2 paras 41 to 43].

Income taxes

24 A tax deduction that relates to share-based employee compensation may differ from the related cumulative remuneration expense and may arise in different periods. Such temporary differences result in recognition of deferred taxes. Deferred tax in equity-settled transactions should be charged to equity if the anticipated tax deduction exceeds the tax effects of the related cumulative remuneration expense (the remuneration expense multiplied by the tax rate). [IAS 12 paras 68A-C].

Disclosures

25 The standard requires extensive disclosure under three broad headings:

- The nature and extent of share-based payment arrangements that existed during the period, including: a description of each type of share-based arrangement; details of share options at the beginning and end of the period and movements during the period.
- How the fair value of the goods or services received, or the fair value of the equity instruments granted during the period, was determined, including details of inputs to option pricing models used.
- The effect of share-based payment transactions on the entity's profit or loss for the period and balance sheet giving: the total expense charged and, separately, the amount charged in respect of equity-settled share-based transactions; the amount of any liabilities arising from share-based payment transactions (cash-settled awards) and the amount of vested share appreciation rights.

[IFRS 2 paras 44 to 52].

Share capital and reserves (equity)

Overview

Equity, along with assets and liabilities, is one of the three elements used to portray an entity's financial position. Equity is defined in the IASB's Framework as the residual interest in the entity's assets after deducting all its liabilities. The term 'equity' is often used to encompass an entity's equity instruments and reserves. Equity is given various descriptions in the financial statements. Corporate entities may refer to it as owners' equity, shareholders' equity, capital and reserves, shareholders' funds and proprietorship. Equity includes various components with different characteristics.

Determining what constitutes an equity instrument for the purpose of IFRS and how it should be accounted for falls within the scope of the financial instrument standard IAS 32, 'Financial instruments: Presentation'.

Different classes of share capital may be treated as either debt or equity, or a compound instrument with both debt and equity components. Equity instruments (for example, issued, non-redeemable ordinary shares) are generally recorded at the proceeds of issue net of transaction costs. Equity instruments are not re-measured after initial recognition.

Reserves include retained earnings, together with fair value reserves, hedging reserves, asset revaluation reserves and foreign currency translation reserves and other statutory reserves.

Treasury shares

Treasury shares are deducted from equity. No gain or loss is recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments.

Non-controlling interests

Non-controlling interests (previously termed 'minority interests') in consolidated financial statements are presented as a component of equity, separately from the parent shareholders' equity.

Disclosures

IAS 1 (revised), 'Presentation of financial statements', requires various disclosures. These include the total issued share capital and reserves, presentation of a statement of changes in equity, capital management policies and dividend information.

Resources

Standards and interpretations

- IAS 1, 'Presentation of financial statements'
- IAS 1 (revised), 'Presentation of financial statements'
- IAS 27, 'Consolidated and separate financial statements'
- IAS 32, 'Financial instruments: Presentation'
- Amendment IAS 32, 'Financial instruments: Presentation', and IAS 1, 'Presentation of financial statements'

PwC guidance

- Manual of Accounting chapter 23, Share capital and reserves

Summary of key requirements

Equity

1 Changes in equity result from:

- the issue of equity share capital and equity instruments (including derivatives on own equity);
- contributions from owners;
- the repurchase of equity instruments;
- transaction costs directly attributable to the issue or repurchase of equity instruments;
- distributions to owners;
- statutory capital maintenance requirements;
- comprehensive income for the period.

2 Non-controlling interest is the equity in a subsidiary not attributable, directly or indirectly, to a parent. [IFRS 3 Appendix A, IAS 27 para 4]. In other words, non-controlling interest represents equity instruments issued by a group's subsidiaries to persons outside the group. Non-controlling interest is presented in the consolidated balance sheet within equity, separately from the equity of the shareholders of the parent. [IAS 1 para 54(q)].

Equity instruments including equity share capital

3 Equity instruments include an entity's issued ordinary shares, and options and warrants held by external parties to purchase those shares. [IAS 39 para 2(d)]. IFRS specifically defines equity instruments as any contract that evidences a residual interest in an entity's assets after deducting its liabilities. [IAS 32 para 11]. An equity instrument, in contrast with a financial liability, does not give rise to a contractual obligation on the issuer's part to deliver cash or another financial asset or to exchange another financial instrument under conditions that are potentially unfavourable. [IAS 32 paras 15-18].

Share capital

4 Legally, there are many types of share capital, including: ordinary shares, preference shares, non-voting shares, participating shares and redeemable shares. Classification as equity depends on the rights associated with the shares. The holders of equity share capital are the entity's owners.

Own equity instruments

5 Own equity instruments include derivatives on an entity's own equity shares such as options and warrants and forward contracts to purchase or sell an entity's own equity shares. Classification of own equity instruments and the accounting for them is dependent on the terms of the instruments.

Measurement

6 Initial measurement of equity instruments reflects the net proceeds from issue, defined as the fair value of the consideration received, net of the costs of the equity transaction. Equity instruments are not re-measured following initial recognition.

Treasury shares

7 Where an entity purchases its own equity shares in the market, these shares should be presented as a deduction from equity, at the amount paid including transaction costs. [IAS 32 paras 33, and 35]. No gain or loss is recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments. Consideration paid should be recognised directly as a reduction in equity. Subsequent resale of the shares does not give rise to a gain or loss and is, therefore, not part of profit or loss for the period. The sales consideration should be presented as an increase in equity.

Contributions from owners

8 Contributions from owners are increases in ownership interest resulting from transfers from owners in their capacity as such. Owners may make a contribution to the entity by transferring cash, other assets, performing services, or accepting ownership interest in satisfaction of liabilities. The most common form of contribution from owners is cash in consideration for the issue of equity shares. Other forms of contribution, more usually seen in a parent / subsidiary relationship, may involve the contribution of property, plant and equipment or shares in another entity, or the provision of services or interest-free loans. Contributions from the owner that increase its investment in the entity should be distinguished from transfers that arise from trading activities in the normal course of business. [IAS 1 paras 106-109].

9 IFRS does not provide conceptual guidance about the nature and characteristics of contributions from owners. Contributions from owners are usually non-reciprocal in nature. Non-reciprocal transfers involve the giving of assets or services, or liabilities forgiven, without the transferee being obliged to give something of benefit in exchange. A reciprocal transfer such as the sale of goods and services usually gives rise to a present obligation on the part of the transferee to provide a benefit in return for the benefit received. Reciprocal transfers usually result from trading activities.

Distributions to owners

10 Distributions by an entity to the holders of its equity instruments are usually made in the form of dividends or a return of capital, for example a share buyback. Distributions to owners are made at the discretion of an entity's directors (but are often subject to shareholders' approval) and are often influenced by legal requirements. Like contributions, distributions by a subsidiary to its parent may take other forms. The principles of reciprocity, outlined above, should be applied to determine whether the transfer is a distribution that the subsidiary should recognise as a reduction of equity, or one that represents the cost of trading activities.

11 Distributions on shares that are not classified as equity are presented as an expense in the income statement. However, in many legal jurisdictions, such shares are part of an entity's legal capital and distributions on such shares are subject to the same capital maintenance rules as distributions to owners.

Reserves

12 Reserves, together with equity share capital and other own equity instruments, make up the shareholders' equity section of an entity's balance sheet. Reserves are not specifically defined in IFRS and are frequently referred to as components of equity.

13 As well as retained earnings, reserves include fair value (or AFS) reserve, cash flow hedge reserves, asset revaluation reserve and foreign currency translation reserve and other statutory reserves. Most reserves result from accounting requirements to reflect certain measurement changes in equity rather than profit and loss.

Fair value (or AFS) reserve

14 Unrealised gains/losses (net of tax) on investments classified as available-for-sale are recognised in equity in a fair value (or AFS) reserve. [IAS 39 para 55]. These gains/losses are recycled to profit or loss on disposal or when the asset becomes impaired. The gain or loss taken to

equity is subject to adjustment to ensure that interest, dividends and, in the case of monetary available-for-sale items, foreign exchange gains and losses are recognised in profit or loss. [IAS 39 paras 55(b) and AG 83].

Cash flow hedge reserve

15 IFRS requires that the effective portion of gains and losses (net of tax) arising from the revaluation of a financial instrument designated as a cash flow hedge is deferred in a separate component of equity. [IAS 39 para 95]. The reserve is commonly described as a hedging reserve.

16 These deferred gains and losses are subsequently released through profit or loss in the period or periods when the hedged item affects profit or loss. [IAS 39 para 100]. If the hedged cash flows result in the recognition of a non-financial asset or non-financial liability on the balance sheet, the entity can choose to adjust the measurement of the asset or liability by the amount that otherwise would be deferred in equity. [IAS 39 para 98]. However, this is not permitted if the hedged cash flows result in the recognition of a financial asset or financial liability.

Asset revaluation reserve

17 Subsequent to initial recognition, an item of property, plant and equipment and, in certain circumstances, an intangible asset, may be revalued to fair value. However, if such an item is revalued, the whole class of asset to which that asset belongs has to be revalued. [IAS 16 para 36]. The revaluation surplus is recognised in equity, unless it reverses a decrease in the fair value of the same asset that was previously recognised as an expense, in which case it is recognised in profit or loss. [IAS 16 para 39; IAS 38 para 85]. A subsequent decrease in the fair value is charged against this reserve to the extent that there is a credit balance relating to the same asset, with the balance being recognised in profit or loss. [IAS 16 para 40; IAS 38 para 86].

18 The revaluation surplus may be transferred to retained earnings periodically, net of the tax effect. The amount realised is the difference between depreciation based on the revalued carrying amount of the asset and depreciation based on the asset's original cost. When the asset is sold or scrapped, the balance in the reserve may be transferred to retained earnings, without passing through profit or loss. [IAS 16 para 41; IAS 38 para 87].

Foreign currency translation reserve

19 Foreign currency translation differences arising from the translation of assets, liabilities, income and expenses from an entity's functional currency to presentation currency are recognised in equity in a foreign currency reserve. [IAS 21 para 39].

20 Translation adjustments must be separately tracked in equity. On disposal of a foreign entity, the cumulative translation difference relating to the entity is included in the gain or loss on sale. [IAS 21 para 48].

Retained earnings

21 Retained earnings reflect the entity's accumulated earnings less dividends paid and payable (where the conditions for recognising a dividend are met to shareholders, and transfers from other reserves as outlined above. The cumulative effect on earnings of changes in accounting policy and the correction of errors is also reflected in retained earnings. [IAS 8 paras 22-23 and 42-43; IAS 10 para 12; IAS 32 para AG13].

22 Other effects on equity arising from credits for equity-settled share-based payments, or actuarial gains and losses on defined benefit pension plans (IAS 19 para 93A) are usually dealt with in retained earnings.

Other statutory reserves

22 Entities are often also required to maintain certain types of reserves by their national legislation, for example they may be required to maintain a capital redemption reserve to the extent of the nominal value of shares that are repurchased and cancelled, in order to maintain capital. The premium above the nominal value of equity shares issued may also have to be recorded in a separate share premium account. Where such requirements exist, the reserves that are created in consequence will also form separate components of equity.

23 Where a premium is received above the nominal (par) value of shares that are classified as financial liabilities, national legal requirements may dictate that this amount should be recorded in a share premium account. Such a reserve may not be presented as a component of equity but included in financial liabilities together with the nominal (par) value of the related shares. However, presentation as financial liabilities does not disapply any statutory capital maintenance requirements applicable to those shares and their associated share premium account. Consequently, a repurchase or redemption of such shares can have an impact on equity when observing the capital maintenance requirements of national legislation.

Presentation and disclosure

Share capital

24 Disclosure requirements for share capital are found in IAS 1 (revised). These disclosures should be made for each class of share capital.

- the number of shares authorised;
- the number of shares issued and fully paid and issued but not fully paid;
- par value per share, or the fact that they have no par value;
- a reconciliation of shares outstanding at the beginning, and at the end of the year;
- the rights, preferences and restrictions attaching to each type of share;
- shares in the entity held by the entity or by its subsidiaries or associates;
- shares reserved for issue under options and contracts for the sale of shares, including the terms and amounts: and
- a reconciliation between the opening and closing balance of each class of contributed equity.

[IAS 1 paras 76, 79, 97(c), 106(d), 108].

25 IAS 1 does not define 'share capital. In our view, the disclosures apply only to share capital classified as equity. Disclosures regarding Instruments with the legal form of shares but the contractual form of liabilities are made under IFRS 7 (see separate topic summary).

Minority or non-controlling interests

26 Minority or non-controlling interests are presented in the consolidated balance sheet / statement of financial position within equity, separately from the equity of the owners of the parent. [IAS 27 para 4 and 27].

Reserves

27 In relation to each reserve (component of equity) an entity should disclose:

- a reconciliation between the opening and closing balances, separately disclosing changes resulting from
- (i) profit or loss; (ii) each item of other comprehensive income; and (iii) transactions with owners in their capacity as owners, showing separately contributions by and distributions to owners and changes in ownership interests in subsidiaries that do not result in a loss of control in a statement of changes in equity; and
- a description of its nature and purpose.

[IAS 1 paras 79(b), 106(d)].

28 IAS 1 (revised) requires that components of income are recognised either in a single statement of comprehensive income, which includes profits and losses plus income and expenses directly recognised in equity, or in two statements comprising a separate income statement and a second statement of other comprehensive income. [IAS 1 para 81].

Dividends

29 In relation to dividends an entity should disclose:

- the amount of dividends recognised as distributions to equity holders during the period, and the related amount per share;
- the amount of dividends proposed or declared before the financial statements were approved for issue but not recognised as a dividend during the period and the related amount per share; and
- the amount of any cumulative preference dividends not recognised.

[IAS 1 paras 107, 137].

30 Under the revised standard, dividends should be presented in the statement of changes in equity and not the income statement or statement of comprehensive income [IAS 1 para 107].

Capital management

31 IAS 1 requires entities to disclose information that will enable users of its financial statements to evaluate the entity's objectives, policies and processes for managing capital. [IAS 1 para 134].

Taxation

Overview

IAS 12 only deals with taxes on income, comprising current tax and deferred tax.

Current tax expense for a period is based on the taxable and deductible amounts that will be shown on the tax return for the current year. An entity recognises a liability in the balance sheet in respect of current tax expense for the current and prior periods to the extent unpaid. It recognises an asset if current tax has been overpaid.

Current tax assets and liabilities for the current and prior periods are measured at the amount expected to be paid to (recovered from) the taxation authorities, using the tax rates and tax laws that have been enacted or substantively enacted by the balance sheet date.

Tax payable based on taxable profit seldom matches the tax expense that might be expected based on pre-tax accounting profit. The mismatch can occur because IFRS recognition criteria for items of income and expense are different from the treatment of items under tax law.

Deferred tax accounting seeks to deal with this mismatch. It is based on the temporary differences between the tax base of an asset or liability and its carrying amount in the financial statements. For example, if an investment property is revalued upwards but not sold, the revaluation creates a temporary difference (the carrying amount of the asset in the financial statements is greater than the tax base of the asset), and the tax consequence is a deferred tax liability.

Deferred tax is provided in full for all temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the financial statements, except when the temporary difference arises from:

- Initial recognition of goodwill (for deferred tax liabilities only).
- Initial recognition of an asset or liability in a transaction that is not a business combination and that affects neither accounting profit nor taxable profit.
- Investments in subsidiaries, branches, associates and joint ventures, but only where certain criteria apply.

Deferred tax assets and liabilities are measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted by the balance sheet date. Discounting of deferred tax assets and liabilities is not permitted.

The measurement of deferred tax liabilities and deferred tax assets reflects the tax consequences that would follow from the manner in which the entity expects, at the balance sheet date, to recover or settle the carrying amount of its assets and liabilities. The expected manner of recovery for land with an unlimited life is always through sale. For other assets, the manner in which management expects to recover the asset (that is, through use or through sale or through a combination of both) should be considered at each balance sheet date.

Management only recognises a deferred tax asset for deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised. This also applies to deferred tax assets for unused tax losses carried forward.

Current and deferred tax is recognised in profit or loss for the period, unless the tax arises from a business combination or a transaction or event that is recognised outside profit or loss, either in other comprehensive income or directly in equity in the same or different period. The tax consequences that accompany, for example, a change in tax rates or tax laws, a reassessment of the recoverability of deferred tax assets or a change in the expected manner of recovery of an asset are recognised in profit or loss, except to the extent that they relate to items previously charged or credited outside profit or loss.

Resources

Standards and interpretations

- IAS 12, 'Income taxes'
- SIC 21, 'Income taxes – Recovery of revalued non-depreciable assets'
- SIC 25, 'Income taxes – Changes in the tax status of an entity or its shareholders'

Exposure drafts and discussion papers

- Exposure draft on income taxes

PwC views

- PwC comment letter on the Income tax exposure draft

PwC guidance

- Manual of Accounting chapter 13, Taxation

Tools practice aids and publications

- IFRS extracts from accounts

Summary of key requirements

Objective and scope

1 IAS 12, 'Income taxes', addresses the accounting for the current and future tax consequences of:

- Transactions and other events of the current period that are recognised in an entity's financial statements.

- The future recovery (settlement) of the carrying amount of assets (liabilities) that are recognised in an entity's balance sheet.

It also addresses the recognition of deferred tax assets arising from unused tax losses or unused tax credits.

2 The standard applies to accounting for income taxes – that is, taxes that are based on taxable profit. Income taxes include all domestic and foreign income taxes including foreign withholding taxes payable by a subsidiary, associate or joint venture on distributions to the reporting entity. [IAS 12 para 2].

Current taxation

Recognition of current tax

3 Current tax for the current and prior periods is, to the extent unpaid, recognised as a liability. It is recognised as an asset to the extent that the amounts already paid exceed the amount due. The benefit of a tax loss, which can be carried back to recover current tax of a prior period, is recognised as an asset. [IAS 12 paras 12, 13].

Measurement of current tax

4 Current tax assets and liabilities for the current and prior periods are measured at the amount expected to be paid to (recovered from) the taxation authorities, using the tax rates and tax laws that have been enacted or substantively enacted by the balance sheet date. [IAS 12 para 46].

Deferred taxation

Key definitions and method of calculation

Definitions

5 Some of the definitions that are key to understanding the standard are given below:

- Tax base: The tax base of an asset or liability is the amount attributed to it for tax purposes, based on the expected manner of recovery.

  An asset's tax base is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an entity when it recovers the asset's carrying amount. If those economic benefits will not be taxable, the tax base of the asset is equal to its carrying amount. [IAS 12 para 7]. The formula below may be helpful in determining the tax base of an asset.

Tax base of asset	=	Carrying amount	–	Future taxable amounts	+	Future deductible amounts

  IAS 12 focuses on the future tax consequences of recovering an asset only to the extent of its carrying amount at the balance sheet date. The future taxable amounts arising from recovery of the asset will be capped at the asset's carrying amount.

A liability's tax base is its carrying amount, less any amount that will be deductible for tax purposes in respect of that liability in future periods. In the case of revenue that is received in advance, the tax base of the resulting liability is its carrying amount, less any amount of the revenue that will not be taxable in future periods. [IAS 12 para 8]. The formula below may be helpful in determining the tax base of a liability.

Tax base of liability	=	Carrying amount	–	Future deductible amounts	+	Future taxable amounts

- Temporary difference: the difference between the carrying amount of an asset or liability and its tax base. [IAS 12 para 5]. The corresponding formulae for a temporary difference are as follows:

Temporary difference of an asset	=	Future taxable amounts	–	Future deductible amounts

Temporary difference of a liability	=	Future deductible amounts	–	Future taxable amounts

- Taxable temporary difference: a temporary difference that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled. [IAS 12 para 5].

- Deductible temporary difference: a temporary difference that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled. [IAS 12 para 5].

Calculation

6 IAS 12 adopts a balance sheet approach to income tax accounting. Deferred tax is calculated as follows:

Carrying amount of assets or liabilities	–	Tax base of assets or liabilities	=	Taxable or deductible temporary differences

Taxable or deductible temporary differences	×	Tax rate	=	Deferred tax liabilities or assets

Deferred tax assets may also arise from unused tax losses and tax credits that are carried forward for tax purposes. These are calculated as follows:

Unused tax losses or credits	×	Tax rate	=	Deferred tax assets

Recognition of deferred tax liabilities

7 Under IAS 12, deferred tax liabilities are recognised for all taxable temporary differences, except to the extent that the deferred tax liability arises from:

- The initial recognition of goodwill.
- The initial recognition of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).
- Investments in subsidiaries, branches and associates, and interests in joint ventures, where the parent, investor or venturer is able to control the timing of the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future.

[IAS 12 paras 15, 39].

8 Taxable temporary differences arise when an asset's carrying amount is greater than its tax base, or when a liability's carrying amount is less than its tax base. [IAS 12 para 5(a)]. As the entity recovers the asset's carrying amount or settles the liability, the temporary difference reverses and the entity incurs a taxable amount.

Recognition of deferred tax assets

9 A deferred tax asset is recognised for all deductible temporary differences to the extent that it is *probable* that taxable profit will be available against which the deductible temporary difference can be utilised, unless the deferred tax asset arises from the initial recognition of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss). [IAS 12 para 24].

10 However, a deferred tax asset for deductible temporary differences arising from investments in subsidiaries, branches and associates, and interests in joint ventures is only recognised to the extent that it is probable that the temporary difference will reverse in the foreseeable future and that taxable profit will be available against which the temporary differences can be utilised. [IAS 12 paras 24, 44].

11 Deductible temporary differences arise when an asset's carrying amount is less than its tax base, or when a liability's carrying amount is greater than its tax base. [IAS 12 para 5(b)]. As the entity recovers the asset's carrying amount or settles the liability, the temporary difference reverses and the entity has a deductible amount for tax purposes.

12 A deferred tax asset is recognised for the carry forward of unused tax losses and unused tax credits to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised. [IAS 12 para 34].

13 The carrying amount of deferred tax assets should be reviewed at each balance sheet date. The carrying amount is reduced to the extent that it is no longer probable that sufficient taxable profit will be available to allow the benefit of part or all of that deferred tax asset to be utilised. The recoverability of the deferred tax asset is re-assessed at each balance sheet date and adjustments are made to the carrying amount as appropriate. [IAS 12 para 56].

Measurement of deferred tax assets and liabilities

14 Deferred tax assets and liabilities are measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates and tax laws that have been enacted or substantively enacted by the balance sheet date. [IAS 12 para 47].

15 The measurement of deferred tax liabilities and deferred tax assets reflects the tax consequences that would follow from the manner in which the entity expects, at the balance sheet date, to recover or settle the carrying amount of its assets and liabilities. [IAS 12 para 51]. However, the deferred tax liabilities or deferred tax assets associated with a non-depreciable asset (such as land with an unlimited life) are measured based on the tax consequences that would follow from the sale of that asset. [SIC 21 para 5]. This is because no part of its carrying amount is expected to be recovered (that is, consumed) through use: therefore, the land's carrying amount reflects the value recoverable from its sale.

16 Deferred tax assets and liabilities should not be discounted. [IAS 12 para 53].

Tax consequences of dividends

17 In some jurisdictions, income taxes are payable at a higher or lower rate if part or all of the net profit or retained earnings is paid out as a dividend. In other jurisdictions, income taxes may be refundable or payable if part or all of the net profit or retained earnings is paid out as a dividend. In these circumstances, current and deferred tax assets and liabilities are measured at the rate applicable to undistributed profits. In other words, possible future

dividend distributions or tax refunds are not anticipated and the tax consequences of dividends are recognised when the liability to pay the dividend is recognised. [IAS 12 paras 52A, 52B].

Current and deferred tax – recognition in or outside profit or loss

18 Current and deferred tax are recognised as income or expense and included in profit or loss for the period, except to the extent that the tax arises from:

- a transaction or event that is recognised, in the same or different accounting period, outside profit or loss, either in other comprehensive income or directly in equity; or
- a business combination.

[IAS 12 para 58 as amended by IAS 1].

19 Current tax and deferred tax is recognised outside profit or loss if the tax relates to items that are recognised, in the same or a different period, outside profit or loss. Therefore, current tax and deferred tax that relates to items that are recognised, in the same or a different period:

- in other comprehensive income, are recognised in other comprehensive income; or
- directly in equity, are recognised directly in equity.

[IAS 12 para 61A as added by IAS 1].

20 Tax relating to dividends that is paid or payable to taxation authorities on behalf of the shareholders (for example, withholding tax) is charged to equity as part of the dividends. [IAS 12 para 65A].

21 Foreign currency-denominated deferred tax assets and liabilities are translated at the closing balance sheet rate, being the date at which they are measured. Exchange differences that arise on foreign currency-denominated deferred tax assets and liabilities may be included as part of the deferred tax expense (income). [IAS 12 para 78]. An alternative and more usual presentation is to include the exchange differences on deferred taxes as part of the foreign exchange gains and losses.

Presentation

22 Current tax assets and current tax liabilities are offset on the balance sheet only if the entity has a legally enforceable right to set off the recognised amounts and intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously. [IAS 12 para 71].

23 Deferred tax assets and deferred tax liabilities are offset on the balance sheet only if the entity has a legally enforceable right to set off current tax assets against current tax liabilities and they are levied by the same taxation authority on either:

- the same taxable entity; or
- different taxable entities that intend either to settle current tax liabilities and assets on a net basis, or to realise the assets and settle the liabilities simultaneously, in each future period in which significant amounts of deferred tax liabilities or assets are expected to be settled or recovered.

[IAS 12 para 74].

24 The tax expense (income) related to the profit or loss is presented on the face of the statement of comprehensive income (or income statement, if presented separately). [IAS 12 para 77].

25 Liabilities and assets for current tax are presented separately on the face of the balance sheet. [IAS 1 para 54(n)].

26 Deferred tax liabilities and deferred tax assets are presented separately on the face of the balance sheet and are always classified as non-current. [IAS 1 para 54(o), 56].

Disclosure

27 IAS 12 requires certain information to be disclosed to allow the reader to understand the factors that have impacted income tax in the current period and those that may impact income tax in future periods. The following should be disclosed:

- The major components of the tax expense (income).
- The amount of income tax relating to each component of other comprehensive income.
- The aggregate current and deferred tax relating to items recognised directly in equity.
- An explanation of the relationship between tax expense (income) and the tax that would be expected by applying the applicable tax rate to accounting profit or loss (this can be presented as a reconciliation of amounts of tax or a reconciliation of the rate of tax).
- Changes in tax rates.
- Amounts (and expiry date, if any) of deductible temporary differences, unused tax losses and unused tax credits for which no deferred tax has been recognised.
- The aggregate amount of temporary differences associated with investments in subsidiaries, branches and associates and interest in joint ventures for which deferred tax liabilities have not been recognised.
- For each type of temporary difference and unused tax loss and credit, the amount of deferred tax assets or liabilities recognised in the balance sheet and the amount of deferred tax income or expense recognised in profit or loss.
- Tax relating to discontinued operations.
- Tax consequences of post-balance-sheet dividends.
- The amount and nature of evidence supporting recognition of deferred tax assets in respect of loss-making entities.

- In the circumstances described in paragraph 2.17 above, the nature and amount (where practicably determinable) of the potential tax consequences that would result from the payment of dividends to shareholders.
- For annual periods beginning on or after 1 July 2009, entities are required to give disclosures in respect of deferred tax assets relating to business combinations.

[IAS 12 paras 79 to 82A].

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