
*Manual of
accounting*
IFRS for the UK 2012

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Global harmonisation — IFRS and US GAAP

1.5 Global harmonisation, then, is what the IASB is all about. But true global harmonisation would include not only the impressive array of countries just mentioned but also the USA. The IASB cannot claim to be *the* global standard setter as long as the FASB sets rules for the US markets.

1.6 Things started to change, first, with the IASB/FASB ‘Norwalk Agreement’ of 2002; and then with the announcement in July 2007 by the US SEC of two important initiatives relating to US GAAP and IFRS. The first was that, at the end of 2007, the SEC introduced a new rule dropping the ‘US GAAP reconciliation’ – that is, the reconciliation required to be given by foreign private issuers (FPIs) from home country GAAP, which is often IFRS, to US GAAP. These reconciliations were a cost and burden to FPIs and yet the general view was that hardly any use is made of them by investors or others. We should note, however, that the SEC said that the home country GAAP – the principal financial reporting convention – should be IFRS as issued by the IASB, not another variant of IFRS.

1.7 This alone was a big step, but the second part of the July 2007 announcement was potentially more far-reaching. The second development was that the SEC proposed that IFRS might be permissible in the US markets as an alternative to US GAAP. The timescale is extended. At the time, they indicated that the decision might be confirmed in 2011, with implementation perhaps as soon as 2014, though potentially later, and subject to various conditions. A formal announcement from the SEC is still expected at the end of 2011. In the meantime, an SEC staff announcement in May 2011 may give us some clues. The staff outlined a possible approach, which was termed ‘condorsement’, evidently a mixture of convergence and endorsement. The SEC and FASB would remain in place with authority to set standards for the US markets, but US GAAP and IFRS would gradually converge such that, in time, the two would be similar or the same. Whether it will emerge in this way can only be, at this stage, a matter of speculation.

1.8 Many questions arise from these potential developments:

- Given their years of reliance on detailed prescription under US GAAP, how easy would US accountants find the change to IFRS?
- Would US GAAP survive at all in the medium and longer-term?
- Would the US influence on the IASB increase, as the US would be a major constituency? Would the IASB still have convergence with US GAAP as an objective, or would it be just the FASB that had an objective of convergence?
- What attitude will the SEC take to the enforcement and interpretation of IFRS and what will be the implications of this for the rest of the world?

■ What does this mean for the complexity and degree of prescription in the IFRS of the future? It will be some years before the answers to these questions become clear.

1.9 Co-operation between the two boards has increased since 2007, with frequent joint board meetings, adoption of the same standards in some areas (for example, operating segments, business combinations) and joint working towards convergence on other subjects, such as financial instruments and revenue recognition. Nevertheless, the boards do not always agree, as the current different proposals on financial instruments show. Despite this, the boards are working towards completion of what are now called ‘the big four’ – revenue, leasing, financial instruments and insurance. The objective had been to finish these converged standards by June 2011 – not least as that was the date when Sir David Tweedie handed over to the new IASB chairman, Hans Hoogervorst. However, the complexities and disagreements were such that none of the four were finished and indeed the new IASB board has announced that revenue and leasing will be re-exposed before they are finalised.

1.10 It is perhaps too early to tell to what extent the change of chairman will herald a change of strategy. An early sign lies in the IASB’s July 2011 formal public consultation on its work programme. This is a first. It is also quite possible that the new chairman will see convergence with US GAAP as being less important than did his predecessor.

1.11 The close co-operation with the FASB and the SEC’s recent move towards introducing IFRS into the USA seem to be steps that should be welcomed as the final stages of global harmonisation of accounting. If only it were so straightforward. Certainly, the Norwalk Agreement was strategically a highly important step to harmonise accounting around the world. For a year or two after the Agreement was made in 2002, it seemed so obviously right that to challenge its basis would have been heretical. More recently, that view has started to change. As the world has seen more of the effects of harmonisation, it has begun to ask whether incorporating aspects of US GAAP into IFRS is actually the good idea that it seemed. This is not to say that harmonisation has been a one-way track. Indeed there are many examples where the FASB is changing its standards to adopt IFRS solutions. But despite that, there is a perception that IFRS is suffering from two things: first, the importing of specific US rules and secondly the adoption of US-style detailed prescription. The US has been setting detailed accounting rules for over 70 years and recent decades have witnessed more and more detailed rules being written in response to the combination of a complex business environment and a litigious society. US GAAP may not be perfect, but it does suit the US environment – where it is written essentially for listed (that is, SEC-registered) companies. Hence, a problem with IFRS/US GAAP harmonisation is that US GAAP is in danger of being exported, *via* IFRS, to many countries that have a different business environment to the USA, have smaller economies and a smaller accounting infrastructure. In many of those countries it is often being applied across the whole economy, not just to the listed

sector. So, there is a potential problem of unsuitability of standards for the contexts in which they are being applied. It is important, therefore, that the IASB remembers that convergence with US GAAP, although an important objective, should not be carried out in such a way as to make its standards unsuitable for its widespread and varied constituency.

1.12 In this regard, the IASB's recent work on developing a form of IFRS for small and medium-sized entities (SMEs) is particularly important. The IFRS for SMEs was published in July 2009 and is intended, despite its somewhat inaccurate name, for those entities that are not publicly accountable. It is up to each country to decide whether to use IFRS for SMEs, and when; and to decide to whom it would apply or be available. In comparison with full IFRS, the IFRS for SMEs has somewhat simplified recognition and measurement rules and reduced disclosures. A number of territories have adopted full IFRS for the whole economy and are finding it overly complex for the non-publicly-accountable sector. Hence, they have welcomed the IFRS for SMEs. Early signs are encouraging though it is too early to say exactly how many countries will use it. But in principle it allows the IASB to offer to a vast number of companies world-wide a set of standards in a form that is suitable to their scale and sophistication. The IFRS for SMEs may also be useful at the national level. That is, some countries may not want to adopt, in place of national GAAP, the full rigours of IFRS, but may consider that IFRS for SMEs is suitable for the unlisted sector to which national GAAP often applies. So, while the world's listed and public interest companies will stay with, or adopt full IFRS, there is likely to be a much bigger adoption, measured by number of companies, of IFRS for SMEs.

The EU and politics

1.13 The EU Regulation of 2002 required listed groups to prepare their consolidated financial statements using IFRS for periods commencing on or after 1 January 2005. The Regulation introduced a permissive regime for other entities. As noted above, this regulation was a major step for Europe and for the IASB – as well as being an encouragement for other territories to adopt IFRS. EU adoption of IFRS is good news for harmonisation, but with an important proviso. The EU needs to bring IFRSs into EU law and it cannot do so without a formal process of adoption. To achieve this, it has developed a complex 'endorsement mechanism'. This comprises the Commission; an official Accounting Regulatory Committee (ARC); and a private sector body – the European Financial Reporting Advisory Group (EFRAG) – which works with the IASB to ensure full understanding of the European viewpoint and advises the Commission and the ARC.

1.14 The endorsement mechanism is proving to be, at best, a mixed blessing. Most of the IASB's standards have been endorsed, though IAS 39, 'Financial instruments: Recognition and measurement', was not endorsed in full. After a lengthy process that owed more to politics than to accounting, a so-called 'carve-out' version of IAS 39 was approved. That is, the November 2004 EU-endorsed

version of IAS 39 excluded a few paragraphs to which some EU banks objected. These paragraphs are a small part of only one standard, but politically they are highly significant, as they show that the IASB cannot take EU-endorsement for granted. Politically, the process is highly significant as it introduces the prospect that, with one or more future standards, there may emerge a more fundamental difference between EU-IFRS and IFRS as promulgated by the IASB.

1.15 The second effect of the EU endorsement process is that it introduces delay and uncertainty. It has tended to take about six to ten months, after a standard has been finalised by the IASB, for it to be endorsed by the EU. This makes it difficult for companies to know whether a particular new or amended standard, or interpretation from the IFRS IC, will be endorsed and available to be applied at an imminent year end.

1.16 In a broader context, politics and accounting – for long only occasional bedfellows – have been interacting more since 2009. Specifically, the G20 heads of state and finance ministers have taken an interest in accounting, as part of their work on trying to stabilise the global financial system. They have put pressure on the IASB and the FASB to accelerate their work on improving and simplifying IAS 32, 'Financial instruments: Presentation', and IAS 39. A result of this is that the two boards are working hard on the reform of financial instrument accounting – but doing so in bits. Papers appear on fair value measurement; then on classification and measurement; then on impairment; then on hedge accounting; and so on. This is far from ideal, as the pieces of the jigsaw interact in complex ways. Certainly the process of improving these standards is taking longer than the G20 had in mind.

Preparers and users of financial statements

1.17 Looking back on first-time adoption in the EU and elsewhere, we can see that experience with the new IFRS information has been mixed. Some analysts were, inevitably, better prepared than others. Some company finance teams had prepared better than others. Some companies were affected more fundamentally than others. Companies are required by the first-time adoption rules in IFRS 1 to publish reconciliations of profit and net assets as between national GAAP and IFRS. For many companies, the aspects of converting to IFRS that had the biggest numerical impact on profit measurement were goodwill (no longer having an amortisation charge) and share-based payment (starting to have an IFRS 2 charge against profits). A lot of companies were affected by IASs 32 and 39 on financial instruments, especially in the banking and insurance sectors. Other subjects were more of a surprise. For example, there were more implementation problems and profit and balance sheet effects arising out of lease accounting and foreign currency rules than had been expected. All this is starting to read like history for countries that adopted IFRS in 2005. But countries in the next wave of transitioning territories are now starting to encounter the same issues. They are, at least, better off in that they can learn from the experience of the 2005-wave of transitions.

1.18 But an important distinction can be seen overall between the attitudes of preparers and users. Experience in the EU has been that finance directors and other preparers were relatively negative towards IFRS in the sense that they saw considerable cost and work in performing the conversion; and they saw a result that was different rather than better. Some preparers took the view that the results under IFRS were not as realistic a representation of underlying performance as under national GAAP. Users – fund managers, analysts and others – were more positive. They did not directly incur the costs and the work of conversion, though they did have to become familiar with a new GAAP. But they see the fruits of harmonisation much more than preparers do, as they are the beneficiaries of comparable information for the economy, or for the sector that they follow. A trend of the last three years is that of user groups becoming much more involved in the standard-setting process. A leading example of this is the Corporate Reporting User Forum (CRUF).

1.19 This is not to say, however, that standard setters and companies are giving users exactly what they want. Accounting information is intended to be useful to users of financial statements in making economic decisions. But the recent and imminent reforms will bring new challenges as well as new information. Something of a polarity is already noticeable. Three examples illustrate this. First, standard-setters are working towards a more comprehensive notion of performance, incorporating both transaction-based realised profits and a wider range of value changes than before. Both of those elements of performance will display volatility. At the same time, companies want to give analysts, and analysts seemingly want to receive, information that is (a) close to cash flows and (b) stable and useful as a predictor of future results. Hence the popularity of EBITDA and ‘adjusted earnings’ and ‘adjusted EPS’ of different types. Numbers of this type are perfectly valid, but need to be placed in context; it is important that they are not given more prominence than the GAAP numbers.

1.20 A second example where standard-setters and users are not aligned is in the vexed area of fair value accounting. Some of the thinking and proposals by the IASB and FASB in the last three years suggest that the standard-setters are pursuing a medium and longer-term agenda of more fair value information. Yet this is not necessarily what many users want. Certainly, users are interested in fair value information for many assets and liabilities, but this does not, from their point of view, need to be on the balance sheet: some can be given adequately in the footnotes. At an extreme, if all assets and liabilities, including inherent goodwill, were to be fair valued, the result might, in principle, be the value of the entity. But most users would balk at this, saying that it is their job to value the entity and its shares, not the role of accounting information to do so. Of course, this extreme is highly unlikely to be reached in reality, due to limits on what assets and liabilities can be recognised and on what can be valued satisfactorily.

1.21 The third example is the extent of disclosure. The increasing level of disclosure required by IFRS, together with other factors, has led to annual reports becoming longer and longer. This is a concern to those who have to prepare financial statements. Conversely, analysts seem to want more and more

information and new accounting standards push practice in the same direction. But the growing list of disclosures is a concern to the IASB. They commissioned a study in 2011 that was carried out jointly by the Scottish and New Zealand Institutes of Chartered Accountants. The report – ‘Losing the excess baggage – reducing disclosures in financial statements to what’s important’ – was published in August 2011. Their conclusion was that as much as 30 per cent of the content of financial statements could be deleted without serious consequences.

Conclusion

1.22 The adoption of IFRS reporting has given rise to new challenges both as regards the accounting principles (recognition and measurement) and matters of presentation and disclosure. IFRS is used increasingly by companies throughout the world. It is important that the interpretation and application of IFRS is consistent from country to country. We hope that this Manual will be helpful to those wishing to understand IFRS and its consistent, practical application. For the avoidance of doubt, this Manual deals with full IFRS, not IFRS for SMEs.

1.23 The PricewaterhouseCoopers’ Manual of Accounting – Financial Instruments forms part of this Manual of Accounting but is now published in a separate book, which accompanies this Manual.

UK.1.24 Throughout this book paragraphs styled like this have been added to the text to explain the implications of the guidance for UK companies and groups that adopt IFRS. These additional paragraphs often cover the rules that UK companies and groups have also to comply with that are included primarily in the Companies Act 2006 and the FSA’s Listing Rules.

UK.1.25 The PricewaterhouseCoopers’ Manual of Accounting – Narrative Reporting supports this manual by providing UK companies with guidance on the ‘front half’ of the financial statements.

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Accounting principles and applicability of IFRS

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Accounting principles and applicability of IFRS

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Chapter 2

Accounting principles and applicability of IFRS

Introduction

2.1 This chapter introduces the concepts underlying accounting practices that are discussed in greater detail throughout this book as they relate to particular accounting issues and problems. These concepts are set out under IFRS in the IASB's 'Conceptual Framework for Financial Reporting' issued in September 2010 (the Framework). It supersedes the 'Framework for the preparation and presentation of financial statements' (the Framework (1989)).

GAAP in the UK

The composition of GAAP in the UK

UK.2.1.2 The components of GAAP in the UK vary according to the type of company or entity. However, generally there are components that are mandatory (in law or in practice) and components that are not mandatory. The core mandatory components are set out in the following paragraphs.

UK.2.1.3 For those companies applying IFRS, GAAP in the UK is:

- The Companies Act 2006, insofar as it applies to entities adopting IFRS (see from para UK.2.1.38).
- Accounting standards that have been adopted by the EU (see from para 2.10.54). These standards are some or all of the following:
 - International Accounting Standards (IASs).
 - International Financial Reporting Standards (IFRSs).
- Interpretations that have been adopted by the EU. That is:
 - Interpretations developed originally by the Standing Interpretations Committee (SIC).
 - Interpretations issued by the International Financial Reporting Interpretations Committee (IFRIC).
- For listed companies, the Listing Rules and the Disclosure and Transparency Rules.

UK.2.1.3.1 The IASB has also published IFRS for Small and Medium-sized Entities (SMEs). This is a standalone suite of standards tailored for non publicly accountable entities as opposed to a standard within the sphere of the

main IFRS framework. IFRS for SMEs is not currently available for UK companies preparing financial statements under IFRS. See further from paragraph 2.5.1.

UK.2.1.4 Other components of GAAP in the UK for those applying IFRS will be authoritative to varying degrees but non-mandatory. These include:

- The IASB's Framework. The Framework does not have the status of an accounting standard. Nevertheless, it is authoritative in two senses. First, it provides a frame of reference to guide the IASB in its development of standards. It should help guide companies and auditors as to the meaning and intention of individual standards if they are unclear. Secondly, the Framework provides a reference for the accounting treatment of transactions for which there is no specific GAAP.
- Statements issued by the ASB that are relevant for UK companies reporting under IFRS.
- Statements and recommendations from the professional bodies, such as ICAEW Technical Releases and accounting recommendations. Professional bodies' accounting-related statements are unlikely to address the interpretation of IFRS, but they will still be relevant in the context of company law issues.
- Established practice. Practices that are generally accepted, even though not codified in official literature, can be regarded as part of GAAP in the UK. An example of this is the guidance in this Manual of Accounting.

UK.2.1.5 UK Financial Reporting Standards (FRSs) and Statements of Standard Accounting Practice (SSAPs) do not apply to entities using IFRS. However, IAS 8, 'Accounting policies, changes in accounting estimates and errors', contains guidance on the selection of accounting policies. In the hierarchy of selection, management should first consider IFRSs and interpretations of IFRSs. If there is no standard or interpretation in the relevant area, management should develop a policy that addresses the decision-making needs of users and that is reliable. [IAS 8 para 10].

UK.2.1.6 In doing so, the entity should consider (in this order):

- Requirements and guidance in other international standards and interpretations dealing with similar issues.
- The content of the IASB's Framework (see from para 2.1.1).

[IAS 8 para 11].

UK.2.1.7 After referring to the items in paragraph UK.2.1.6, management may consider the pronouncements of other standard-setting bodies that use a similar conceptual framework to the IASB's, other accounting literature (such as this Manual of Accounting) and industry practices, as long as they do not

conflict with the sources of guidance outlined in paragraph UK.2.1.6. [IAS 8 para 12].

UK.2.1.8 Some FRSs and SSAPs may address topics not covered by IFRSs and serve as a reference where IFRSs are silent.

UK.2.1.9 Certain industry groups in the UK develop Statements of Recommended Practice ('SORPs'). These give guidance on the application of accounting standards to specialised industries and non-profit-making sectors. SORPs cannot override the requirements of IFRS. However, the SORP may fit into the hierarchy for selecting accounting policies (see para UK.2.1.5) as additional guidance in areas that are not covered by IFRS, as long as that guidance does not contradict IFRS, interpretations of IFRSs or the Framework.

UK.2.1.10 The sectors for which SORPs are in issue are:

- Authorised funds.
- Charities.
- Further and higher education institutions.
- Insurance.
- Investment trusts.
- Local authorities.
- Oil and gas.
- Pension schemes.
- Registered social landlords.
- Unit trusts.
- Leasing.
- Open-ended investment companies (OEICs).
- Limited liability partnerships.

UK.2.1.11 The output of the Financial Reporting Review Panel (FRRP), the enforcer of financial reporting in the UK, constitutes part of GAAP in the UK. The FRRP does not issue rules but announces its findings in relation to individual companies or groups and makes statements of more general application (see from para UK.2.1.65). These companies generally change their accounting practices or give additional disclosure, following discussion with the FRRP. The FRRP usually issues formal statements only where companies have deviated from existing requirements of UK company law or accounting standards. However, in some cases, the FRRP's views have added to, or modified, the previous understanding of UK GAAP and IFRS. Companies and auditors should take heed of the FRRP announcements.

[The next paragraph is UK.2.1.13.]

Applicability of IFRS in the UK

EU Regulation on IFRS

UK.2.1.13 All listed companies in the EU (including banks and insurance companies) have been required to prepare consolidated financial statements under EU-adopted IFRS since financial years beginning on or after 1 January 2005 under the 'EU 2005 Regulation'. The Regulation permits Member States to extend the requirement to use IFRS to unlisted groups and to individual company financial statements (see from para UK.2.1.20 onwards) and the UK permits this.

UK.2.1.14 Listed companies in this context means any companies that, at the balance sheet date, have securities admitted to trading on a regulated market of any member state. Securities in this context include debt as well as shares.

UK.2.1.15 Regulated markets in the UK are the following:

- London Stock Exchange – Regulated Market
- The London Metal Exchange
- ICE Futures Europe
- SWX Europe Limited
- The London International Financial Futures and Options Exchange (LIFFE)
- EDX
- PLUS-listed Market

UK.2.1.16 AIM is not included in the above list, because it ceased to be a 'regulated market' in 2004. AIM companies are not subject to the EU 2005 Regulation that requires them to prepare financial statements under IFRS. However, the AIM rules require companies that have subsidiaries and are incorporated in any EEA member state, the Isle of Man or the Channel Islands to apply EU-adopted IFRS.

UK.2.1.17 The 2005 Regulation applies to the *consolidated* financial statements of entities with securities admitted to trading on a regulated market. Entities should first examine whether they are required to prepare consolidated financial statements under the 7th Directive, set out in UK law in sections 399 to 403 of the Companies Act 2006 and described in chapter 24. Entities that are not required to prepare such financial statements under EU law are outside the Regulation's scope. This is the case whether or not IFRS would require consolidated financial statements.

UK.2.1.18 The 7th Directive sets out certain exclusions from consolidation (transposed to UK law in sections 402 and 405 of the Companies Act 2006). However, these exclusions are not relevant to companies to whom the 2005 Regulation applies. Adopted IFRSs will set out the scope of the consolidated financial statements – that is, which entities should be included and how they should be accounted for. [EU clarification para 2.2.2(c)].

UK.2.1.19 The scope of the 2005 Regulation applies only to companies governed by a law of a Member State. This means that, for example, a US company that has a listing on the London Stock Exchange does not have to prepare consolidated financial statements under IFRS.

Extension of the EU Regulation

UK.2.1.20 The EU 2005 Regulation allows Member States to extend the requirement to use IFRS to unlisted groups and to individual company financial statements. All UK companies (except charitable companies) and building societies are permitted to use EU-adopted IFRS in their individual and/or consolidated financial statements. However, there are some restrictions and conditions:

- Once a company has prepared its financial statements under EU-adopted IFRS, it cannot revert to UK GAAP in a later financial year, unless there is a 'relevant change in circumstance'. A relevant change in circumstance occurs if the company becomes a subsidiary of an undertaking that is not preparing its individual financial statements under EU-adopted IFRS or if the company (or its parent) ceases to have its securities traded on a regulated market. [CA06 Sec 395(3)].
- A parent company may elect to prepare its individual financial statements under UK GAAP even if it uses EU-adopted IFRS in its consolidated financial statements.
- Where the parent company prepares group accounts, the directors of the parent company have a responsibility to ensure that all UK subsidiaries in the same group adopt the same accounting framework as each other, unless there are 'good reasons' not to do so. The parent should ensure that all UK companies in the group use either EU-adopted IFRS or UK GAAP. However, where a parent adopts EU-adopted IFRS in both its consolidated financial statements and its individual financial statements, it will not be required to ensure that all its subsidiaries use EU-adopted IFRS too. [CA06 Sec 407(5)]. The Department for Business, Innovation and Skills (the BIS) issued guidance notes on these rules, including an explanation of when there might be 'good reasons' (see para UK.2.1.21).
- Building societies are subject to the same requirements as companies in that they have the option of adopting IFRS in their individual and consolidated financial statements.

- Charitable companies may not prepare financial statements under IFRS. IFRS does not specifically address charity sector transactions and the government believes that the direct application of IFRS without modification through a SORP might create 'interpretational issues'. In addition, there are no plans to permit unincorporated charities to use IFRS.

UK.2.1.21 The BIS has issued guidance to help companies apply these rules. These include an explanation of where there might be 'good reasons' for the directors not to prepare all the individual financial statements within a group by using the same accounting framework. The provision allows a degree of flexibility where there are genuine, including cost/benefit, grounds for not using the same framework. Such reasons include:

- An IFRS group acquires a subsidiary that does not use IFRS. In the year of acquisition, it might not be practicable for the newly-acquired subsidiary to move to IFRS straight away.
- A group might include subsidiaries that are themselves publicly traded. In this case, market pressures or regulatory requirements to use IFRS might come into play, without necessarily justifying a move to IFRS by the non-publicly traded subsidiaries.
- Where a subsidiary or a parent is planning to list and might wish to convert to IFRS in advance, but the rest of the group is not intending to list.
- The group might include small subsidiaries where the cost of moving to IFRS might outweigh the benefits.

If the parent's directors adopt a different framework for any entities within the group, they should be able to justify any inconsistency to shareholders, regulators or other interested parties.

UK.2.1.22 The BIS guidance does not mention tax as a 'good reason' for adopting a different framework for one or more UK subsidiaries within a group. In commercial terms tax is a business cost like any other. We have sought advice from legal counsel as to whether tax may be a good reason. The question is one of degree, depends on individual facts and circumstances, and the directors must weigh up various matters in reaching their conclusion.

UK.2.1.23 In the case of existing arrangements or structures, where a transition from UK GAAP to EU-adopted IFRS would result in a significant increase or potential volatility in taxable profits, or a significant acceleration of tax cash outflows, or introduce a significant new tax exposure, compared with the company continuing to use UK GAAP, the tax consequences may be a 'good reason' to keep one or more subsidiaries on UK GAAP. For example, a company's revenue recognition might be accelerated under IFRS, accelerating tax payments. 'Significant' in this context might be in absolute terms or relative

to the company's size. A trivial tax effect should not be used as an excuse to keep a company on UK GAAP. Similarly, if, as a result of a company using EU-adopted IFRS, the group could no longer claim the benefits of existing tax planning (or the benefits would be significantly reduced or new tax risks would arise under EU-adopted IFRS such that the planning would not have been entered into with companies using EU-adopted IFRS) the tax effect of using EU-adopted IFRS may be a good reason for one or more subsidiaries to remain on UK GAAP. However, as noted above it is also necessary to weigh up other matters in reaching the conclusion on whether tax may be a good reason such as comparability with the rest of the group.

UK.2.1.23.1 In contrast, where the accounting frameworks of subsidiaries in a group are currently aligned, the burden of proof to justify departing from this situation is more onerous. The main purpose of having aligned accounting frameworks is to enable shareholders (amongst other interested parties) to understand the accounts and compare them with the accounts of other companies in the group. In considering whether there are good reasons to adopt different accounting frameworks, the directors must ask how obscure or difficult to understand different accounting frameworks would make the accounts in comparison to the rest of the group. Other factors include how certain it is that any tax planning arrangements put in place will lead to tax benefit, the size of any ensuing tax saving and reputational risk.

UK.2.1.24 Individual companies prepare either 'Companies Act individual financial statements' or 'IAS individual financial statements'. A group's consolidated financial statements are prepared as 'Companies Act consolidated financial statements' or 'IAS consolidated financial statements'. Schedules 1 and 6 of SI 2008/410, 'The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008', apply to 'Companies Act individual financial statements' and 'Companies Act consolidated financial statements' respectively. Those schedules do not apply to 'IAS individual financial statements' or 'IAS consolidated financial statements'. However, the basic requirement to prepare financial statements, including the circumstances in which consolidated financial statement are required, as well as the requirements on audit, approval, distribution and filing, continue to apply to all companies (see from para UK.2.1.38).

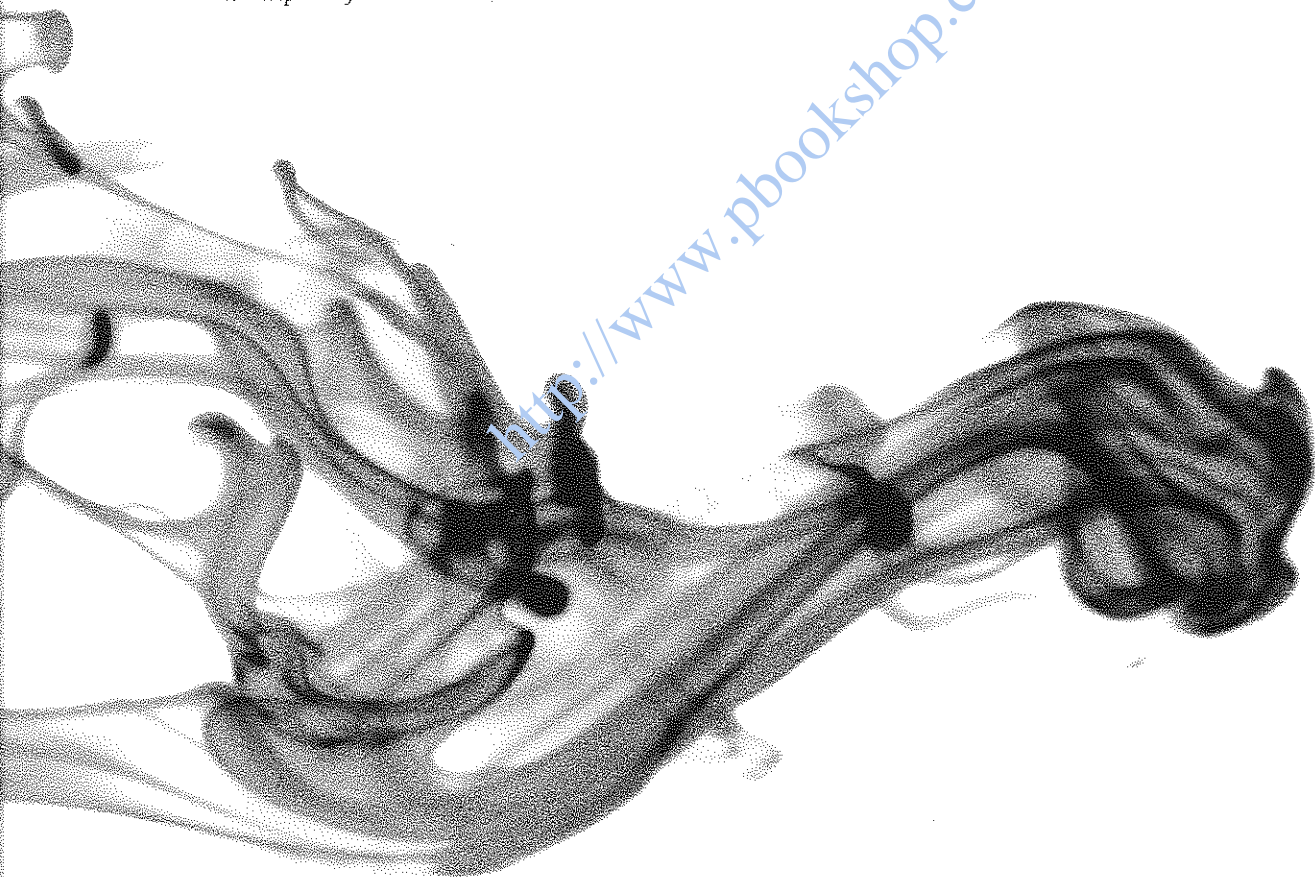
UK.2.1.25 Although the government has allowed a free choice for companies over IFRS adoption, within the limits described, there are other parties (such as regulators) that may force adoption or limit it.

UK.2.1.26 The requirements and options to prepare financial statements under UK GAAP or IFRS are considered in the next section.

*UK illustrative
financial statements*
for 2011 year ends

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(All amounts in £ thousands unless otherwise stated)

- (d) the date as at which it plans to apply it initially, and
 (e) either:
 (i) a discussion of the impact that initial application of the IFRS is expected to have on the entity's financial statements, or
 (ii) if that impact is not known or reasonably estimable, a statement to that effect.

11. Our view is that disclosures in the paragraph above are not necessary in respect of standards and interpretations that are clearly not applicable to the entity (for example industry-specific standards) or that are not expected to have a material effect on the entity. Instead, disclosure should be given in respect of the developments that are, or could be, significant to the entity. Management will need to apply judgement in determining whether a standard is expected to have a material effect. The assessment of materiality should consider the impact both on previous transactions and financial position and on reasonably foreseeable future transactions. For pronouncements where there is an option that could have an impact on the entity, the management expectation on whether the entity will use the option should be disclosed.

Disclosures not illustrated in IFRS GAAP plc financial statements

For disclosures relating to IAS 29, 'Financial reporting in hyperinflationary economies' and IFRS 6, 'Exploration for and evaluation of mineral resources', please refer to PwC's *IFRS disclosure checklist 2011*.

3 Financial risk management

Group

3.1 Financial risk factors

IFRS7p31 The group's activities expose it to a variety of financial risks: market risk (including currency risk, fair value interest rate risk, cash flow interest rate risk and price risk), credit risk and liquidity risk. The group's overall risk management programme focuses on the unpredictability of financial markets and seeks to minimise potential adverse effects on the group's financial performance. The group uses derivative financial instruments to hedge certain risk exposures.

Risk management is carried out by a central treasury department (group treasury) under policies approved by the board of directors. Group treasury identifies, evaluates and hedges financial risks in close co-operation with the group's operating units. The board provides written principles for overall risk management, as well as written policies covering specific areas, such as foreign exchange risk, interest rate risk, credit risk, use of derivative financial instruments and non-derivative financial instruments, and investment of excess liquidity.

(a) Market risk

(i) Foreign exchange risk

IFRS7 p33(a) The group operates internationally and is exposed to foreign exchange risk arising from various currency exposures, primarily with respect to the US dollar and the UK pound. Foreign exchange risk arises from future commercial transactions, recognised assets and liabilities and net investments in foreign operations.

IFRS7 p33(b), 22(c) Management has set up a policy to require group companies to manage their foreign exchange risk against their functional currency. The group companies are required to hedge their entire foreign exchange risk exposure with the group treasury. To manage their foreign exchange risk arising from future commercial transactions and recognised assets and liabilities, entities in the group use forward contracts, transacted with group treasury. Foreign exchange risk arises when future commercial transactions or recognised assets or liabilities are denominated in a currency that is not the entity's functional currency.

IFRS7 p22(c) The group treasury's risk management policy is to hedge between 75% and 100% of anticipated cash flows (mainly export sales and purchase of inventory) in each major foreign currency for the subsequent 12 months. Approximately 90% (2010: 95%) of projected sales in each major currency qualify as 'highly probable' forecast transactions for hedge accounting purposes.

**IFRS7 p33(a)(b)
IFRS7 p22(c)** The group has certain investments in foreign operations, whose net assets are exposed to foreign currency translation risk. Currency exposure arising from the net assets of the group's foreign operations is managed primarily through borrowings denominated in the relevant foreign currencies.

**IFRS7p40
IFRS7IG36** At 31 December 2011, if the currency had weakened/strengthened by 11% against the US dollar with all other variables held constant, post-tax profit for the year would have been £362 (2010: £51) higher/lower, mainly as a result of foreign exchange gains/losses on translation of US dollar-denominated trade receivables, financial assets at fair value through profit or loss, debt securities classified as available-for-sale and foreign exchange losses/gains on translation of US dollar-denominated borrowings. Profit is more sensitive to movement in currency/US dollar exchange rates in 2011 than 2010 because of the increased amount of US dollar-denominated borrowings. Similarly, the impact on equity would have been £6,850 (2010: £6,650) higher/ lower due to an increase in the volume of cash flow hedging in US dollars.

(All amounts in C thousands unless otherwise stated)

At 31 December 2011, if the currency had weakened/strengthened by 4% against the UK pound with all other variables held constant, post-tax profit for the year would have been C135 (2010: C172) lower/higher, mainly as a result of foreign exchange gains/losses on translation of UK pound-denominated trade receivables, financial assets at fair value through profit or loss, debt securities classified as available-for-sale and foreign exchange losses/gains on translation of UK pound-denominated borrowings.

(ii) Price risk

IFRS7
p33(a)(b)

The group is exposed to equity securities price risk because of investments held by the group and classified on the consolidated balance sheet either as available-for-sale or at fair value through profit or loss. The group is not exposed to commodity price risk. To manage its price risk arising from investments in equity securities, the group diversifies its portfolio. Diversification of the portfolio is done in accordance with the limits set by the group.

The group's investments in equity of other entities that are publicly traded are included in one of the following three equity indexes: DAX equity index, Dow Jones equity index and FTSE 100 UK equity index.

IFRS7p40
IFRS7IG36

The table below summarises the impact of increases/decreases of the three equity indexes on the group's post-tax profit for the year and on equity. The analysis is based on the assumption that the equity indexes had increased/decreased by 5% with all other variables held constant and all the group's equity instruments moved according to the historical correlation with the index:

Index	Impact on post-tax profit in C		Impact on other components of equity in C	
	2011	2010	2011	2010
DAX	200	120	290	290
Dow Jones	150	120	200	70
FTSE 100 UK	60	30	160	150

Post-tax profit for the year would increase/decrease as a result of gains/losses on equity securities classified as at fair value through profit or loss. Other components of equity would increase/ decrease as a result of gains/losses on equity securities classified as available for sale.

(iii) Cash flow and fair value interest rate risk

IFRS7p33
(a)(b).
IFRS7p22(c)

The group's interest rate risk arises from long-term borrowings. Borrowings issued at variable rates expose the group to cash flow interest rate risk which is partially offset by cash held at variable rates. Borrowings issued at fixed rates expose the group to fair value interest rate risk. Group policy is to maintain approximately 60% of its borrowings in fixed rate instruments. During 2011 and 2010, the group's borrowings at variable rate were denominated in the Currency and the UK pound.

IFRS7p22(b)(c) The group analyses its interest rate exposure on a dynamic basis. Various scenarios are simulated taking into consideration refinancing, renewal of existing positions, alternative financing and hedging. Based on these scenarios, the group calculates the impact on profit and loss of a defined interest rate shift. For each simulation, the same interest rate shift is used for all currencies. The scenarios are run only for liabilities that represent the major interest-bearing positions.

Based on the simulations performed, the impact on post tax profit of a 0.1% shift would be a maximum increase of C41 (2010: C37) or decrease of C34 (2010: C29), respectively. The simulation is done on a quarterly basis to verify that the maximum loss potential is within the limit given by the management.

IFRS7p22(b)(c) Based on the various scenarios, the group manages its cash flow interest rate risk by using floating-to-fixed interest rate swaps. Such interest rate swaps have the economic effect of converting borrowings from floating rates to fixed rates. Generally, the group raises long-term borrowings at floating rates and swaps them into fixed rates that are lower than those available if the group borrowed at fixed rates directly. Under the interest rate swaps, the group agrees with other parties to exchange, at specified intervals (primarily quarterly), the difference between fixed contract rates and floating-rate interest amounts calculated by reference to the agreed notional amounts.

IFRS7p22(b)(c) Occasionally the group also enters into fixed-to-floating interest rate swaps to hedge the fair value interest rate risk arising where it has borrowed at fixed rates in excess of the 60% target.

IFRS7p40
IFRS7IG36

At 31 December 2011, if interest rates on Currency-denominated borrowings had been 10 basis points higher/lower with all other variables held constant, post-tax profit for the year would have been C22 (2010: C21) lower/higher, mainly as a result of higher/lower interest expense on floating rate borrowings; other components of equity would have been C5 (2010: C3) lower/ higher mainly as a result of a decrease/increase in the fair value of fixed rate financial assets classified as available for sale. At 31 December 2011, if interest rates on UK pound-denominated borrowings at that date had been 0.5% higher/lower with all other variables held constant, post-tax profit for the year would have been C57 (2010: C38) lower/higher, mainly as a result of higher/lower interest expense on floating rate borrowings; other components of equity would have been C6 (2010: C4) lower/higher mainly as a result of a decrease/increase in the fair value of fixed rate financial assets classified as available for sale.

(All amounts in C thousands unless otherwise stated)

(b) Credit risk

IFRS7p33(a)(b)
IFRS7p34(a) Credit risk is managed on group basis, except for credit risk relating to accounts receivable balances. Each local entity is responsible for managing and analysing the credit risk for each of their new clients before standard payment and delivery terms and conditions are offered. Credit risk arises from cash and cash equivalents, derivative financial instruments and deposits with banks and financial institutions, as well as credit exposures to wholesale and retail customers, including outstanding receivables and committed transactions. For banks and financial institutions, only independently rated parties with a minimum rating of 'A' are accepted. If wholesale customers are independently rated, these ratings are used. If there is no independent rating, risk control assesses the credit quality of the customer, taking into account its financial position, past experience and other factors. Individual risk limits are set based on internal or external ratings in accordance with limits set by the board. The utilisation of credit limits is regularly monitored. Sales to retail customers are settled in cash or using major credit cards. See note 9(b) for further disclosure on credit risk.

No credit limits were exceeded during the reporting period, and management does not expect any losses from non-performance by these counterparties.

(c) Liquidity risk

IFRS7
p33(a),(b)
34(a) Cash flow forecasting is performed in the operating entities of the group in and aggregated by group finance. Group finance monitors rolling forecasts of the group's liquidity requirements to ensure it has sufficient cash to meet operational needs while maintaining sufficient headroom on its undrawn committed borrowing facilities (note 22) at all times so that the group does not breach borrowing limits or covenants (where applicable) on any of its borrowing facilities. Such forecasting takes into consideration the group's debt financing plans, covenant compliance, compliance with internal balance sheet ratio targets and, if applicable external regulatory or legal requirements – for example, currency restrictions.

IFRS7
p33(a),(b)
39(c)
IFRS7B11E Surplus cash held by the operating entities over and above balance required for working capital management are transferred to the group treasury. Group treasury invests surplus cash in interest bearing current accounts, time deposits, money market deposits and marketable securities, choosing instruments with appropriate maturities or sufficient liquidity to provide sufficient head-room as determined by the above-mentioned forecasts. At the reporting date, the group held money market funds of C6, 312 (2010: C934) and other liquid assets of C321 (2010: C1, 400) that are expected to readily generate cash inflows for managing liquidity risk.

IFRS7p39(a)(b) The table below analyses the group's non-derivative financial liabilities and net-settled derivative financial liabilities into relevant maturity groupings based on the remaining period at the balance sheet date to the contractual maturity date. Derivative financial liabilities are included in the analysis if their contractual maturities are essential for an understanding of the timing of the cash flows. The amounts disclosed in the table are the contractual undiscounted cash flows¹.

At 31 December 2011	Less than 3 months	Between 3 months and 1 year ²	Between 1 and 2 years ²	Between 2 and 5 years ²	Over 5 years ²
Borrowings (ex finance lease liabilities)	5,112	15,384	22,002	67,457	38,050
Finance lease liabilities	639	2,110	1,573	4,719	2,063
Trading and net settled derivative financial instruments (interest rate swaps)	280	–	10	116	41
Trade and other payables	12,543	3,125 ²	–	–	–
Financial guarantee contracts	21	–	–	–	–
At 31 December 2010					
Borrowings (ex finance lease liability)	4,061	12,197	11,575	58,679	38,103
Finance lease liabilities	697	2,506	1,790	5,370	2,891
Trading and net settled derivative financial instruments (interest rate swaps)	317	–	15	81	50
Trade and other payables	9,214	2,304 ³	–	–	–
Financial guarantee contracts	10	–	–	–	–

IFRS7
B10A(a) Of the C67,457 disclosed in the 2011 borrowings time band 'Between 2 and 5 years' the company intends to repay C40,000 in the first quarter of 2011 (2010: nil).

IFRS7p39(b) The group's trading portfolio derivative instruments with a negative fair value have been included at their fair value of C268 (2010: C298) within the less than three month time bucket. This is because the contractual maturities are not

¹ IFRS7 p39(a)(b) The amounts included in the table are the contractual undiscounted cash flows, except for trading derivatives, which are included at their fair value (see below). As a result, these amounts will not reconcile to the amounts disclosed on the balance sheet except for short-term payables where discounting is not applied. Entities can choose to add a reconciling column and a final total that ties into the balance sheet, if they wish.

² The specific time-buckets presented are not mandated by the standard but are based on a choice by management based on how the business is managed. Sufficient time buckets should be provided to give sufficient granularity to provide the reader with an understanding of the entity's liquidity.

³ The maturity analysis applies to financial instruments only; non-financial liabilities are not therefore included.

(All amounts in C thousands unless otherwise stated)

essential for an understanding of the timing of the cash flows. These contracts are managed on a net-fair value basis rather than by maturity date. Net settled derivatives comprise interest rate swaps used by the group to manage the group's interest rate profile.

IFRS7p39(b) All of the non-trading group's gross settled derivative financial instruments are in hedge relationships and are due to settle within 12 months of the balance sheet date. These contracts require undiscounted contractual cash inflows of C78,756 (2010: C83,077) and undiscounted contractual cash outflows of C78,241 (2010: C83,366).

1p134,135,
IG10

3.2 Capital management

The group's objectives when managing capital are to safeguard the group's ability to continue as a going concern in order to provide returns for shareholders and benefits for other stakeholders and to maintain an optimal capital structure to reduce the cost of capital.

In order to maintain or adjust the capital structure, the group may adjust the amount of dividends paid to shareholders, return capital to shareholders, issue new shares or sell assets to reduce debt.

Consistent with others in the industry, the group monitors capital on the basis of the gearing ratio. This ratio is calculated as net debt divided by total capital. Net debt is calculated as total borrowings (including 'current and non-current borrowings' as shown in the consolidated balance sheet) less cash and cash equivalents. Total capital is calculated as 'equity' as shown in the consolidated balance sheet plus net debt.

During 2011, the group's strategy, which was unchanged from 2010, was to maintain the gearing ratio within 45% to 50% and a BB credit rating. The BB credit rating has been maintained throughout the period. The gearing ratios at 31 December 2011 and 2010 were as follows:

	2011	2010
Total borrowings (note 22)	126,837	114,604
Less: cash and cash equivalents (note 15)	(17,928)	(34,062)
Net debt	108,909	80,542
Total equity	131,773	88,946
Total capital	240,682	169,488
Gearing ratio	45%	48%

The decrease in the gearing ratio during 2011 resulted primarily from the issue of share capital as part of the consideration for the acquisition of a subsidiary (notes 17 and 39).

3.3 Fair value estimation

The table below analyses financial instruments carried at fair value, by valuation method. The different levels have been defined as follows:

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

IFRS7
p27B(a)

The following table presents the group's assets and liabilities that are measured at fair value at 31 December 2011.

	Level 1	Level 2	Level 3	Total
Assets				
Financial assets at fair value through profit or loss				
– Trading derivatives	–	250	111	361
– Trading securities	11,820	–	–	11,820
Derivatives used for hedging	–	1,103	–	1,103
Available-for-sale financial assets				
– Equity securities	18,735	–	–	18,735
– Debt investments	288	347	–	635
Total assets	30,843	1,700	111	32,654
Liabilities				
Financial liabilities at fair value through profit or loss				
– Trading derivatives	–	268	–	268
Derivatives used for hedging	–	327	–	327
Total liabilities	–	595	–	595

(All amounts in £ thousands unless otherwise stated)

The following table presents the group's assets and liabilities that are measured at fair value at 31 December 2010.

	Level 1	Level 2	Level 3	Total
Assets				
Financial assets at fair value through profit or loss:				
- Trading derivatives	-	321	-	321
- Trading securities	7,972	-	-	7,972
Derivatives used for hedging	-	875	-	875
Available-for-sale financial assets:				
- Equity securities	14,646	-	-	14,646
- Debt investments	-	264	-	264
Total assets	22,618	1,460		24,078
Liabilities				
Financial liabilities at fair value through profit or loss:				
- Trading derivatives	-	298	-	298
Derivatives used for hedging	-	449	-	449
Total liabilities		747		747

IFRS7p27

The fair value of financial instruments traded in active markets is based on quoted market prices at the balance sheet date. A market is regarded as active if quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service, or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis. The quoted market price used for financial assets held by the group is the current bid price. These instruments are included in Level 1. Instruments included in Level 1 comprise primarily DAX, FTSE 100 and Dow Jones equity investments classified as trading securities or available for sale.

The fair value of financial instruments that are not traded in an active market (for example, over-the-counter derivatives) is determined by using valuation techniques. These valuation techniques maximise the use of observable market data where it is available and rely as little as possible on entity specific estimates. If all significant inputs required to fair value an instrument are observable, the instrument is included in Level 2.

If one or more of the significant inputs is not based on observable market data, the instrument is included in Level 3.

Specific valuation techniques used to value financial instruments include:

- Quoted market prices or dealer quotes for similar instruments.
- The fair value of interest rate swaps is calculated as the present value of the estimated future cash flows based on observable yield curves.
- The fair value of forward foreign exchange contracts is determined using forward exchange rates at the balance sheet date, with the resulting value discounted back to present value.
- Other techniques, such as discounted cash flow analysis, are used to determine fair value for the remaining financial instruments.

Note that all of the resulting fair value estimates are included in Level 2 except for certain forward foreign exchange contracts explained below.

IFRS7p27B(c) The following table presents the changes in Level 3 instruments for the year ended 31 December 2011.

	Trading derivative's at fair value through profit or loss	Total
Opening balance	-	-
Transfers into Level 3	115	115
Gains and losses recognised in profit or loss	(4)	(4)
Closing balance	111	111
Total gains or losses for the period included in profit or loss for assets held at the end of the reporting period	(4)	(4)

(All amounts in C thousands unless otherwise stated)

The following table presents the changes in Level 3 instruments for the year ended 31 December 2010.

	Trading derivative's at fair value through profit or loss	Total
Opening balance	62	62
Settlements	(51)	(51)
Gains and losses recognised in profit or loss	(11)	(11)
Closing balance	-	-
Total gains or losses for the period included in profit or loss for assets held at the end of the reporting period	-	-

In 2011, the group transferred a held-for-trading forward foreign exchange contract from Level 2 into Level 3. This is because the counterparty for the derivative encountered significant financial difficulties, which resulted in a significant increase to the discount rate due to increased counterparty credit risk, which is not based on observable inputs.

if the change in the credit default rate would be shifted +/- 5% the impact on profit or loss would be C20.

IFRS7 p27B(e)

Commentary – financial risk management

Accounting standard for presentation and disclosure of financial instruments

IFRS7p3

1. IFRS 7, 'Financial Instruments: Disclosures', applies to all reporting entities and to all types of financial instruments except:

- Those interests in subsidiaries, associates and joint ventures that are accounted for under IAS 27, 'Consolidated and separate financial statements', IAS 28, 'Investments in associates', or IAS 31, 'Interests in joint ventures'. However, entities should apply IFRS 7 to an interest in a subsidiary, associate or joint venture that according to IAS 27, IAS 28 or IAS 31 is accounted for under IAS 39, 'Financial Instruments: Recognition and measurement'. Entities should also apply IFRS 7 to all derivatives on interests in subsidiaries, associates or joint ventures unless the derivative meets the definition of an equity instrument in IAS 32, 'Financial Instruments: Presentation'.
- Employers' rights and obligations under employee benefit plans, to which IAS 19, 'Employee benefits', applies.
- Insurance contracts as defined in IFRS 4, 'Insurance contracts'. However, IFRS 7 applies to derivatives that are embedded in insurance contracts if IAS 39 requires the entity to account for them separately. It also applies to financial guarantee contracts if the issuer applies IAS 39 in recognising and measuring the contracts.
- Financial instruments, contracts and obligations under share-based payment transactions to which IFRS 2, 'Share-based payments', applies, except for contracts within the scope of paragraphs 5-7 of IAS 39, which are disclosed under IFRS 7.
- Puttable financial instruments that are required to be classified as equity instruments in accordance with paragraphs 16A and 16B or 16C and 16D of IAS 32.

Parent entity disclosures

IFRS7

2. Where applicable, all disclosure requirements outlined in IFRS 7 should be made for both the parent and consolidated entity. The relief from making parent entity disclosures, which was previously available under IAS 30, 'Disclosures in the financial statements of banks and similar financial institutions', and IAS 32, has not been retained in IFRS 7.

Classes of financial instrument

IFRS7p6, B1-B3

3. Where IFRS 7 requires disclosures by class of financial instrument, the entity groups its financial instruments into classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those financial instruments. The entity should provide sufficient information to permit reconciliation to the line items presented in the balance sheet. Guidance on classes of financial instruments and the level of required disclosures is provided in appendix B of IFRS 7.

Level of detail and selection of assumptions – information through the eyes of management

IFRS7p34(a)

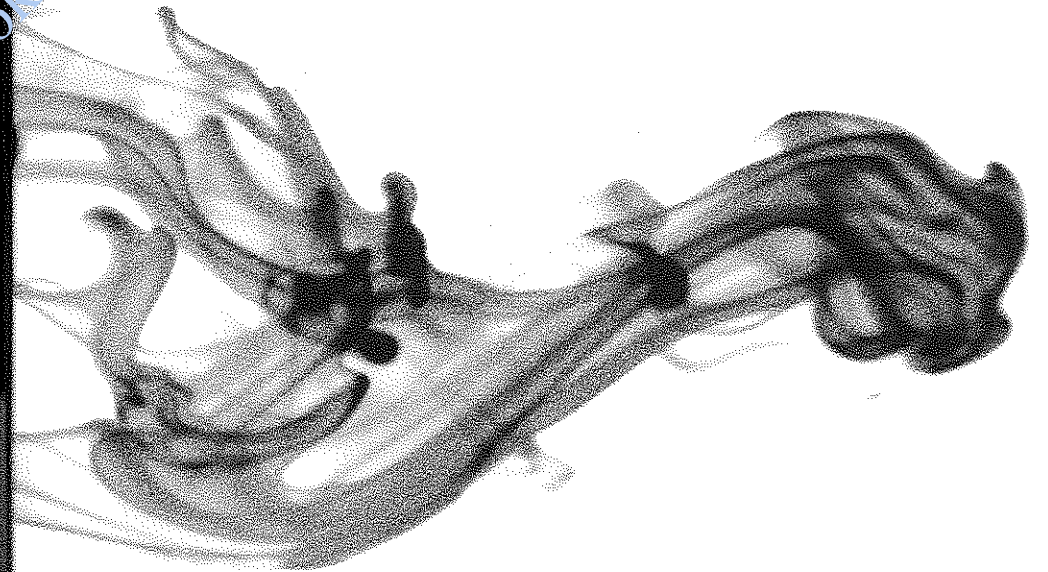
4. The disclosures in relation to an entity's financial risk management should reflect the information provided internally to key management personnel. As such, the disclosures that will be provided by an entity, their level of detail and the underlying assumptions used will vary greatly from entity to entity. The disclosures in this illustrative financial statement are only one example of the kind of information that may be disclosed; the entity should consider carefully what may be appropriate in its individual circumstances.

Manual of accounting

Financial instruments
2012

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Manual of Accounting – IFRS

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Abbreviations and terms used

VAT	value added tax
VIE	variable interest entity
WACC	weighted average cost of capital
WEEE	Waste electrical and electronic equipment
WLR	Weekly Law Reports
xBRL	extensible business reporting language

Chapter 1

Overview

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Chapter 1

Overview

Introduction

1.1 Current requirements for financial instruments are included in IAS 32, 'Financial instruments: Presentation', IAS 39, 'Financial instruments: Recognition and measurement', IFRS 9, 'Financial instruments', IFRS 7, 'Financial instruments: Disclosures', and IFRS 13, 'Fair value measurement'.

1.2 To apply in the EU, IFRSs must be endorsed by an EU 'endorsement mechanism'. In November 2004, the European Commission adopted a 'carve-out' version of IAS 39, which deleted a limited number of words and paragraphs from IAS 39 relating to the use of the 'fair value option' for financial liabilities and certain aspects of hedge accounting. Since that time, the IASB has published an amendment to IAS 39 incorporating a revised 'fair value option' and this has been adopted for use within the EU. However, differences between the IASB's 'full IAS 39' and the EU's 'carve-out' version of the standard still remain. The IASB issued IFRS 9 in November 2009 and updated the standard in October 2010 for financial liabilities. The EU has not yet endorsed IFRS 9.

1.2.1 The Board intends that IFRS 9 will ultimately replace IAS 39 in its entirety. However, in response to requests from interested parties that the accounting for financial instruments should be improved quickly, the Board divided its project to replace IAS 39 into three main phases. The first phase, which is now completed, relates to the classification and measurement of financial assets and liabilities. The new requirements are discussed in chapter 12 of this publication and can be early adopted subject to EU endorsement. Proposals addressing the second phase relating to the impairment methodology for financial assets and proposals addressing the third phase relating to hedge accounting continue to be developed. IFRS 9 and IAS 39 will operate in tandem for some time, with entities selecting which one of the two to apply. IAS 32 and IFRS 7 will apply whichever regime is adopted, albeit with some adaptations. Additionally, the Board is addressing offsetting of financial assets and financial liabilities to replace the relevant part of IAS 32.

1.2.2 IFRS 13, 'Fair value measurement', was issued in May 2011 and has not yet been endorsed by the EU. Its scope extends to any item recognised in the financial statements at fair value and its application to financial instruments is discussed in chapter 34 of the IFRS Manual of Accounting.

Objectives and scope of IAS 32, IAS 39 and IFRS 7

1.3 IAS 32 establishes principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and liabilities. It applies to the classification of financial instruments into 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.

1.4 IAS 39 is an extremely long and complex standard that establishes principles 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.

1.5 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.

1.6 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". 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.

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 accounted for under IAS 39. Contingent consideration in a business combination that is a financial instrument (Note 1).	Any forward contract between an acquirer and a selling shareholder to buy or sell an acquiree that will result in a business combination at a future acquisition date (Note 2).	Investments in subsidiaries, associates and joint ventures accounted for under IAS 27, IAS 28 or IAS 31.
Loans and receivables	Lease receivables (Note 3)	
Gross amount due from customers for construction contract work		
Own debt	Lease payables (Note 3) Own equity	Employee benefits Share-based payments
Cash and cash equivalents		
Derivatives – for example:	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 4)
■ Interest rate swaps		
■ Currency forwards/swaps		
■ Purchased/written options		
■ Commodity contracts (Note 4)		
■ Collars/caps		
■ Credit derivatives		
■ Cash or net share settleable derivatives on own shares		
Derivatives on subsidiaries, associates and joint ventures that do not meet the criteria of an equity instrument		
Embedded derivatives		
Weather derivatives		
Loan commitments held for trading (Note 5)	Other loan commitments	
Financial guarantees (Note 6)		Insurance contracts Contracts with discretionary participation features (Note 7)

Note 1 – IFRS 3 has removed the scope exemption for contingent consideration in a business combination. On adoption of IFRS 3 contingent consideration from both the acquiree and acquirer's perspective is in the scope of IAS 32, IAS 39 and IFRS 7.

Note 2 – The term of the forward contract should not exceed a reasonable period normally necessary to obtain any required approvals and to complete the transaction. Any forward contract between an acquirer and a selling shareholder to buy or sell an acquiree that will result in a business combination at a future acquisition date is within IFRS 7's scope.

Note 3 – 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 4 – 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 5 – 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 designated as financial liabilities at fair value through profit or loss; or are held to generate assets of a class which the entity has a past practice of selling; or the commitment is to provide a loan at a below-market interest rate.

Note 6 – From the issuer's perspective, financial guarantee contracts are within IAS 39's scope, unless the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, in which case either IAS 39 or IFRS 4, 'Insurance contracts' may be applied.

Note 7 – Contracts with discretionary participation features are within the scope of IFRS 4, 'Insurance contracts'. The issuer of these instruments is exempt from applying paragraphs 15-32 and AG25-AG35 of IAS 32, 'Financial Instruments: presentation', regarding the distinction between financial liabilities and equity instruments. However, these instruments are subject to all other requirements of IAS 32.

1.7 The objectives and scope of IAS 32, IAS 39 and IFRS 7 are explained in greater detail in chapter 3.

Nature and characteristics of financial instruments

1.8 The definition of a financial instrument is set out in paragraph 1.6 above. 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.

1.9 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 financial instruments, instruments that impose on the entity an obligation to deliver to another party a *pro rata* share of the entity's net assets on liquidation and are classified as equity instruments, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.

1.10 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, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants *pro rata* to all of the existing owners of the same class of its own non-derivative equity instruments. Also, for these purposes, the entity's own equity instruments do not include puttable financial instruments that are classified as equity instruments, instruments that impose on the entity an obligation to deliver to another party a *pro rata* share of the entity's net assets only on liquidation and are classified as equity instruments, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.

1.10.1 As an exception, certain puttable instruments and obligations arising on liquidation are classified as equity, despite the contractual requirement to deliver cash or another financial asset.

1.10.2 Classifying, as equity instruments, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency became effective for accounting periods beginning on or after 1 February 2010. Such classification only applies where the entity offers the rights, options or warrants *pro rata* to all of its existing owners of the same class of its own non-derivative equity instruments.

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

1.12 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. 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.

1.13 The nature and characteristics of financial instruments are considered further in chapter 4.

Embedded derivatives

1.14 A derivative instrument that falls within IAS 39's scope need not be free-standing. Terms and conditions may also be embedded within another financial instrument or non-financial contract (referred to as the 'host' contract) that behave like a free standing derivative. These 'embedded derivatives' should be recognised at their fair value, separately from the non-derivative host contract, when they have economic characteristics and risks that are not closely related to those of the host contract. However, an entity may designate a contract that contains one or more embedded derivatives as a financial asset or financial liability at fair value through profit or loss, unless the embedded derivative does not significantly modify the cash flows otherwise required by the contract or it is clear that separation of the embedded derivative is prohibited.

1.15 Analysing non-derivative financial instruments and executory contracts for potential embedded derivatives is one of the more challenging aspects of IAS 39. This subject is considered further in chapter 5.

Classification of financial instruments

1.16 IAS 39 is a partial rather than a full fair value model. Financial assets and liabilities are measured at fair value or amortised cost depending on which defined category they fall into under the standard.

1.17 IAS 39 has four clearly defined categories of financial assets:

- A financial asset (or financial liability) is 'at fair value through profit or loss' if it is either:
 - Held-for-trading, that is:
 - it was acquired (or incurred) principally for the purpose of selling (or repurchasing) it in the near term;
 - it forms part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or
 - it is a derivative (except for a derivative that is a designated and effective hedging instrument).
 - Designated on initial recognition as 'at fair value through profit or loss'. The conditions that are required to be met in order to designate a financial asset (or a financial liability) as 'at fair value through profit or loss' are any of the following:
 - Where the designation eliminates or significantly reduces an accounting mismatch.
 - When a group of financial assets, financial liabilities or both are managed and their performance is evaluated on a fair value basis in accordance with a documented risk management or investment strategy and information about this group is provided on that basis to the entity's key management personnel.
 - When a contract contains an embedded derivative that meets particular conditions.

The designation is irrevocable.

- Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, with the following exceptions:
 - Those that are to be sold immediately or in the near future (held-for-trading) and any others that are designated as 'at fair value through profit or loss' on initial recognition.
 - Those that are designated as available-for-sale on initial recognition.
 - Those where the entity may not recover substantially all of its original investment, other than because of credit deterioration. Such assets should be classified as available-for-sale.
- Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturity (for example, debt securities, quoted loans and mandatory redeemable preferred shares) that an entity has the positive intention and ability to hold to maturity. Exceptions are those investments that an entity designates on initial recognition as 'at fair value

through profit or loss' or as 'available-for-sale' and those that meet the definition of 'loans and receivables'. Held-to-maturity instruments must have a maturity date, so investments in equity shares cannot fall into this category. There are a number of conditions set out in IAS 39 that restrict an entity's ability to categorise investments as held-to-maturity. For example, an entity may not classify any financial assets as held-to-maturity if during the current or preceding two financial years it has sold or reclassified more than an insignificant amount of held-to-maturity investments, except in certain very narrowly defined circumstances.

- Available-for-sale financial assets are non-derivative financial assets that are designated as such on initial recognition or that are not classified in any other category.

1.18 IAS 39 defines two categories of financial liabilities:

- A financial liability is 'at fair value through profit or loss' if it is either held-for-trading or designated at initial recognition as 'at fair value through profit or loss' (see the first major bullet point in para 1.17).
- All other financial liabilities fall into the other liabilities category.

1.19 The classification of financial assets and financial liabilities is considered further in chapter 6.

Financial liabilities and equity

1.20 The classification of a financial instrument as either a financial liability (debt) or equity is governed by the contractual arrangements' substance rather than its legal form. An instrument is debt when the issuer is or can be required to deliver either cash or another financial asset to the holder. This is the critical feature that distinguishes debt from equity. An instrument is classified as equity when it represents a residual interest in the issuer's net assets.

1.21 All relevant features need to be considered when classifying a financial instrument. The following are some basic examples of where an instrument will be classified as a financial liability disregarding, for the moment, the requirements for certain puttable instruments and obligations arising on liquidation:

- If the issuer can or will be forced to redeem the instrument, classification as debt is appropriate.
- If the choice of settling a financial instrument in cash or otherwise is contingent on the outcome of genuine circumstances beyond the control of both the issuer and the holder, the instrument is debt as the issuer does not have an unconditional right to avoid settlement.
- An instrument that includes an option for the holder to put the rights inherent in that instrument back to the issuer for cash or another financial instrument is debt.

1.21.1 Applying the requirements for certain puttable instruments and obligations arising on liquidation, some of the instruments in the first and third bullet points above that give the holder an equity-like return will be classified as equity, provided that all of the strict criteria in the amendment are met.

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

1.23 Not all instruments are either debt or equity. Some, known as compound instruments, contain elements of both in a single contract. Such instruments, such as bonds that are convertible into equity shares either mandatorily or at the holder's option, must be split into debt and equity components. Each is then accounted for separately. The debt element is determined first by fair valuing the cash flows excluding any equity component and the residual is assigned to equity.

1.24 Derivative contracts 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. All other derivatives on own equity are treated as derivatives and accounted for as such. This includes any that:

- can or must be settled on a net basis in cash (or other financial assets) or in shares;
- 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).

Any derivative on own equity that gives either party a choice over how it is settled is a financial asset or liability, unless all of the settlement alternatives would result in equity classification.

1.25 The classification of financial instruments as either debt or equity and the treatment of contracts that may be settled in an entity's own shares are considered further in chapter 7.

Recognition and derecognition

1.26 A financial asset or liability is recognised on the balance sheet when an entity becomes a party to the contract. IAS 39's rules for removing or 'derecognising' a financial asset or liability are far more complex.

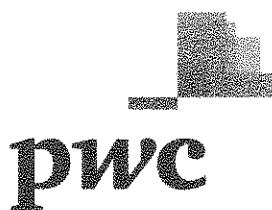
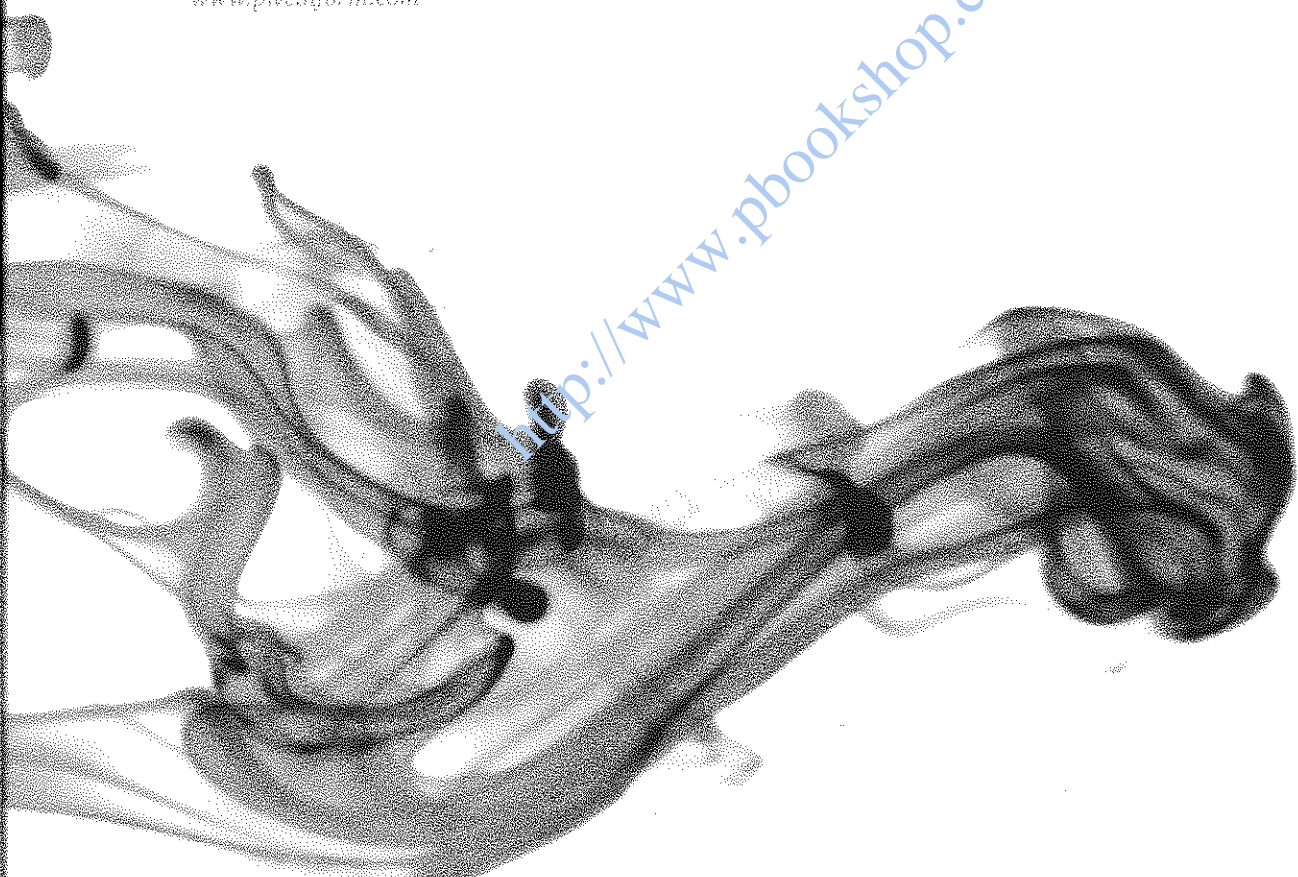
1.27 IAS 39 includes a flow chart that summarises the criteria for derecognising a financial asset and this is reproduced below.

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Chapter 2

Directors' report

Introduction

2.1 The directors' report is one of the mandatory components of a company's annual financial statements and reports for members. It must also be delivered to the Registrar of Companies by all companies except those entitled to the small companies exemption (see from para 2.143). [CA06 Secs 444(1), 444A(1), 445(1), 446(1), 447(1)].

2.2 The duty to prepare a directors' report is contained in section 415 of the Companies Act 2006. However, the Companies Act 2006 does not contain all the disclosure requirements: many of the detailed requirements are contained in Schedule 5 to SI 2008/409, 'The Small Companies and Groups (Accounts and Directors' Report) Regulations 2008', for companies or groups falling within the definition of 'small' (see chapter 31 of the Manual of Accounting – UK GAAP) and Schedule 7 to SI 2008/410, 'The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008' for all other companies.

2.3 Directors have a responsibility to prepare the report even if none of the directors at the time the report is produced were directors during the period covered by the report. They cannot avoid this responsibility simply because they were not responsible for all or some of the activities that are being reported on.

2.4 The principal objectives of the directors' report are to supplement the information in the financial statements with discussions and explanations about the company's activities and its future and also to provide details of other non-financial matters. The purpose of the narrative information is to give the user of the financial statements a more complete picture of the company.

2.5 Listed companies regard the annual report and financial statements as an important mode of communication with shareholders. They, therefore, use the annual report to provide shareholders with information about all aspects of the company's activities and the environment in which it operates, the company's objectives and its values. Such information may be presented outside the statutory directors' report, for example, in the chairman's statement or in a separate operating and financial review (see further chapter 3).

2.6 Companies structure the 'front half' of their annual reports (that is, the elements of the annual report that come before the financial statements) in a variety of ways. The Companies Act 2006 gives directors safe harbour from civil liability for statements or omissions in the directors' report (and also the directors' remuneration report prepared by quoted companies) and as a result many identify the entire front half as the directors' report. (See para 2.150.1.) Others name the majority of the front half 'business review', or alternatively have separate sections for an operating, financial and/or business review, directors' report, corporate governance statement and directors' remuneration report.

2.7 In this chapter, we deal with the mandatory disclosure requirements that apply to the directors' report, including the business review. In addition to those requirements, the ASB has published non-mandatory good practice guidance on the operating and financial review (OFR). In deciding how to comply with the some of the disclosure requirements, companies may wish to consider that guidance. In discussing the various disclosure requirements in this chapter, we refer to chapter 3 on the OFR, when the ASB's statement provides guidance on the particular point under discussion.

[The next paragraph is 2.11.]

Companies reporting under IFRS

2.11 The requirements relating to the directors' report are contained within the body of the Companies Act and, thus, apply to all companies, regardless of whether the financial statements are prepared under IFRS or UK GAAP.

Consolidated financial statements

2.12 The Companies Act 2006 requires that, where an entity is a parent company and the directors prepare consolidated financial statements, the directors' report must be a consolidated report covering the company and its subsidiary undertakings included in the consolidation. [CA06 Sec 415(2)].

2.13 Where appropriate, the consolidated report should give greater emphasis to matters that are significant to the company and its subsidiary undertakings included in the consolidation, taken as a whole. [CA06 Sec 415(3)].

[The next paragraph is 2.16.]

Matters to be dealt with in the directors' report

Principal activities

2.16 The principal activities of both the company and of its subsidiaries during the year should be stated. [CA06 Sec 416(1)]. It is appropriate to include details of any significant change in the group's activities. Listed companies are required to go further and describe their business model (see para 2.21.40).

2.16.1 It is worth noting that a 'listed company' is not the same as a 'quoted company'. Rules applying to listed companies are set out in the FSA Handbook, which includes the Listing Rules, Disclosure Rules and Transparency Rules. Rules applying to quoted companies are set out in the Companies Act 2006. A company may be both 'listed' and 'quoted'; as such, it has to comply with both sets of rules. A 'listed company' is defined in the FSA Handbook as one that has any class of its securities listed. A 'quoted company' is defined as a company whose equity share capital:

- has been included in the official list in accordance with the provisions of Part VI of the Financial Services and Markets Act 2000;
 - is officially listed in an EEA State; or
 - is admitted to dealing on either the New York Stock Exchange or the exchange known as NASDAQ.
- [CA06 Sec 385].

2.16.2 The application of the definitions to different categories of company is set out in the table below.

Status of company's securities	FSA Handbook: 'listed company'	Companies Act 2006: 'quoted company'
Equity shares listed in the UK official list	✓	✓
Debt securities (but not equity shares) listed in the UK official list	✓	✗
Equity shares listed in another EEA state or admitted to dealing on New York Stock Exchange or NASDAQ, but not on UK official list	✗	✓
Equity shares traded on AIM	✗	✗

2.17 The term 'principal activities' is not defined in the Companies Act 2006. A useful description of a company's principal activities would describe what the company does to make money (or to achieve whatever other objective it has). Often, a company's activities are in diverse industries or classes of business, which represent segments for the purposes of its financial statements. Guidance is provided in SSAP 25, 'Segmental reporting', which defines a separate class of business as the distinguishable component of the entity that provides a separate product or service or a separate group of related products or services. [SSAP 25 para 11]. Distinguishable components of an entity may include, for example, mining, textiles, electrical etc. Broad categories such as manufacturing, wholesaling and retailing are not indicative of the industries in which the entity operates. Those terms should not generally be used to describe an entity's industry segments without identification of the products or services. IFRS 8, 'Operating segments', considers segments entirely differently and uses a 'through the eyes of management' approach. Under this approach, the operating segments reported externally are those that management uses as a basis for its decision-making.

[The next paragraph is 2.19.]

2.19 The categories of principal activities described in the directors' report should, as far as possible, be consistent with the information that is provided for segmental reporting purposes. So that investors can build a picture of the company from its component parts, it is desirable to have consistency between the description of the company's activities and the measurement of its performance. There are various factors that should be taken into account when deciding whether or not an entity operates in different industry segments and these are discussed further in chapter 10 on segmental reporting in both the Manual of Accounting – UK GAAP and the Manual of Accounting – IFRS for the UK.

2.20 A change in activity should be reported whenever there has been a commencement of a new activity or a complete withdrawal from a previous activity rather than a change in the degree of the activity undertaken. Such a change may be brought about by the acquisition or disposal of a subsidiary undertaking. In order to provide meaningful disclosure of the changes in activities, the extent to which the acquisition or disposal has impacted on any resultant change in the group's activities should be considered. Indeed, FRS 3, 'Reporting financial performance', requires that if an acquisition, a sale or a termination has a material impact on a major business segment, this impact should be disclosed and explained. [FRS 3 para 53]. IFRS 8's predecessor, IAS 14, 'Segment reporting', encouraged entities to disclose the nature and amount of any items of segment revenue and segment expense that were of such size, nature or incidence that their disclosure was relevant to explain the performance of each reportable segment for the period. [IAS 14 para 59]. Although there are no equivalent requirements in IFRS 8 or in UK GAAP, we consider such disclosure to be strongly recommended.

2.21 The degree of detail that should be given under principal activities will obviously depend upon the nature of the company's business. For companies operating in one or two business segments, the relevant information is normally given in the directors' report. Multinational corporations engaged in a wide range of business activities tend to include the relevant details elsewhere in the annual report and accounts, for example, in a separate statement that sets out a detailed review of their operations. Where this is done, a reference should be given in the directors' report to where the necessary information can be found. Table 2.1 provides an illustration of the disclosure of principal activities.

Table 2.1 — Principal activities

Smiths Group plc — Annual report and accounts — 31 July 2010

Group directors' report (extract)

Principal activities

The principal activities of the Company and its subsidiaries (the Group) are and, during the year ended 31 July 2010, were the development, manufacture, sale and support of:

- advanced security equipment, including trace detection, millimetre-wave, infrared, biological detection and diagnostics, that detect and identify explosives, narcotics, weapons, chemical agents, biohazards and contraband;
- mechanical seals, seal support systems, engineered bearings, power transmission couplings, specialist filtration systems and other hardware for the oil and gas, chemical, pharmaceutical, pulp and paper and mining sectors;
- medical devices aligned to specific therapies, principally airway, pain and temperature management, infusion, needle protection, critical care monitoring and vascular access;
- specialised electronic and radio frequency products that connect, protect and control critical systems for the global wireless telecommunications, aerospace, defence, space, medical, rail, test and industrial markets; and
- engineered components including ducting, hose assemblies and heating elements that move and heat fluids for the aerospace, medical, industrial, construction and domestic markets.

The main manufacturing operations are in the UK, the Americas, Continental Europe and China.

Business review

2.21.1 The directors should include in their report a review of the business of the company and its subsidiaries. [CA06 Sec 417(1)]. Where it is not included within the directors' report, the business review should be incorporated into the directors' report by specific cross-reference. Where a company is entitled to either the small companies or medium sized companies exemption (see further chapter 31 of the Manual of Accounting – UK GAAP), there are reduced disclosure requirements (see para 2.21.4 below).

2.21.2 The purpose of the business review is to inform the company's members and help them assess how the directors have performed their duty to promote the company's success. [CA06 Sec 417(2)].

2.21.3 In promoting the company's success, directors must, in particular, have regard to the following:

- The likely consequences of any decision in the long-term.
- The interests of the company's employees.
- The need to foster the company's business relationships with suppliers, customers and others.
- The impact of the company's operations on the community and the environment.
- The desirability for the company maintaining a reputation for high standards of business conduct.
- The need to act fairly as between the company's members.

[CA06 Sec 172].

2.21.3.1 The business review must be 'balanced and comprehensive'. [Sec 417(4)] A balanced review is one that reports both good and bad news. In a press notice, the FRRP reported that it had held discussions with Rio Tinto plc on whether additional information about some of the company's operations referred to in the 2008 business review ought to have been included in the review to comply with the legal requirement for a balanced analysis. Following those discussions, in their report and accounts for the year ended 31 December 2010, the directors of Rio Tinto plc included more information about environmental matters, social and community issues and related reputational risk.

2.21.3.2 Little authoritative guidance is available on the practical aspects of preparing a business review, which, for a large diverse company, could be detailed and complex. Although not written with the business review specifically in mind, the ASB's reporting statement on the OFR ('RS (OFR)') does deal with a number of its required disclosures, as shown in the table above. So, it is common for those preparing an OFR — which incorporates a statutory business review — or those simply preparing a business review as part of the directors' report to comply with the RS (OFR), to ensure that investors receive the most appropriate information. Hence, the example disclosures within the chapter on the OFR may also be considered when preparing a business review. See chapter 3 for guidance on the RS (OFR). Chapter 3 also provides information about publications that will be of assistance to companies preparing a business review, whether complying with the RS (OFR) or not. These publications and other good practice examples can be found at www.corporatereporting.com.

2.21.4 The legal requirements vary according to the type of company: a small company does not have to prepare a business review; all other companies must do so; but the reporting requirements vary depending on the company's size and status. A company will comply with the legal requirements for a business review if it elects to comply with the ASB's RS (CFR) (see chapter 3). This overlap between the law and the RS (OFR) is expressed diagrammatically below and described more fully in the subsequent paragraphs.

Type of company	Disclosure requirement	Non-mandatory guidance in the RS (OFR) paragraphs
Small company (see from para 2.143)	Business review not required. [Sec 417(1)].	
Medium-sized company	<ul style="list-style-type: none"> ■ The business review must contain, at a minimum: <ul style="list-style-type: none"> ■ A fair review of the company's business. ■ A description of the principal risks and uncertainties facing the company. ■ The review should be consistent with the business' size and complexity and provide a balanced and comprehensive analysis of: <ul style="list-style-type: none"> ■ The development and performance of the company's business during the financial year. ■ The company's position at the end of the year. ■ The review should also include, to the extent necessary for an understanding of the company's business, analysis using <i>financial</i> key performance indicators (KPIs). ■ The review must contain, where appropriate, references to and additional explanation of amounts included in the financial statements. 	<p>22, 30-32, 36-37</p> <p>27(c), 52-56</p> <p>27(b), 30-32, 43-46</p> <p>27(d), 30-32, 50-51, 60-74</p> <p>38-42, 75-77</p> <p>13-15</p>
Large unquoted company	<p>[Sec 417 (3), (4), (6)(a), (7), (8)].</p> <p>All of the above plus, where appropriate, analysis using other KPIs, including information on environmental and employee matters. [Sec 417(6)(b)].</p>	38-42,75-77
Quoted company (see para 2.16.1)	<ul style="list-style-type: none"> ■ The main trends and factors likely to affect the future development, performance and position of the company's business (see from para 2.37.6 below). ■ *Information about persons with whom the company has contractual or other arrangements that are essential to the company's business (see from para 2.21.35). ■ *Information about <ul style="list-style-type: none"> ■ environmental matters (including the impact of the company's business on the environment) (see from para 2.28); ■ the company's employees (see from para 2.28); ■ social and community issues (see from para 2.28); and ■ including information about any of the company's policies in relation to those matters and the effectiveness of those policies. 	<p>8-12, 27(b), 33-35, 47-49</p> <p>28(d),57-59</p> <p>28(a), (b), (c) 29,35</p>
	<p>[CA06 Sec 417(5)].</p> <p>The disclosures above are required "to the extent necessary for an understanding of the development, performance or position of the company's business".</p> <p>*If the review does not contain information on any of the items asterisked above, it must state that fact. [CA06 Sec 417(5)].</p>	

2.21.4.2 The meaning of 'quoted company' is discussed in paragraph 2.16.1.

2.21.4.3 Balanced reporting is discussed further in chapter 2.

2.21.5 Where an entity is a parent company and prepares consolidated financial statements, the business review should be a consolidated review covering the company and its subsidiary undertakings included in the consolidation. [CA06 Sec 417(9)]. There is no requirement for the parent company to prepare a separate review for the company alone.

[The next paragraph is 2.21.9.]

Applying the requirements to different types of company

2.21.9 As mentioned above, all companies must prepare a business review, other than those entitled to the small companies exemption (see para 2.21.1). The ASB's RS (OFR) offers some guidance on practically implementing the various business review requirements; this guidance is most often used by listed companies (see chapter 3). Guidance to assist directors in preparing a business review is limited for private entities, although it is open to them to use the RS (OFR) if they wish to do so.

2.21.10 Many of the requirements of the business review are preceded with the words "*to the extent necessary for an understanding of the development, performance or position of the company's business*"; this gives directors some discretion over the level of detail that should be presented in the business review.

2.21.11 Bearing in mind that the overriding purpose of the business review is as a tool for communicating with members (see para 2.21.2), we believe that the type and extent of disclosure required depends on the extent to which an entity's share ownership is dispersed and how close/involved the owners are to the business' management. This distinction can be illustrated as follows:

- *Owner-managed companies:* Members already have a good understanding of the company's development, performance and position. The minimum information to comply with the legislation is all that is needed to present a clear picture to members.
- *Wholly owned subsidiaries:* The position for wholly-owned subsidiaries of a parent company that actively monitors the business performance on an ongoing basis is similar to that for owner-managed companies. Often both the management and reporting of risk and key performance indicators for wholly-owned subsidiaries are undertaken at the group level. In such circumstances, it is appropriate to clarify this position and also to state that the company's directors believe that analysis using key performance indicators is not necessary or appropriate to understand the business' development, performance or position. The statement should usefully refer to further information available in the group annual report, making clear that it does not form part of the company's annual report. The cross-reference should be to a specific paragraph, heading, or page in the group annual report. See further paragraph 2.21.13 below.
- *Public interest, AIM-listed or separately managed private companies:* For public interest companies, AIM-listed (or PLUS-quoted) companies and private companies (including non-wholly owned subsidiaries) where ownership is distinct from those who manage the entity on members' behalf, the amount of information disclosed should reflect the explicit requirements implied by BIS in its pronouncements and guidance (for example, "*the business review would include information on objectives, strategies and resources where necessary to provide a fair review of the company*"). The minimum disclosures described for owner-managed entities should be supplemented by additional contextual information around risk and key performance indicators, as well as a description of the entity's strategy and business environment.
- *Quoted companies:* Fuller disclosure is necessary for quoted companies, to assist members in understanding the entity's development, performance and position. The most appropriate guidance is in the recommendations of the ASB's RS (OFR). (See chapter 3).

2.21.12 Given the broad nature of the categories set out above, and particularly public interest entities with dispersed ownership, there needs to be a degree of flexibility in the approach chosen by companies depending on their circumstances.

2012

International Financial Reporting Standards®

IFRS®

Consolidated without early application

Official pronouncements applicable on 1 January 2012

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30 Cannon Street, London EC4M 6XH, United Kingdom.

Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411

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IFRS Foundation Publications Department

30 Cannon Street, London EC4M 6XH, United Kingdom.

Telephone: +44 (0)20 7332 2730 Fax: +44 (0)20 7332 2749

Email: publications@ifrs.org Web: www.ifrs.org

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International Financial Reporting Standard 1

First-time Adoption of International Financial Reporting Standards

IFRS 1 *First-time Adoption of International Financial Reporting Standards* was issued by the International Accounting Standards Board (IASB) in June 2003. It replaced SIC-8 *First-time Application of IASs as the Primary Basis of Accounting* (issued by the Standing Interpretations Committee in July 1998).

IFRS 1 and its accompanying documents have been amended by the following IFRSs:

- IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* (issued December 2003)
- IAS 16 *Property, Plant and Equipment* (as revised in December 2003)
- IAS 17 *Leases* (as revised in December 2003)
- IAS 21 *The Effects of Changes in Foreign Exchange Rates* (as revised in December 2003)
- IAS 39 *Financial Instruments: Recognition and Measurement* (as revised in December 2003)
- IFRS 2 *Share-based Payment* (issued February 2004)
- IFRS 3 *Business Combinations* (issued March 2004)
- IFRS 4 *Insurance Contracts* (issued March 2004)
- IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* (issued March 2004)
- IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* (issued May 2004)
- IFRIC 4 *Determining whether an Arrangement contains a Lease* (issued December 2004)
- IFRS 6 *Exploration for and Evaluation of Mineral Resources* (issued December 2004)
- *Actuarial Gains and Losses, Group Plans and Disclosures* (Amendment to IAS 19) (issued December 2004)
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 - *The Fair Value Option* (issued June 2005)
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- IFRS 8 *Operating Segments* (issued November 2006)
- IFRIC 12 *Service Concession Arrangements* (issued November 2006)

- IAS 23 *Borrowing Costs* (as revised in March 2007)^g
- IAS 1 *Presentation of Financial Statements* (as revised in September 2007)[†]
- IFRS 3 *Business Combinations* (as revised in January 2008)[†]
- IAS 27 *Consolidated and Separate Financial Statements* (as amended in January 2008)[†]
- *Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate* (Amendments to IFRS 1 and IAS 27) (issued May 2008)[†]
- *Improvements to IFRSs* (issued May 2008).[†]

In November 2008 the IASB issued a revised IFRS 1. In December 2008 the IASB deferred the effective date of the revised version from 1 January 2009 to 1 July 2009.

IFRS 1, as revised in November 2008, has been amended by the following documents:

- IFRIC 18 *Transfers of Assets from Customers* (issued January 2009)[†]
- *Additional Exemptions for First-time Adopters* (Amendments to IFRS 1) (issued July 2009)[§]
- IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments* (issued November 2009)^o
- *Limited Exemption from Comparative IFRS 7 Disclosures for First-time Adopters* (Amendments to IFRS 1) (issued January 2010)^o
- *Disclosures—Transfers of Financial Assets* (Amendments to IFRS 7) (issued October 2010)[‡]
- *Severe Hyperinflation and Removal of Fixed Dates for First-time Adopters* (Amendments to IFRS 1) (issued December 2010)[‡]
- *Improvements to IFRSs* (issued May 2010).[#]

Amendments with an effective date later than 1 January 2012

IFRS 1 and its accompanying documents have been amended by:

- IFRS 9 *Financial Instruments* (issued November 2009 and issued October 2010)
- IFRS 10 *Consolidated Financial Statements* (issued May 2011)
- IFRS 11 *Joint Arrangements* (issued May 2011)
- IFRS 13 *Fair Value Measurement* (issued May 2011)
- *Presentation of Items of Other Comprehensive Income* (Amendments to IAS 1) (issued June 2011)
- IAS 19 *Employee Benefits* (issued June 2011)

As these amendments have an effective date later than 1 January 2012 they are not included in this edition.

^g effective date 1 January 2009

[†] effective date 1 July 2009

[§] effective date 1 January 2010

^o effective date 1 July 2010

[‡] effective date 1 July 2011

[#] effective date 1 January 2011

Apart from IFRICs 1, 4, 12, 18 and 19 the following Interpretation refers to IFRS 1:

- IFRIC 9 *Reassessment of Embedded Derivatives* (issued March 2006).

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This table shows how the contents of the superseded version of IFRS 1 and the revised version of IFRS 1 correspond.

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23	D18	36	21	47L	39
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24	D16	36C	None	None	13, 18, 40
25	D17	37	22		

International Financial Reporting Standard 2

Share-based Payment

IFRS 2 *Share-based Payment* was issued by the International Accounting Standards Board (IASB) in February 2004.

The International Financial Reporting Interpretations Committee developed the following Interpretations:

- IFRIC 8 *Scope of IFRS 2* (issued January 2006)
- IFRIC 11 *IFRS 2—Group and Treasury Share Transactions* (issued November 2006).

Since then the IASB has issued the following amendments to IFRS 2:

- *Vesting Conditions and Cancellations* (issued January 2008)⁶
- *Group Cash-settled Share-based Payment Transactions* (issued June 2009).[†]
This replaced IFRIC 8 and IFRIC 11.

The following Interpretations refer to IFRS 2:

- SIC-12 *Consolidation—Special Purpose Entities* (as amended in 2004)
- IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments* (issued November 2009).[§]

IFRS 2 and its accompanying documents were also amended by the following IFRSs:

- IFRS 3 *Business Combinations* (as revised in 2008)⁶
- *Improvements to IFRSs* (issued April 2009).⁶

Amendments with an effective date later than 1 January 2012

IFRS 2 and its accompanying documents have been amended by:

- IFRS 9 *Financial Instruments* (issued November 2009 and October 2010)
- IFRS 10 *Consolidated Financial Statements* (issued May 2011)
- IFRS 11 *Joint Arrangements* (issued May 2011)
- IFRS 13 *Fair Value Measurement* (issued May 2011)
- IAS 19 *Employee Benefits* (issued June 2011)

As these amendments have an effective date later than 1 January 2012 they are not included in this edition.

⁶ effective date 1 January 2009

[†] effective date 1 January 2010

[§] effective date 1 July 2010

⁶ effective date 1 July 2009

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Vesting Conditions and Cancellations
issued in January 2008*Group Cash-settled Share-based Payment Transactions*
issued in June 2009

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International Financial Reporting Standard 2 *Share-based Payment* (IFRS 2) is set out in paragraphs 1-64 and Appendices A-C. All the paragraphs have equal authority. Paragraphs in **bold type** state the main principles. Terms defined in Appendix A are in *italics* the first time they appear in the Standard. Definitions of other terms are given in the Glossary for International Financial Reporting Standards. IFRS 2 should be read in the context of its objective and the Basis for Conclusions, the *Preface to International Financial Reporting Standards* and the *Conceptual Framework for Financial Reporting*. IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Introduction

Reasons for issuing the IFRS

- IN1 Entities often grant shares or share options to employees or other parties. Share plans and share option plans are a common feature of employee remuneration, for directors, senior executives and many other employees. Some entities issue shares or share options to pay suppliers, such as suppliers of professional services.
- IN2 Until this IFRS was issued, there was no IFRS covering the recognition and measurement of these transactions. Concerns were raised about this gap in IFRSs, given the increasing prevalence of share-based payment transactions in many countries.

Reasons for amending IFRS 2 in June 2009

INZA In June 2009 the International Accounting Standards Board amended IFRS 2 to clarify its scope and the accounting for group cash-settled share-based payment transactions in the separate or individual financial statements of the entity receiving the goods or services when that entity has no obligation to settle the share-based payment transaction. The amendments also incorporate the guidance contained in the following Interpretations:

- IFRIC 8 *Scope of IFRS 2*
- IFRIC 11 *IFRS 2—Group and Treasury Share Transactions*.

As a result, the Board withdrew IFRIC 8 and IFRIC 11.

Main features of the IFRS

- IN3 The IFRS requires an entity to recognise share-based payment transactions in its financial statements, including transactions with employees or other parties to be settled in cash, other assets, or equity instruments of the entity. There are no exceptions to the IFRS, other than for transactions to which other Standards apply.
- IN4 The IFRS sets out measurement principles and specific requirements for three types of share-based payment transactions:
- (a) equity-settled share-based payment transactions, in which the entity receives goods or services as consideration for equity instruments of the entity (including shares or share options);
 - (b) cash-settled share-based payment transactions, in which the entity acquires goods or services by incurring liabilities to the supplier of those goods or services for amounts that are based on the price (or value) of the entity's shares or other equity instruments of the entity; and
 - (c) transactions in which the entity receives or acquires goods or services and the terms of the arrangement provide either the entity or the supplier of

those goods or services with a choice of whether the entity settles the transaction in cash or by issuing equity instruments.

IN5 For equity-settled share-based payment transactions, the IFRS requires an entity to measure the goods or services received, and the corresponding increase in equity, directly, at the fair value of the goods or services received, unless that fair value cannot be estimated reliably. If the entity cannot estimate reliably the fair value of the goods or services received, the entity is required to measure their value, and the corresponding increase in equity, indirectly, by reference to the fair value of the equity instruments granted. Furthermore:

- (a) for transactions with employees and others providing similar services, the entity is required to measure the fair value of the equity instruments granted, because it is typically not possible to estimate reliably the fair value of employee services received. The fair value of the equity instruments granted is measured at grant date.
- (b) for transactions with parties other than employees (and those providing similar services), there is a rebuttable presumption that the fair value of the goods or services received can be estimated reliably. That fair value is measured at the date the entity obtains the goods or the counterparty renders service. In rare cases, if the presumption is rebutted, the transaction is measured by reference to the fair value of the equity instruments granted, measured at the date the entity obtains the goods or the counterparty renders service.
- (c) for goods or services measured by reference to the fair value of the equity instruments granted, the IFRS specifies that all non-vesting conditions are taken into account in the estimate of the fair value of the equity instruments. However, vesting conditions that are not market conditions are not taken into account when estimating the fair value of the shares or options at the relevant measurement date (as specified above). Instead, vesting conditions are taken into account by adjusting the number of equity instruments included in the measurement of the transaction amount so that, ultimately, the amount recognised for goods or services received as consideration for the equity instruments granted is based on the number of equity instruments that eventually vest. Hence, on a cumulative basis, no amount is recognised for goods or services received if the equity instruments granted do not vest because of failure to satisfy a vesting condition (other than a market condition).
- (d) the IFRS requires the fair value of equity instruments granted to be based on market prices, if available, and to take into account the terms and conditions upon which those equity instruments were granted. In the absence of market prices, fair value is estimated, using a valuation technique to estimate what the price of those equity instruments would have been on the measurement date in an arm's length transaction between knowledgeable, willing parties.
- (e) the IFRS also sets out requirements if the terms and conditions of an option or share grant are modified (eg an option is repriced) or if a grant is cancelled, repurchased or replaced with another grant of equity instruments. For example, irrespective of any modification, cancellation or

settlement of a grant of equity instruments to employees, the IFRS generally requires the entity to recognise, as a minimum, the services received measured at the grant date fair value of the equity instruments granted.

IN6 For cash-settled share-based payment transactions, the IFRS requires an entity to measure the goods or services acquired and the liability incurred at the fair value of the liability. Until the liability is settled, the entity is required to remeasure the fair value of the liability at the end of each reporting period and at the date of settlement, with any changes in value recognised in profit or loss for the period.

IN7 For share-based payment transactions in which the terms of the arrangement provide either the entity or the supplier of goods or services with a choice of whether the entity settles the transaction in cash or by issuing equity instruments, the entity is required to account for that transaction, or the components of that transaction, as a cash-settled share-based payment transaction if, and to the extent that, the entity has incurred a liability to settle in cash (or other assets), or as an equity-settled share-based payment transaction if, and to the extent that, no such liability has been incurred.

IF6 The IFRS prescribes various disclosure requirements to enable users of financial statements to understand:

- (a) the nature and extent of share-based payment arrangements that existed during the period;
- (b) how the fair value of the goods or services received, or the fair value of the equity instruments granted, during the period was determined; and
- (c) the effect of share-based payment transactions on the entity's profit or loss for the period and on its financial position.

International Financial Reporting Standard 2

Share-based Payment

Objective

- 1 The objective of this IFRS is to specify the financial reporting by an entity when it undertakes a *share-based payment transaction*. In particular, it requires an entity to reflect in its profit or loss and financial position the effects of share-based payment transactions, including expenses associated with transactions in which *share options* are granted to employees.

Scope

- 2 An entity shall apply this IFRS in accounting for all share-based payment transactions, whether or not the entity can identify specifically some or all of the goods or services received, including:
- (a) *equity-settled share-based payment transactions*,
 - (b) *cash-settled share-based payment transactions*, and
 - (c) transactions in which the entity receives or acquires goods or services and the terms of the arrangement provide either the entity or the supplier of those goods or services with a choice of whether the entity settles the transaction in cash (or other assets) or by issuing equity instruments.

except as noted in paragraphs 3A–6. In the absence of specifically identifiable goods or services, other circumstances may indicate that goods or services have been (or will be) received, in which case this IFRS applies.

- 3 [Deleted]

- 3A A share-based payment transaction may be settled by another group entity (or a shareholder of any group entity) on behalf of the entity receiving or acquiring the goods or services. Paragraph 2 also applies to an entity that

- (a) receives goods or services when another entity in the same group (or a shareholder of any group entity) has the obligation to settle the share-based payment transaction, or
- (b) has an obligation to settle a share-based payment transaction when another entity in the same group receives the goods or services

unless the transaction is clearly for a purpose other than payment for goods or services supplied to the entity receiving them.

- 4 For the purposes of this IFRS, a transaction with an employee (or other party) in his/her capacity as a holder of equity instruments of the entity is not a share-based payment transaction. For example, if an entity grants all holders of a particular class of its equity instruments the right to acquire additional equity instruments

of the entity at a price that is less than the fair value of those equity instruments, and an employee receives such a right because he/she is a holder of equity instruments of that particular class, the granting or exercise of that right is not subject to the requirements of this IFRS.

- 5 As noted in paragraph 2, this IFRS applies to share-based payment transactions in which an entity acquires or receives goods or services. Goods includes inventories, consumables, property, plant and equipment, intangible assets and other non-financial assets. However, an entity shall not apply this IFRS to transactions in which the entity acquires goods as part of the net assets acquired in a business combination as defined by IFRS 3 *Business Combinations* (as revised in 2008), in a combination of entities or businesses under common control as described in paragraphs B1–B4 of IFRS 3, or the contribution of a business on the formation of a joint venture as defined by IAS 31 *Interests in Joint Ventures*. Hence, equity instruments issued in a business combination in exchange for control of the acquiree are not within the scope of this IFRS. However, equity instruments granted to employees of the acquiree in their capacity as employees (eg in return for continued service) are within the scope of this IFRS. Similarly, the cancellation, replacement or other modification of *share-based payment arrangements* because of a business combination or other equity restructuring shall be accounted for in accordance with this IFRS. IFRS 3 provides guidance on determining whether equity instruments issued in a business combination are part of the consideration transferred in exchange for control of the acquiree (and therefore within the scope of IFRS 3) or are in return for continued service to be recognised in the post-combination period (and therefore within the scope of this IFRS).

- 6 This IFRS does not apply to share-based payment transactions in which the entity receives or acquires goods or services under a contract within the scope of paragraphs 8–10 of IAS 32 *Financial Instruments: Presentation* (as revised in 2003) or paragraphs 5–7 of IAS 39 *Financial Instruments: Recognition and Measurement* (as revised in 2003).

Recognition

- 7 An entity shall recognise the goods or services received or acquired in a share-based payment transaction when it obtains the goods or as the services are received. The entity shall recognise a corresponding increase in equity if the goods or services were received in an equity-settled share-based payment transaction, or a liability if the goods or services were acquired in a cash-settled share-based payment transaction.

- 8 When the goods or services received or acquired in a share-based payment transaction do not qualify for recognition as assets, they shall be recognised as expenses.

- 9 Typically, an expense arises from the consumption of goods or services. For example, services are typically consumed immediately, in which case an expense is recognised as the counterparty renders service. Goods might be consumed over a period of time or, in the case of inventories, sold at a later date,

* The title of IAS 32 was amended in 2005.

in which case an expense is recognised when the goods are consumed or sold. However, sometimes it is necessary to recognise an expense before the goods or services are consumed or sold, because they do not qualify for recognition as assets. For example, an entity might acquire goods as part of the research phase of a project to develop a new product. Although those goods have not been consumed, they might not qualify for recognition as assets under the applicable IFRS.

Equity-settled share-based payment transactions

Overview

- 10 For equity-settled share-based payment transactions, the entity shall measure the goods or services received, and the corresponding increase in equity, directly, at the fair value of the goods or services received, unless that fair value cannot be estimated reliably. If the entity cannot estimate reliably the fair value of the goods or services received, the entity shall measure their value, and the corresponding increase in equity, indirectly, by reference to^{*} the fair value of the equity instruments granted.
- 11 To apply the requirements of paragraph 10 to transactions with employees and others providing similar services,[†] the entity shall measure the fair value of the services received by reference to the fair value of the equity instruments granted, because typically it is not possible to estimate reliably the fair value of the services received, as explained in paragraph 12. The fair value of those equity instruments shall be measured at *grant date*.
- 12 Typically, shares, share options or other equity instruments are granted to employees as part of their remuneration package, in addition to a cash salary and other employment benefits. Usually, it is not possible to measure directly the services received for particular components of the employee's remuneration package. It might also not be possible to measure the fair value of the total remuneration package independently, without measuring directly the fair value of the equity instruments granted. Furthermore, shares or share options are sometimes granted as part of a bonus arrangement, rather than as a part of basic remuneration, eg as an incentive to the employees to remain in the entity's employ or to reward them for their efforts in improving the entity's performance. By granting shares or share options, in addition to other remuneration, the entity is paying additional remuneration to obtain additional benefits. Estimating the fair value of those additional benefits is likely to be difficult. Because of the difficulty of measuring directly the fair value of the services received, the entity shall measure the fair value of the employee services received by reference to the fair value of the equity instruments granted.

* This IFRS uses the phrase 'by reference to' rather than 'at', because the transaction is ultimately measured by multiplying the fair value of the equity instruments granted, measured at the date specified in paragraph 11 or 13 (whichever is applicable), by the number of equity instruments that vest, as explained in paragraph 19.

† In the remainder of this IFRS, all references to employees also include others providing similar services.

13 To apply the requirements of paragraph 10 to transactions with parties other than employees, there shall be a rebuttable presumption that the fair value of the goods or services received can be estimated reliably. That fair value shall be measured at the date the entity obtains the goods or the counterparty renders service. In rare cases, if the entity rebuts this presumption because it cannot estimate reliably the fair value of the goods or services received, the entity shall measure the goods or services received, and the corresponding increase in equity, indirectly, by reference to the fair value of the equity instruments granted, measured at the date the entity obtains the goods or the counterparty renders service.

13A In particular, if the identifiable consideration received (if any) by the entity appears to be less than the fair value of the equity instruments granted or liability incurred, typically this situation indicates that other consideration (ie unidentifiable goods or services) has been (or will be) received by the entity. The entity shall measure the identifiable goods or services received in accordance with this IFRS. The entity shall measure the unidentifiable goods or services received (or to be received) as the difference between the fair value of the share-based payment and the fair value of any identifiable goods or services received (or to be received). The entity shall measure the unidentifiable goods or services received at the grant date. However, for cash-settled transactions, the liability shall be remeasured at the end of each reporting period until it is settled in accordance with paragraphs 30–33.

Transactions in which services are received

- 14 If the equity instruments granted vest immediately, the counterparty is not required to complete a specified period of service before becoming unconditionally entitled to those equity instruments. In the absence of evidence to the contrary, the entity shall presume that services rendered by the counterparty as consideration for the equity instruments have been received. In this case, on grant date the entity shall recognise the services received in full, with a corresponding increase in equity.
- 15 If the equity instruments granted do not vest until the counterparty completes a specified period of service, the entity shall presume that the services to be rendered by the counterparty as consideration for those equity instruments will be received in the future, during the *vesting period*. The entity shall account for those services as they are rendered by the counterparty during the vesting period, with a corresponding increase in equity. For example:
- if an employee is granted share options conditional upon completing three years' service, then the entity shall presume that the services to be rendered by the employee as consideration for the share options will be received in the future, over that three-year vesting period.
 - if an employee is granted share options conditional upon the achievement of a performance condition and remaining in the entity's employ until that performance condition is satisfied, and the length of the vesting period varies depending on when that performance condition is satisfied, the entity shall presume that the services to be rendered by the employee as consideration for the share options will be received in the future, over the

expected vesting period. The entity shall estimate the length of the expected vesting period at grant date, based on the most likely outcome of the performance condition. If the performance condition is a *market condition*, the estimate of the length of the expected vesting period shall be consistent with the assumptions used in estimating the fair value of the options granted, and shall not be subsequently revised. If the performance condition is not a market condition, the entity shall revise its estimate of the length of the vesting period, if necessary, if subsequent information indicates that the length of the vesting period differs from previous estimates.

Transactions measured by reference to the fair value of the equity instruments granted

Determining the fair value of equity instruments granted

- 16 For transactions measured by reference to the fair value of the equity instruments granted, an entity shall measure the fair value of equity instruments granted at the *measurement date*, based on market prices if available, taking into account the terms and conditions upon which those equity instruments were granted (subject to the requirements of paragraphs 19–22).
- 17 If market prices are not available, the entity shall estimate the fair value of the equity instruments granted using a valuation technique to estimate what the price of those equity instruments would have been on the measurement date in an arm's length transaction between knowledgeable, willing parties. The valuation technique shall be consistent with generally accepted valuation methodologies for pricing financial instruments, and shall incorporate all factors and assumptions that knowledgeable, willing market participants would consider in setting the price (subject to the requirements of paragraphs 19–22).
- 18 Appendix B contains further guidance on the measurement of the fair value of shares and share options, focusing on the specific terms and conditions that are common features of a grant of shares or share options to employees.

Treatment of vesting conditions

- 19 A grant of equity instruments might be conditional upon satisfying specified *vesting conditions*. For example, a grant of shares or share options to an employee is typically conditional on the employee remaining in the entity's employ for a specified period of time. There might be performance conditions that must be satisfied, such as the entity achieving a specified growth in profit or a specified increase in the entity's share price. Vesting conditions, other than market conditions, shall not be taken into account when estimating the fair value of the shares or share options at the measurement date. Instead, vesting conditions shall be taken into account by adjusting the number of equity instruments included in the measurement of the transaction amount so that, ultimately, the amount recognised for goods or services received as consideration for the equity instruments granted shall be based on the number of equity instruments that eventually vest. Hence, on a cumulative basis, no amount is recognised for goods

or services received if the equity instruments granted do not vest because of failure to satisfy a vesting condition, eg the counterparty fails to complete a specified service period, or a performance condition is not satisfied, subject to the requirements of paragraph 21.

- 20 To apply the requirements of paragraph 19, the entity shall recognise an amount for the goods or services received during the vesting period based on the best available estimate of the number of equity instruments expected to vest and shall revise that estimate, if necessary, if subsequent information indicates that the number of equity instruments expected to vest differs from previous estimates. On vesting date, the entity shall revise the estimate to equal the number of equity instruments that ultimately vested, subject to the requirements of paragraph 21.

- 21 Market conditions, such as a target share price upon which vesting (or exercisability) is conditioned, shall be taken into account when estimating the fair value of the equity instruments granted. Therefore, for grants of equity instruments with market conditions, the entity shall recognise the goods or services received from a counterparty who satisfies all other vesting conditions (eg services received from an employee who remains in service for the specified period of service), irrespective of whether that market condition is satisfied.

Treatment of non-vesting conditions

- 21A Similarly, an entity shall take into account all non-vesting conditions when estimating the fair value of the equity instruments granted. Therefore, for grants of equity instruments with non-vesting conditions, the entity shall recognise the goods or services received from a counterparty that satisfies all vesting conditions that are not market conditions (eg services received from an employee who remains in service for the specified period of service), irrespective of whether those non-vesting conditions are satisfied.

Treatment of a reload feature

- 22 For options with a *reload feature*, the reload feature shall not be taken into account when estimating the fair value of options granted at the measurement date. Instead, a *reload option* shall be accounted for as a new option grant, if and when a reload option is subsequently granted.

After vesting date

- 23 Having recognised the goods or services received in accordance with paragraphs 10–22, and a corresponding increase in equity, the entity shall make no subsequent adjustment to total equity after vesting date. For example, the entity shall not subsequently reverse the amount recognised for services received from an employee if the vested equity instruments are later forfeited or, in the case of share options, the options are not exercised. However, this requirement does not preclude the entity from recognising a transfer within equity, ie a transfer from one component of equity to another.

If the fair value of the equity instruments cannot be estimated reliably

24 The requirements in paragraphs 16-23 apply when the entity is required to measure a share-based payment transaction by reference to the fair value of the equity instruments granted. In rare cases, the entity may be unable to estimate reliably the fair value of the equity instruments granted at the measurement date, in accordance with the requirements in paragraphs 16-22. In these rare cases only, the entity shall instead:

- (a) measure the equity instruments at their *intrinsic value*, initially at the date the entity obtains the goods or the counterparty renders service and subsequently at the end of each reporting period and at the date of final settlement, with any change in intrinsic value recognised in profit or loss. For a grant of share options, the share-based payment arrangement is finally settled when the options are exercised, are forfeited (eg upon cessation of employment) or lapse (eg at the end of the option's life).
- (b) recognise the goods or services received based on the number of equity instruments that ultimately vest or (where applicable) are ultimately exercised. To apply this requirement to share options, for example, the entity shall recognise the goods or services received during the vesting period, if any, in accordance with paragraphs 14 and 15, except that the requirements in paragraph 15(b) concerning a market condition do not apply. The amount recognised for goods or services received during the vesting period shall be based on the number of share options expected to vest. The entity shall revise that estimate, if necessary, if subsequent information indicates that the number of share options expected to vest differs from previous estimates. On vesting date, the entity shall revise the estimate to equal the number of equity instruments that ultimately vested. After vesting date, the entity shall reverse the amount recognised for goods or services received if the share options are later forfeited, or lapse at the end of the share option's life.

25 If an entity applies paragraph 24, it is not necessary to apply paragraphs 26-29, because any modifications to the terms and conditions on which the equity instruments were granted will be taken into account when applying the intrinsic value method set out in paragraph 24. However, if an entity settles a grant of equity instruments to which paragraph 24 has been applied:

- (a) if the settlement occurs during the vesting period, the entity shall account for the settlement as an acceleration of vesting, and shall therefore recognise immediately the amount that would otherwise have been recognised for services received over the remainder of the vesting period.
- (b) any payment made on settlement shall be accounted for as the repurchase of equity instruments, ie as a deduction from equity, except to the extent that the payment exceeds the intrinsic value of the equity instruments, measured at the repurchase date. Any such excess shall be recognised as an expense.

Modifications to the terms and conditions on which equity instruments were granted, including cancellations and settlements

26 An entity might modify the terms and conditions on which the equity instruments were granted. For example, it might reduce the exercise price of options granted to employees (ie reprice the options), which increases the fair value of those options. The requirements in paragraphs 27-29 to account for the effects of modifications are expressed in the context of share-based payment transactions with employees. However, the requirements shall also be applied to share-based payment transactions with parties other than employees that are measured by reference to the fair value of the equity instruments granted. In the latter case, any references in paragraphs 27-29 to grant date shall instead refer to the date the entity obtains the goods or the counterparty renders service.

27 The entity shall recognise, as a minimum, the services received measured at the grant date fair value of the equity instruments granted, unless those equity instruments do not vest because of failure to satisfy a vesting condition (other than a market condition) that was specified at grant date. This applies irrespective of any modifications to the terms and conditions on which the equity instruments were granted, or a cancellation or settlement of that grant of equity instruments. In addition, the entity shall recognise the effects of modifications that increase the total fair value of the share-based payment arrangement or are otherwise beneficial to the employee. Guidance on applying this requirement is given in Appendix B.

28 If a grant of equity instruments is cancelled or settled during the vesting period (other than a grant cancelled by forfeiture when the vesting conditions are not satisfied):

- (a) the entity shall account for the cancellation or settlement as an acceleration of vesting, and shall therefore recognise immediately the amount that otherwise would have been recognised for services received over the remainder of the vesting period.
- (b) any payment made to the employee on the cancellation or settlement of the grant shall be accounted for as the repurchase of an equity interest, ie as a deduction from equity, except to the extent that the payment exceeds the fair value of the equity instruments granted, measured at the repurchase date. Any such excess shall be recognised as an expense. However, if the share-based payment arrangement included liability components, the entity shall remeasure the fair value of the liability at the date of cancellation or settlement. Any payment made to settle the liability component shall be accounted for as an extinguishment of the liability.
- (c) if new equity instruments are granted to the employee and, on the date when those new equity instruments are granted, the entity identifies the new equity instruments granted as replacement equity instruments for the cancelled equity instruments, the entity shall account for the granting of replacement equity instruments in the same way as a modification of the original grant of equity instruments, in accordance with paragraph 27 and the guidance in Appendix B. The incremental fair value granted is the

The main revisions made in 2008 were:

- The scope was broadened to cover business combinations involving only non-identifiable entities and business combinations achieved by contract alone.
- The definitions of a *business* and a *business combination* were amended and additional guidance was added for identifying when a group of assets constitutes a business.
- For each business combination, the acquirer must measure any non-controlling interest in the acquiree either at fair value or as the non-controlling interest's proportionate share of the acquiree's net identifiable assets. Previously, only the latter was permitted.
- The requirements for how the acquirer makes any classifications, designations and assessments for the identifiable assets acquired and liabilities assumed in a business combination were clarified.
- The period during which changes to deferred tax benefits acquired in a business combination can be adjusted against goodwill has been limited to the measurement period (through a consequential amendment to IAS 12 *Income Taxes*).
- An acquirer is no longer permitted to recognise contingencies acquired in a business combination that do not meet the definition of a liability.
- Costs the acquirer incurs in connection with the business combination must be accounted for separately from the business combination, which usually means that they are recognised as expenses (rather than included in goodwill).
- Consideration transferred by the acquirer, including contingent consideration, must be measured and recognised at fair value at the acquisition date. Subsequent changes in the fair value of contingent consideration classified as liabilities are recognised in accordance with IAS 39, IAS 37 or other IFRSs, as appropriate (rather than by adjusting goodwill). The disclosures required to be made in relation to contingent consideration were enhanced.
- Application guidance was added in relation to when the acquirer is obliged to replace the acquiree's share-based payment awards; measuring indemnifiable assets; rights sold previously that are reacquired in a business combination; operating leases; and valuation allowances related to financial assets such as receivables and loans.
- For business combinations achieved in stages, having the acquisition date as the single measurement date was extended to include the measurement of goodwill. An acquirer must remeasure any equity interest it holds in the acquiree immediately before achieving control at its acquisition-date fair value and recognise the resulting gain or loss, if any, in profit or loss.

International Financial Reporting Standard 4

Insurance Contracts

IFRS 4 *Insurance Contracts* was issued by the International Accounting Standards Board (IASB) in March 2004.

IFRS 4 and its accompanying documents have been amended by the following IFRSs:

- IFRS 7 *Financial Instruments: Disclosures* (issued August 2005)
- *Financial Guarantee Contracts* (Amendments to IAS 39 and IFRS 4) (issued August 2005)
- IFRS 8 *Operating Segments* (issued November 2006)^{*}
- IAS 1 *Presentation of Financial Statements* (as revised in September 2007)^{*}
- IFRS 3 *Business Combinations* (as revised in January 2008)[†]
- IAS 27 *Consolidated and Separate Financial Statements* (as amended in January 2008)[†]
- *Improving Disclosures about Financial Instruments* (Amendments to IFRS 7) (issued March 2009).^{*}

In December 2005 the IASB published revised Guidance on implementing IFRS 4.

Amendments with an effective date later than 1 January 2012

IFRS 4 and its accompanying documents have been amended by:

- IFRS 9 *Financial Instruments* (issued November 2009 and October 2010)
- IFRS 13 *Fair Value Measurement* (issued May 2011)

As these amendments have an effective date later than 1 January 2012 they are not included in this edition.

The following interpretation refers to IFRS 4:

- SIC-27 *Evaluating the Substance of Transactions Involving the Legal Form of a Lease* (as amended in 2004).

* effective date 1 January 2009

† effective date 1 July 2009

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BASIS FOR CONCLUSIONS

IMPLEMENTATION GUIDANCE

International Financial Reporting Standard 4 Insurance Contracts (IFRS 4) is set out in paragraphs 1–45 and Appendices A–C. All the paragraphs have equal authority. Paragraphs in **bold type** state the main principles. Terms defined in Appendix A are in **italics** the first time they appear in the Standard. Definitions of other terms are given in the Glossary for International Financial Reporting Standards. IFRS 4 should be read in the context of its objective and the Basis for Conclusions, the Preface to International Financial Reporting Standards and the Conceptual Framework for Financial Reporting. IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Introduction

Reasons for issuing the IFRS

- IN1 This is the first IFRS to deal with insurance contracts. Accounting practices for insurance contracts have been diverse, and have often differed from practices in other sectors. Because many entities will adopt IFRSs in 2005, the International Accounting Standards Board has issued this IFRS:
- (a) to make limited improvements to accounting for insurance contracts until the Board completes the second phase of its project on insurance contracts;
 - (b) to require any entity issuing insurance contracts (an insurer) to disclose information about those contracts.
- IN2 This IFRS is a stepping stone to phase II of this project. The Board is committed to completing phase II without delay once it has investigated all relevant conceptual and practical questions and completed its full due process.

Main features of the IFRS

- IN3 The IFRS applies to all insurance contracts (including reinsurance contracts) that an entity issues and to reinsurance contracts that it holds, except for special contracts covered by other IFRSs. It does not apply to other assets and liabilities of an insurer, such as financial assets and financial liabilities within the scope of IAS 39 *Financial Instruments: Recognition and Measurement*. Furthermore, it does not address accounting by policyholders.
- IN4 The IFRS exempts an insurer temporarily (ie during phase I of this project) from some requirements of other IFRSs, including the requirements to consider the *Framework*^{*} in selecting accounting policies for insurance contracts. However, the IFRS:
- (a) prohibits provisions for possible claims under contracts that are not expected to exist at the end of the reporting period (such as catastrophe and equalisation provisions);
 - (b) requires a test for the adequacy of recognised insurance liabilities and an impairment test for reinsurance assets;
 - (c) requires an insurer to keep insurance liabilities in its statement of financial position until they are discharged or cancelled, or expire, and to present insurance liabilities without offsetting them against related reinsurance assets.
- IN5 The IFRS permits an insurer to change its accounting policies for insurance contracts only if, as a result, its financial statements present information that is more relevant and no less reliable, or more reliable and no less relevant

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

in particular, an insurer cannot introduce any of the following practices, although it may continue using accounting policies that involve them:

- (a) measuring insurance liabilities on an undiscounted basis;
- (b) measuring contractual rights to future investment management fees at an amount that exceeds their fair value as implied by a comparison with current fees charged by other market participants for similar services;
- (c) using non-uniform accounting policies for the insurance liabilities of subsidiaries.

IN6 The IFRS permits the introduction of an accounting policy that involves remeasuring designated insurance liabilities consistently in each period to reflect current market interest rates (and, if the insurer so elects, other current estimates and assumptions). Without this permission, an insurer would have been required to apply the change in accounting policies consistently to all similar liabilities.

IN7 An insurer need not change its accounting policies for insurance contracts to eliminate excessive prudence. However, if an insurer already measures its insurance contracts with sufficient prudence, it should not introduce additional prudence.

IN8 There is a rebuttable presumption that an insurer's financial statements will become less relevant and reliable if it introduces an accounting policy that reflects future investment margins in the measurement of insurance contracts.

IN9 When an insurer changes its accounting policies for insurance liabilities, it may reclassify some or all financial assets as 'at fair value through profit or loss'.

IN10 The IFRS:

- (a) clarifies that an insurer need not account for an embedded derivative separately at fair value if the embedded derivative meets the definition of an insurance contract;
- (b) requires an insurer to unbundle (ie account separately for) deposit components of some insurance contracts, to avoid the omission of assets and liabilities from its statement of financial position;
- (c) clarifies the applicability of the practice sometimes known as 'shadow accounting';
- (d) permits an expanded presentation for insurance contracts acquired in a business combination or portfolio transfer;
- (e) addresses limited aspects of discretionary participation features contained in insurance contracts or financial instruments.

IN11 The IFRS requires disclosure to help users understand:

- (a) the amounts in the insurer's financial statements that arise from insurance contracts;
- (b) the nature and extent of risks arising from insurance contracts.

IN12 [Deleted]

Potential impact of future proposals

IN13 [Deleted]

International Financial Reporting Standard 4 Insurance Contracts

Objective

1 The objective of this IFRS is to specify the financial reporting for insurance contracts issued by any entity that issues such contracts (described in this IFRS as an insurer). The Board completes the second phase of its project on insurance contracts. In particular, this IFRS requires:

- (a) limited improvements to accounting by insurers for insurance contracts;
- (b) disclosure that identifies and explains the amounts in an insurer's financial statements arising from insurance contracts and helps users of those financial statements understand the amount, timing and uncertainty of future cash flows from insurance contracts.

Scope

2 An entity shall apply this IFRS to:

- (a) insurance contracts (including reinsurance contracts) that it issues and reinsurance contracts that it holds;
- (b) financial instruments that it issues with a discretionary participation feature (see paragraph 35). IFRS 7 *Financial Instruments: Disclosures* requires disclosure about financial instruments, including financial instruments that contain such features.

3 This IFRS does not address other aspects of accounting by insurers, such as accounting for financial assets held by insurers and financial liabilities issued by insurers (see IAS 32 *Financial Instruments: Presentation*, IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 7), except in the transitional provisions in paragraph 45.

4 An entity shall not apply this IFRS to:

- (a) product warranties issued directly by a manufacturer, dealer or retailer (see IAS 18 *Revenue* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*);
- (b) employers' assets and liabilities under employee benefit plans (see IAS 19 *Employee Benefits* and IFRS 2 *Share-based Payment*) and retirement benefit obligations reported by defined benefit retirement plans (see IAS 19 *Accounting and Reporting by Retirement Benefit Plans*);
- (c) contractual rights or contractual obligations that are contingent on the future use of, or right to use, a non-financial item (for example, some licence fees, royalties, contingent lease payments and similar items), as well as a lessee's residual value guarantee embedded in a finance lease (see IAS 17 *Leases*, IAS 18 *Revenue* and IAS 38 *Intangible Assets*);
- (d) financial guarantee contracts unless the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has

accounting applicable to insurance contracts, in which case the issuer may elect to apply either IAS 39, IAS 32 and IFRS 7 or this IFRS to such financial guarantee contracts. The issuer may make that election contract by contract, but the election for each contract is irrevocable.

- (e) contingent consideration payable or receivable in a business combination (see IFRS 3 *Business Combinations*);
- (f) direct insurance contracts that the entity holds (ie direct insurance contracts in which the entity is the policyholder). However, a cedant shall apply this IFRS to reinsurance contracts that it holds.

For ease of reference, this IFRS describes any entity that issues an insurance contract as an insurer, whether or not the issuer is regarded as an insurer for legal or supervisory purposes.

A reinsurance contract is a type of insurance contract. Accordingly, all references in this IFRS to insurance contracts also apply to reinsurance contracts.

Embedded derivatives

IAS 39 requires an entity to separate some embedded derivatives from their host contract, measure them at fair value and include changes in their fair value in profit or loss. IAS 39 applies to derivatives embedded in an insurance contract unless the embedded derivative is itself an insurance contract.

As an exception to the requirement in IAS 39, an insurer need not separate, and measure at fair value, a policyholder's option to surrender an insurance contract for a fixed amount (or for an amount based on a fixed amount and an interest rate), even if the exercise price differs from the carrying amount of the host insurance liability. However, the requirement in IAS 39 does apply to a put option or cash surrender option embedded in an insurance contract if the surrender value varies in response to the change in a financial variable (such as an equity or commodity price or index), or a non-financial variable that is not specific to a party to the contract. Furthermore, that requirement also applies if the holder's ability to exercise a put option or cash surrender option is triggered by a change in such a variable (for example, a put option that can be exercised if a stock market index reaches a specified level).

Paragraph 8 applies equally to options to surrender a financial instrument containing a discretionary participation feature.

Unbundling of deposit components

Some insurance contracts contain both an insurance component and a deposit component. In some cases, an insurer is required or permitted to unbundle those components:

- (a) unbundling is required if both the following conditions are met:
 - (i) the insurer can measure the deposit component (including any embedded surrender options) separately (ie without considering the insurance component);

- (ii) the insurer's accounting policies do not otherwise require it to recognise all obligations and rights arising from the deposit component.
 - (b) unbundling is permitted, but not required, if the insurer can measure the deposit component separately as in (a)(i) but its accounting policies do not require it to recognise all obligations and rights arising from the deposit component, regardless of the basis used to measure those rights and obligations.
 - (c) unbundling is prohibited if an insurer cannot measure the deposit component separately as in (a)(i).
- 11 The following is an example of a case when an insurer's accounting policies do not require it to recognise all obligations arising from a deposit component. A cedant receives compensation for losses from a reinsurer, but the contract obliges the cedant to repay the compensation in future years. That obligation arises from a deposit component. If the cedant's accounting policies do not otherwise permit it to recognise the compensation as income, unbundling recognising the resulting obligation, unbundling is required.
- 12 To unbundle a contract, an insurer shall:
- (a) apply this IFRS to the insurance component.
 - (b) apply IAS 39 to the deposit component.

Recognition and measurement

Temporary exemption from some other IFRSs

- 13 Paragraphs 10–12 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* specify criteria for an entity to use in developing an accounting policy. IFRS applies specifically to an item. However, this IFRS exempts an insurer from applying those criteria to its accounting policies for:
- (a) insurance contracts that it issues (including related acquisition costs and related intangible assets, such as those described in paragraphs 31 and 32) and
 - (b) reinsurance contracts that it holds.
- 14 Nevertheless, this IFRS does not exempt an insurer from some implications of the criteria in paragraphs 10–12 of IAS 8. Specifically, an insurer:
- (a) shall not recognise as a liability any provisions for possible future claims that those claims arise under insurance contracts that are not in existence at the end of the reporting period (such as catastrophe provisions and equalisation provisions).
 - (b) shall carry out the *liability adequacy test* described in paragraphs 15–19.
 - (c) shall remove an insurance liability (or a part of an insurance liability) from its statement of financial position when, and only when, it is extinguished—ie when the obligation specified in the contract is discharged or cancelled or expires.

- (d) shall not offset:
 - (i) reinsurance assets against the related insurance liabilities; or
 - (ii) income or expense from reinsurance contracts against the expense or income from the related insurance contracts.
- (e) shall consider whether its reinsurance assets are impaired (see paragraph 20).

Liability adequacy test

15 An insurer shall assess at the end of each reporting period whether its recognised insurance liabilities are adequate, using current estimates of future cash flows under its insurance contracts. If that assessment shows that the carrying amount of its insurance liabilities (less related deferred acquisition costs and related intangible assets, such as those discussed in paragraphs 31 and 32) is inadequate in the light of the estimated future cash flows, the entire deficiency shall be recognised in profit or loss.

- 16 If an insurer applies a liability adequacy test that meets specified minimum requirements, this IFRS imposes no further requirements. The minimum requirements are the following:

- (a) The test considers current estimates of all contractual cash flows, and of related cash flows such as claims handling costs, as well as cash flows resulting from embedded options and guarantees.
- (b) If the test shows that the liability is inadequate, the entire deficiency is recognised in profit or loss.

- 17 If an insurer's accounting policies do not require a liability adequacy test that meets the minimum requirements of paragraph 16, the insurer shall:

- (a) determine the carrying amount of the relevant insurance liabilities^a less the carrying amount of:
 - (i) any related deferred acquisition costs; and
 - (ii) any related intangible assets, such as those acquired in a business combination or portfolio transfer (see paragraphs 31 and 32). However, related reinsurance assets are not considered because an insurer accounts for them separately (see paragraph 20).
- (b) determine whether the amount described in (a) is less than the carrying amount that would be required if the relevant insurance liabilities were within the scope of IAS 37. If it is less, the insurer shall recognise the entire difference in profit or loss and decrease the carrying amount of the related deferred acquisition costs or related intangible assets or increase the carrying amount of the relevant insurance liabilities.

^aThe relevant insurance liabilities are those insurance liabilities (and related deferred acquisition costs and related intangible assets) for which the insurer's accounting policies do not require a liability adequacy test that meets the minimum requirements of paragraph 16.

- 18 If an insurer's liability adequacy test meets the minimum requirements of paragraph 16, the test is applied at the level of aggregation specified in that paragraph. If its liability adequacy test does not meet those minimum requirements, a comparison described in paragraph 17 shall be made at the level of a portfolio of contracts that are subject to broadly similar risks and managed together as a single portfolio.
- 19 The amount described in paragraph 17(b) (ie the result of applying IAS 27) shall reflect future investment margins (see paragraphs 27-29) if, and only if, the amount described in paragraph 17(a) also reflects those margins.

Impairment of reinsurance assets

- 20 If a cedant's reinsurance asset is impaired, the cedant shall reduce its carrying amount accordingly and recognise that impairment loss in profit or loss. A reinsurance asset is impaired if, and only if:
- there is objective evidence, as a result of an event that occurred after the recognition of the reinsurance asset, that the cedant may not receive the amounts due to it under the terms of the contract; and
 - that event has a reliably measurable impact on the amounts that the cedant will receive from the reinsurer.

Changes in accounting policies

- 21 Paragraphs 22-30 apply both to changes made by an insurer that already applies IFRSs and to changes made by an insurer adopting IFRSs for the first time.
- 22 An insurer may change its accounting policies for insurance contracts if, and only if, the change makes the financial statements more relevant to the economic decision-making needs of users and no less reliable, or more reliable and no less relevant to those needs. An insurer shall judge relevance and reliability by the criteria in IAS 8.
- 23 To justify changing its accounting policies for insurance contracts, an insurer shall show that the change brings its financial statements closer to meeting the criteria in IAS 8, but the change need not achieve full compliance with those criteria. The following specific issues are discussed below:
- current interest rates (paragraph 24);
 - continuation of existing practices (paragraph 25);
 - prudence (paragraph 26);
 - future investment margins (paragraphs 27-29); and
 - shadow accounting (paragraph 30).

Current market interest rates

- 24 An insurer is permitted, but not required, to change its accounting policies so that it remeasures designated insurance liabilities to reflect current market interest rates and recognises changes in those liabilities in profit or loss. At the

* In this paragraph, insurance liabilities include related deferred acquisition costs and related intangible assets, such as those discussed in paragraphs 31 and 32.

time, it may also introduce accounting policies that require other current estimates and assumptions for the designated liabilities. The election in this paragraph permits an insurer to change its accounting policies for designated liabilities, without applying those policies consistently to all similar liabilities as IAS 8 would otherwise require. If an insurer designates liabilities for this election, it shall continue to apply current market interest rates (and, if applicable, the other current estimates and assumptions) consistently in all periods to all these liabilities until they are extinguished.

Continuation of existing practices

- 25 An insurer may continue the following practices, but the introduction of any of them does not satisfy paragraph 22:
- measuring insurance liabilities on an undiscounted basis.
 - measuring contractual rights to future investment management fees at an amount that exceeds their fair value as implied by a comparison with current fees charged by other market participants for similar services. It is likely that the fair value at inception of those contractual rights equals the origination costs paid, unless future investment management fees and related costs are out of line with market comparables.
 - using non-uniform accounting policies for the insurance contracts (and related deferred acquisition costs and related intangible assets, if any) of subsidiaries, except as permitted by paragraph 24. If those accounting policies are not uniform, an insurer may change them if the change does not make the accounting policies more diverse and also satisfies the other requirements in this IFRS.

Prudence

- 26 An insurer need not change its accounting policies for insurance contracts to eliminate excessive prudence. However, if an insurer already measures its insurance contracts with sufficient prudence, it shall not introduce additional prudence.

Future investment margins

- 27 An insurer need not change its accounting policies for insurance contracts to eliminate future investment margins. However, there is a rebuttable presumption that an insurer's financial statements will become less relevant and reliable if it introduces an accounting policy that reflects future investment margins in the measurement of insurance contracts, unless those margins affect the contractual payments. Two examples of accounting policies that reflect those margins are:
- using a discount rate that reflects the estimated return on the insurer's assets; or
 - projecting the returns on those assets at an estimated rate of return, discounting those projected returns at a different rate and including the result in the measurement of the liability.

28 An insurer may overcome the rebuttable presumption described in paragraph 27, if, and only if, the other components of a change in accounting policies are sufficient to ensure the relevance and reliability of its financial statements sufficiently to overcome the decrease in relevance and reliability caused by the inclusion of those investment margins. For example, suppose that an insurer's existing accounting policies for insurance contracts involve excessively prudent assumptions at inception and a discount rate prescribed by a regulator without direct reference to market conditions, and ignore some embedded options and guarantees. The insurer might make its financial statements more relevant and more reliable by switching to a comprehensive investor-oriented basis of accounting that is widely used and involves:

- (a) current estimates and assumptions;
- (b) a reasonable (but not excessively prudent) adjustment to reflect risk and uncertainty;
- (c) measurements that reflect both the intrinsic value and time value of embedded options and guarantees; and
- (d) a current market discount rate, even if that discount rate reflects an estimated return on the insurer's assets.

29 In some measurement approaches, the discount rate is used to determine the present value of a future profit margin. That profit margin is then attributed to different periods using a formula. In those approaches, the discount rate affects the measurement of the liability only indirectly. In particular, the use of an appropriate discount rate has a limited or no effect on the measurement of the liability at inception. However, in other approaches, the discount rate determines the measurement of the liability directly. In the latter case, because the introduction of an asset-based discount rate has a more significant effect, it is highly unlikely that an insurer could overcome the rebuttable presumption described in paragraph 27.

Shadow accounting

30 In some accounting models, realised gains or losses on an insurer's assets have a direct effect on the measurement of some or all of (a) its insurance liabilities, (b) related deferred acquisition costs and (c) related intangible assets, such as those described in paragraphs 31 and 32. An insurer is permitted, but not required, to change its accounting policies so that a recognised but unrealised gain or loss on an asset affects those measurements in the same way that a realised gain or loss does. The related adjustment to the insurance liability (or deferred acquisition costs or intangible assets) shall be recognised in other comprehensive income if, and only if, the unrealised gains or losses are recognised in other comprehensive income. This practice is sometimes described as 'shadow accounting'.

Insurance contracts acquired in a business combination or portfolio transfer

31 To comply with IFRS 3, an insurer shall, at the acquisition date, measure at fair value the insurance liabilities assumed and *insurance assets* acquired in a business combination. However, an insurer is permitted, but not required, to use an expanded presentation that splits the fair value of acquired insurance contracts into two components:

- (a) a liability measured in accordance with the insurer's accounting policies for insurance contracts that it issues; and
- (b) an intangible asset, representing the difference between (i) the fair value of the contractual insurance rights acquired and insurance obligations assumed and (ii) the amount described in (a). The subsequent measurement of this asset shall be consistent with the measurement of the related insurance liability.

32 An insurer acquiring a portfolio of insurance contracts may use the expanded presentation described in paragraph 31.

33 The intangible assets described in paragraphs 31 and 32 are excluded from the scope of IAS 36 *Impairment of Assets* and IAS 38. However, IAS 36 and IAS 38 apply to customer lists and customer relationships reflecting the expectation of future contracts that are not part of the contractual insurance rights and contractual insurance obligations that existed at the date of a business combination or portfolio transfer.

Discretionary participation features

Discretionary participation features in insurance contracts

34 Some insurance contracts contain a discretionary participation feature as well as a *guaranteed element*. The issuer of such a contract:

- (a) may, but need not, recognise the guaranteed element separately from the discretionary participation feature. If the issuer does not recognise them separately, it shall classify the whole contract as a liability. If the issuer classifies them separately, it shall classify the guaranteed element as a liability;
- (b) shall, if it recognises the discretionary participation feature separately from the guaranteed element, classify that feature as either a liability or a separate component of equity. This IFRS does not specify how the issuer determines whether that feature is a liability or equity. The issuer may split that feature into liability and equity components and shall use a consistent accounting policy for that split. The issuer shall not classify that feature as an intermediate category that is neither liability nor equity;
- (c) may recognise all premiums received as revenue without separating any portion that relates to the equity component. The resulting changes in the guaranteed element and in the portion of the discretionary participation feature classified as a liability shall be recognised in profit or loss. If part or all of the discretionary participation feature is classified in equity, a