

Measurement

2.70 Assets and liabilities acquired in a business combination and recognised using the business combinations exemption explained in the paragraphs above are measured on the following basis:

- Some assets and liabilities are measured at fair value under IFRS. Such assets should be measured at fair value on transition to IFRS, whether they were acquired in a past business combination or not. [IFRS 1 App C para C4(d)]. Any adjustment arising from remeasurement should be made against retained earnings or another appropriate category of equity.
- Other assets and liabilities are measured on a cost basis under IFRS. The carrying value of an asset or liability immediately after a business combination is deemed cost for any cost-based measurement going forward from the date of the combination. [IFRS 1 App C para C4(e)]. This means that:
 - Previous GAAP fair value adjustments do not have to be revised. The fair value of an asset or liability recorded under previous GAAP on acquisition becomes its deemed cost for IFRS purposes even though the values determined may not comply with IFRS.
 - If the pooling of interests method was applied at the time of acquisition, the deemed cost will be the carrying value in the acquiree's books at the acquisition date.
 - The carrying value of the other tangible and intangible assets would not be adjusted unless:
 - they were impaired in accordance with IAS 36; or
 - the depreciation/amortisation charge since the acquisition date is materially different from the charge calculated in accordance with IFRS.
- Some assets and liabilities may not have been recognised on the acquisition under previous GAAP. These assets and liabilities should only be recognised if they would qualify for recognition in the acquired entity's separate IFRS balance sheet. [IFRS 1 App C para C4(f)].

Practical applications

2.71 The above provisions can be illustrated by the following examples:

Example 1 – First time adoption for business combinations: derecognition of liability

Country S's GAAP permitted provisions to be made on acquisition for restructuring costs as long as the plan had been made within six months of the acquisition. Entity A acquired entity B six months prior to transition to IFRS and made a provision for C1m, based on a plan that was formulated following the acquisition. Entity A's date of

transition to IFRS occurs shortly before the plan is announced in detail to the acquired entity's employees.

The provision would not be permitted under IFRS 3, because there was no liability in the acquired entity at the date of acquisition. The liability of C1m is not recognised under IFRS (following para 2.63). Entity A should derecognise the liability, adjusting retained earnings on adopting IFRS.

Example 2 – First time adoption for business combinations: derecognition of intangible asset

Country T's GAAP required the recognition of a range of intangible assets on acquisition including an assembled workforce. Entity C had recognised an assembled workforce asset on acquisition of entity D.

The asset would not have been recognised on acquisition under IAS 38, as the standard specifies that an assembled workforce is not an identifiable intangible asset. This item should be derecognised with the corresponding entry being an adjustment to goodwill on adoption of IFRS.

Example 3 – First time adoption for business combinations: measurement of finance lease

Entity E acquired entity F and applied country U GAAP to the acquisition. In line with country U GAAP, entity E accounted for property finance leases of entity F as operating leases in its consolidated financial statements.

Entity E should capitalise the finance leases in its consolidated financial statements, as IAS 17 would require entity F to do so in its own separate financial statements. [IFRS 1 App C para C4(f)]. In accordance with IAS 17 entity E's management should record the building as an asset at the net present value of the minimum lease payments at the inception of the lease, less appropriate depreciation. Entity E should also record a finance lease liability at the net present value of the minimum lease payments at the inception of the lease; less capital repayments calculated using the rate of interest implicit in the lease. The difference between the amount recorded as property, plant and equipment and the amount recorded as finance lease liability should be included in retained earnings (following para 2.28 above).

Example 4 – First time adoption for business combinations: measurement of intangible assets

Country V's GAAP does not allow the recognition of intangible assets and, consequently, all are subsumed within goodwill. Entity G acquired entity H two years before transition to IFRS and accounted for the combination as an acquisition. In its consolidated financial statements entity G did not recognise intangibles in respect of entity H's internally generated brands or the costs of its separately acquired licences.

On transition to IFRS entity G should do the following with regard to these costs:

- The brands should not be recognised, as they would not be recognised under IFRS in the individual financial statements of entity H. No adjustment is required (following para 2.64).

- The separately acquired licences should be recognised as intangible assets in entity G's consolidated opening IFRS balance sheet in accordance with IAS 38. The adjustment to recognise this asset is made against goodwill, rather than retained earnings (following para 2.64).

Example 5 – First time adoption for business combinations: measurement of provisions

Entity I, recognised the expected costs of restructuring an acquired business, entity J, although it had not made the announcement necessary to create a legal or constructive obligation to complete the planned restructuring. Entity I also recognised a provision for the expected future losses of entity J's export division.

Entity I is not required to restate the purchase accounting entries made at the time entity J was acquired. However, entity I should consider whether any remaining balance in respect of the restructuring provision and the provision for future operating losses qualify for recognition at the date of transition to IFRS. Any provision that does not meet the IFRS recognition criteria at the date of transition to IFRS would not be recognised on the opening IFRS balance sheet, with a corresponding adjustment to retained earnings.

Goodwill

2.72 Where the IFRS 1 exemption for business combinations is used, goodwill in an entity's opening IFRS balance sheet should be stated at its carrying amount prior to the date of transition under that entity's previous GAAP, adjusted for only two things as described below.

- Any previously recognised intangible assets that do not qualify for recognition under IFRS (see para 2.63), or any previously unrecognised intangible assets where recognition is required under IFRS (see para 2.64). Related adjustments to non-controlling interest and deferred tax should also be made against goodwill. [IFRS 1 App C para C4(g)(i)].

UK note – As stated at paragraph 2.63 above, it is unlikely that under UK GAAP any intangible assets will have been recognised on acquisition that are not allowed under IFRS, though the criteria for recognising development costs are slightly different under IAS 38 compared to SSAP 13, requiring the 'demonstration' of future benefits rather than SSAP 13's 'expectation' of future benefits. On the other hand, it may well be that development costs have not been recognised on a business combination, because it is a UK entity's policy to write off such costs. If they meet the recognition criteria of IAS 38 they should be recognised on transition and an adjustment made against goodwill. This only applies to any development costs that existed at the date of a business combination. Any other development costs that a group is required to recognise under IAS 38 should be adjusted against retained earnings.

- Whether there is any indication of impairment or not, a first-time adopter should apply IAS 36 to test goodwill for impairment at the date of transition to IFRS, based on conditions at the transition date. Any impairment loss

should be recorded in retained earnings (or revaluation reserve if required by IAS 36). [IFRS 1 App C C4(g)(ii)]. Paragraph C4(b)(ii) in Appendix C of IFRS 1 specifically states that goodwill under previous GAAP may not be restated to adjust any previous amortisation of goodwill. Our view is that it also cannot be restated to adjust any previous impairment of goodwill. Accordingly, the impairment review carried out on transition cannot result in an increase in the goodwill balance at the date of transition.

UK note – The requirement to perform an impairment review could prove costly for many UK entities and might be a reason why some may wish to not take the IFRS 1 exemption. However, several factors are likely to mitigate this:

- IAS 36 requires annual impairment tests for all goodwill. There are no exemptions in IFRS 1 from applying IAS 36 and so an impairment test of goodwill would be required on transition to IFRS whether or not the IFRS 1 business combinations exemption is taken.

UK entities have been applying FRS 11 for some years and goodwill that has had an indication of impairment should have been tested for impairment under UK GAAP. There may be more work involved in carrying out a separate test at the transition date, and it may or may not result in adjustments to the carrying amounts of goodwill. Where it does lead to an adjustment, entities have the advantage of the adjustment being made against retained earnings. In such cases, however, entities will have to consider whether the adjustment on transition has been caused by moving to IFRS or whether an impairment existed under previous GAAP. As discussed in paragraph 2.201 below, these two types of adjustments have to be identified and disclosed separately.

- Where goodwill has been given an indefinite useful life or one greater than 20 years under UK GAAP it is already subject to an annual impairment test under FRS 11.

2.73 The previous version of IFRS 1 allowed a first-time adopter to adjust goodwill in respect of contingent consideration on a previous business combination where the contingency had since been resolved or where payment had become probable by the date of transition. If an amount had been recognised that was no longer probable or reliably measurable it was also adjusted against goodwill. This treatment was consistent with that applied by existing IFRS preparers under IFRS 3 (superseded). The ability for first-time adopters to adjust goodwill for contingent consideration was removed in the most recent version of IFRS 3. Existing IFRS preparers are permitted to adjust goodwill in line with IFRS 3 (superseded) for those business combinations accounted for under that standard. In May 2010, the IFRIC confirmed that the transition relief provided to existing IFRS preparers would not be extended to first-time adopters.

2.74 An example of a company that has adopted IFRS and recognised impairment losses on goodwill on transition is Amer Group Plc in Table 2.1.

Table 2.1 – Recognising impairment losses on goodwill on transition to IFRS

Amer Group Plc – Quarterly Report – 31 March 2004

TRANSITION TO IFRS: MAJOR CHANGES TO ACCOUNTING POLICIES AND FINANCIAL STATEMENTS REPORTED IN 2003 (extract)

5. GOODWILL, OTHER INTANGIBLE AND TANGIBLE LONG-TERM ASSETS

The major differences in accounting policies for goodwill, other intangible and tangible long-term assets between IFRS and FAS are included in two standards, IAS 36 and IFRS 3.

In accordance with IAS 36 the carrying amounts of assets are assessed on any indication of an impairment. If such an indication exists, a company should then estimate the recoverable amount of the asset. The recoverable amount is the higher of the asset's net selling price or value in use. An impairment loss is recognised when the recoverable amount of an asset is less than its carrying amount. At the date of transition of 1 January 2003 all goodwill, as well as intangible and tangible long-term assets of independent cash-generating units, were tested for possible impairments.

Impairment testing of goodwill at the date of transition

Goodwill is allocated to business segments. The recoverable amount of each segment's goodwill is calculated based on their discounted future cash flows. Future cash flows are based on the Amer Board's approved budgets and strategic plans for a period of the next three years. Forecasts for the following years are conservatively extrapolated based on the growth rate and profitability outlined in the approved plan. The discount rate is based on a long-term risk free market interest rate and a generally used standard risk premium.

As a result of the impairment tests, an impairment loss of EUR 19.1 million associated with Golf was recognised at the transition balance sheet of 1 January 2003.

Wilson Sporting Goods Co. and its subsidiaries were acquired in 1989. The goodwill generated at the time of the acquisition was not allocated to Wilson's three business segments of Racquet Sports, Golf and Team Sports. According to IAS 14 (Segment Reporting) goodwill should be allocated to segments as a minimum requirement. If the total goodwill of the three Wilson segments would have been tested as a whole at the date of transition, the recoverable amount of goodwill would have been considerably higher than its carrying amount and no impairment loss would have been recognised.

The carrying amount of goodwill in each business segment at the date of transition of 1 January 2003 is (EUR million):

Racquet Sports	73.3
Golf	7.2
Team Sports	48.8
Winter Sports	11.7
Fitness Equipment	140.4
Sports Instruments	29.1
Total	303.3

The recoverable amount of goodwill in each segment except for Golf was significantly higher than its carrying amount at 1 January 2003.

Impairment tests for other intangible and tangible long-term assets

The recoverable amount of intangible and tangible long-term assets for each independent cash-generating unit is based on value-in-use calculations. Discounted future cash flows in these calculations cover the following five years and, similarly to the goodwill impairment testing, they are based on the approved budgets and strategic plans. Estimated net cash flow to be received for the disposal of the asset at the end of its useful life is used as a residual value in the calculations. The discount rate is based on a long-term risk free market interest rate and a generally used standard risk premium.

As a result of the impairment tests an impairment loss of EUR 16.0 million associated to the Golf Division's production plants was recognised at the transition balance sheet of 1 January 2003. This improves the Golf Division's results under IFRS in 2003 by EUR 2.5 million due to lower depreciation. However, a further impairment loss of EUR 4.1 million also associated with the Golf Division's production plants is included in the Group's 2003 results under IFRS. Applying both FAS and local accounting principles in 2002 and 2003's annual closings didn't lead to impairments of the Golf Division's long-term assets.

Recoverable amounts of long-term assets for all other independent cash-generating units except for Golf were significantly higher than their carrying amounts.

Revised standard for business combinations (IFRS 3)

In accordance with the new standard, IFRS 3, goodwill and other intangible long-term assets with indefinite useful lives should not be amortised. Instead these assets should be tested annually for impairment according to IAS 36. Retrospective cancellation of goodwill and other intangible assets' amortisation improves 2003 EBIT under IFRS by EUR 16.5 million.

Additionally, in conjunction with the transition to IFRS, the intangible long-term asset recognised in the acquisition of Atomic Austria GmbH in 1994 has now been reclassified to goodwill (EUR 10.3 million at 1 January 2003).

2.75 IFRS 1 does not allow goodwill that was previously written off to reserves under previous GAAP to be reinstated as an asset. In addition, when a subsidiary is subsequently disposed of, IFRS 1 does not permit the goodwill that was taken direct to reserves to be transferred to the income statement as part of the gain or loss on disposal. IFRS 1 does not allow a transfer to the income statement on impairment of the goodwill. Where goodwill has previously been written off to reserves then any adjustments that IFRS 1 requires to be made against goodwill will also go to reserves, that is, to retained earnings. [IFRS 1 App C para C4(i)].

2.76 Similar rules apply for associates and joint ventures. If the goodwill determined under previous GAAP was deducted from reserves and not included in the carrying amount of the associate, then such goodwill is not reinstated on transition to IFRS. This also applies when the associate is sold; the goodwill is not recycled back through the income statement.

Example – First-time adoption for business combinations: goodwill

The reporting date of an investor's first IFRS financial statements is 31 December 20X7. The investor presents comparatives for one year only as well as an opening balance sheet. Therefore, its date of transition to IFRS is 1 January 20X6. The investor has an associate that was acquired many years ago and goodwill arising on the acquisition of the associate was written off to reserves under previous GAAP. The associate was sold in June 20X6.

In its opening balance sheet the goodwill arising on the acquisition of the associate would remain written off to reserves. The comparative income statement for the year ending 31 December 20X6 would show the gain or loss arising on the sale of the associate. The goodwill would be excluded from the calculation of the gain or loss on disposal.

2.77 IFRS 1 gives a further example of adjustments that cannot be made (by those using the exemption) against a previous GAAP goodwill balance. That is, goodwill should not be adjusted on transition to reverse any adjustments that IFRS 3 would not have permitted, but that had been made under a previous GAAP between the date of the business combination and the date of transition. [IFRS 1 App C para C4(h)(iii)]. For example, IFRS 3 allows a measurement period of a maximum of 12 months from the acquisition date to complete the accounting for a business combination. Within this period, adjustments may be made to goodwill as the fair values of assets and liabilities are finalised. [IFRS 3 para 45]. An entity's previous GAAP may have allowed a period greater than 12 months. Any adjustments to goodwill made under previous GAAP falling outside of the permitted measurement period under IFRS 3 would not be reversed on transition to IFRS.

Deferred tax

2.78 Where an entity takes the exemption from applying IFRS 3 to past business combinations, a number of deferred tax consequences arise in respect of those combinations. These are considered below.

2.79 The requirements of IAS 12 apply in the same way to all the assets and liabilities of a group. Temporary differences arise when the carrying amount of assets and liabilities acquired in a business combination are determined by reference to fair values at the date of exchange, but the tax bases of those assets and liabilities remain unchanged. Deferred tax should, therefore, be provided on the difference between the fair value and the tax base of all assets and liabilities acquired in a business combination. Even if an entity uses the exemption and does not have to restate past business combinations, it may still have to restate the deferred tax arising on those combinations. For example, if assets had been revalued to fair value on acquisition, but no deferred tax had been provided under previous GAAP, provision is required by IAS 12. This adjustment should be made on transition against retained earnings. (An adjustment is only made against goodwill in a few specified cases, see further para 2.72.)

2.80 Deferred tax consequences also arise on intangible assets that were recognised in past business combinations. Examples are given below and in Table 2.2.

Example – Deferred tax: intangible asset through acquisition

Entity A made an acquisition in 20X0. An intangible asset was recognised at that point and given an indefinite life. The intangible asset was not deductible for tax purposes. Under previous GAAP, such an asset did not create a temporary difference and no

deferred tax arises, either on the asset's initial recognition or on impairment or disposal. Entity A will take advantage of the business combinations exemption. What is the treatment on adoption of IFRS?

Entity A must apply IAS 12 to all assets and liabilities acquired. Paragraph 22 of IAS 12 deals with temporary differences that arise on the initial recognition of an asset or liability. Recognition of a non-tax-deductible asset gives rise a temporary difference. When this occurs in a business combination paragraph 22(a) requires that a deferred tax liability is recognised, with the other side of the entry affecting goodwill (that is, increasing goodwill).

However, first-time adopters are bound by the rules in IFRS 1. Paragraph C4(g) in Appendix C of IFRS 1 states that only certain items can adjust previously recognised goodwill when the business combinations exemption is taken. Deferred tax arising on a previously recognised asset is not one of these items. On transition, entity A must recognise a deferred tax liability with the resulting debit being recorded in retained earnings or another category of equity. IFRS 1 overrides the requirement of IAS 12 in this respect.

Table 2.2 – Deferred tax on intangibles acquired before transition date

Unilever PLC – Report and accounts – 31 December 2005

35 First time adoption of International Financial Reporting Standards (extract)

Deferred tax

Under IFRSs deferred tax is recognised in respect of all taxable temporary differences arising between the tax base and the accounting base of balance sheet items. This means that deferred tax is recognised on certain temporary differences that would not have given rise to deferred tax under previous GAAP.

The additional deferred tax included in the balance sheet under IFRSs amounted to a net movement excluding reclassifications of €1 095 million as at 1 January 2004 and €1 068 million as at 31 December 2004. Included in these amounts is a deferred tax liability relating to intangible assets (trademarks and unpatented technologies) which were recognised at the time of the Bestfoods acquisition. As the Bestfoods acquisition was a share-based transaction, these intangible assets have a zero tax base. IAS 12 requires that a deferred tax liability amounting to €1 144 million as at 1 January 2004 and €1 071 million as at 31 December 2004 is recognised in respect of these intangible assets. Normally, recognition of this deferred tax liability would lead to a corresponding increase in goodwill, but under the exemption applied under IFRS 1 relating to business combinations Unilever is precluded from adjusting the carrying value of goodwill in respect of acquisitions prior to the transition date. Recognition of this new deferred tax liability under IFRSs therefore resulted in an equivalent reduction in equity at the transition date.

2.81 Goodwill from past business combinations may have been written off to reserves, but the carrying value of the goodwill is amortised for tax purposes. The goodwill may have a tax base, at the date of transition to IFRS, equal to the amount of tax deductions to be received in the future. The requirements of IAS 12 must be applied to the opening IFRS balance sheet. IAS 12 requires that a deferred tax asset should be recognised for all deductible temporary differences, as long as there will be sufficient taxable profits to recover the asset in future periods. IAS 12 does not provide a specific exemption from recognising deferred tax assets

6.1.29 Contracts that provide compensation if another party fails to perform a contractual obligation, such as an obligation to construct a building, are performance guarantees. They do not transfer credit risk and, therefore, do not meet the definition of a financial guarantee contract. These type of guarantees are accounted for under IFRS 4 as insurance contracts.

6.1.30 The accounting treatment of a financial guarantee contract does not depend on its legal form or whether it is issued by a bank, insurance company or other entity. IAS 39 does not give any guidance on accounting for financial guarantee contracts from the holders' perspective. However, for the issuer, financial guarantee contracts that meet the definition of a financial guarantee fall within IAS 39's scope and are accounted for by the issuer as financial liabilities. However, an option is available to insurers to continue to account for these contracts under IFRS 4 if they had met two conditions before IAS 39 was amended to include financial guarantees in its scope. These are that the issuer has:

- previously *asserted* explicitly that it regards such contracts as insurance contracts; and
- used accounting applicable to insurance contracts.

If these two conditions are met, the issuer may elect to apply either IFRS 4 or IAS 39 to such financial guarantee contracts. The issuer can make the election on a contract-by-contract basis, but the election for each contract is irrevocable [IAS 39 para 2(e), AG4]. Assertions that the issuer regards contracts as insurance can typically be found in business documentation, contracts, accounting records, financial statements and communication with customers and regulators. [IAS 39 para AG 4A].

6.1.31 In contrast, some credit related guarantees do not, as a precondition for payment, require that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due. Such guarantees are not financial guarantee contracts as defined in paragraph 6.1.30 above and are not insurance contracts as defined in IFRS 4. Such guarantees are derivatives that must be accounted for as such under IAS 39. [IAS 39 para AG 4(b)]. However, a contract that requires an entity to make payments when the counterparty to a derivative contract fails to make a payment when due, is considered to meet the definition of a financial guarantee contract. This is because it is not the risk inherent in the derivative that is being guaranteed; it is the counterparty's credit risk that is being guaranteed in the event the counterparty defaults.

Example 1 – Credit related guarantee

A bank issues a credit-related guarantee contract (sometimes referred to as credit derivative) that provides for payment if the credit rating of a debtor falls below a particular level.

In this situation, the credit related contract will be accounted for as a derivative financial instrument under IAS 39, because the contract holder is not required to suffer a loss on a specified debt instrument – the bank will pay for the decrease in the credit worthiness of the debtor even if the debtor does not actually default. However, if the contract provides for payment only in the event that the entity suffers loss as a result of non-payment by the debtor, the contract would be a financial guarantee contract. Holders and issuers of credit derivatives will always account for them under IAS 39.

Example 2 – Residual value guarantee

An insurer is required to make payments to the insured party based on the fair value of a non-financial asset at a future date under a residual value guarantee contract.

In this situation, the risk of changes in the fair value of the non-financial asset is not a financial risk because the fair value reflects not only changes in market prices for such assets (a financial variable), but also the condition of the specific asset held (a non-financial variable). As the change in fair value of the non-financial asset is specific to the owner, it is not a derivative instrument and, therefore, the contract will be accounted for as an insurance contract in accordance with IFRS 4. However, if the contract compensates the insured party only for changes in market prices and not for changes in the condition of the specific non-financial asset held, the contract is a derivative and within IAS 39's scope. [IFRS 4, IG example 1.15, IAS 39 para AG 12A].

6.1.32 There is no exemption under IAS 39 for financial guarantee contracts issued between members of a group or entities under common control similar to those under US GAAP FIN 45. Such guarantees are inter-company transactions that are eliminated on consolidation. However, in the individual financial statements of the group member issuing the guarantee, the guarantee contract will need to be accounted for in accordance with IAS 39. This is considered further in chapter 9.

Example – Parent provides a comfort letter to a subsidiary

A subsidiary of a group takes out a loan with a bank. The parent provides a comfort letter to the subsidiary such that if the subsidiary fails to repay the loan to the bank when due, the parent will pay on its behalf.

The comfort letter simply constitutes an undertaking given by the parent to its subsidiary that, in the event the subsidiary fails to repay the loan to the bank when due, the parent will step in and discharge the subsidiary's debt. This is not a financial guarantee contract as the parent has not provided any guarantee to the bank (nor would the bank be able to enforce payment under what is effectively a private arrangement between the parent and its subsidiary) to repay the loan if the subsidiary defaults.

6.1.33 Intra-group guarantees also frequently cover other obligations, such as pension plan contributions, lease rentals and taxes. The issue is whether the group members' individual financial statements, such obligations are financial guarantee contracts or insurance contracts. As noted in paragraph 6.1.27 above, if a financial instrument takes the form of an insurance contract, but involves a transfer of financial risks, as opposed to insurance risk, the contract would not be within the scope of the financial instrument standards. It is, therefore, necessary to determine whether the risk transferred represents insurance risk or financial risk. The risk transferred in a guarantee of pension plan contributions, lease rentals and taxes is the risk that the subsidiary (or joint venture or associate) will not make a payment when due. The reasons for non-payment could vary widely and, whilst they might include some financial risk variables, it is likely that a significant part of the risk transferred will be operational (for example, cash flow difficulties or, at the extreme, bankruptcy). Hence, it appears that the significant risk transferred in a typical guarantee of pension plan contributions, lease rentals and taxes will be insurance risk. It is arguable, therefore, that guarantees of pension plan contributions, lease rentals and taxes should be treated as insurance contracts and accounted for accordingly.

6.1.34 Even though guarantees of pension plan contributions, operating lease rentals and taxes are insurance contracts within IFRS 4's scope, it is still necessary to consider whether they meet the definition of financial guarantee contract within IAS 39's scope. The definition of a financial guarantee contract refers specifically to the terms of a debt instrument. Although the term 'debt instrument' is not specifically defined in IFRS, it is clear from the various references made in IAS 32 that a debt instrument is a type of loan, involving a borrower and a lender. It can be concluded, therefore, that pension plan contributions and tax liabilities are not debt instruments.

6.1.34.1 As regards leases, paragraph AG9 of IAS 32 states that "a finance lease is regarded as primarily an entitlement of the lessor to receive, and an obligation of the lessee to pay, a stream of payments that are substantially the same as blended payments of principal and interest under a loan agreement. . . . An operating lease, on the other hand, is regarded as primarily an uncompleted contract committing the lessor to provide the use of an asset in future periods in exchange for consideration similar to a fee for a service". This analysis suggests that a finance lease resembles a debt instrument, while an operating lease does not. Guarantees of finance leases but not operating leases, should therefore be included within IAS 39's definition of a financial guarantee contract. However, where operating leases fall within the definition of a financial instrument (that is, in respect of individual payments currently due and payable), the amounts represent a short-term term liability and should be included within IAS 39's definition of a financial guarantee.

6.1.35 Financial guarantee contracts fall within the scope of IAS 32 and IFRS 7 if they are accounted for in accordance with IAS 39. However, if the issuer elects to apply IFRS 4 to those contracts, the disclosure requirements of IFRS 4 and not IFRS 7 apply. [IAS 32 para 4(d); IFRS 7 para 3(d)]. The accounting treatment of financial guarantee contracts is considered further in chapter 9.

Weather derivatives

6.1.36 Some contracts require a payment based on climatic variables (sometimes described as weather derivatives) or on geological or other physical variables. For such contracts, payments are sometimes made on the amount of loss suffered by the entity and sometimes not. Prior to IAS 39's revision, all such contracts were scoped out of IAS 39 and treated as insurance contracts. However, following IFRS 4's publication, such contracts are accounted for as follows:

- Contracts that require a payment only if a particular level of the underlying climatic, geological, or other physical variables adversely affects the contract holder. These are insurance contracts as payment is contingent on changes in a physical variable that is specific to a party to the contract.
- Contracts that require a payment based on a specified level of the underlying variable regardless of whether there is an adverse effect on the contract holder. These are derivatives and are within IAS 39's scope.

[IAS 39 para AG 1, IFRS 4 para BC 55].

Example – Weather derivatives

A farming entity in Punjab, a State in India, relies on the prospect of a good monsoon that would favourably impact its earnings for the season. A good monsoon in Punjab involves an average rainfall of about 400mm during the months of June, July and August. The entity enters into a contract with a counterparty that would pay a fixed sum of Rs1m if the entity suffers loss due to poor production caused by below average rainfall during the monsoon months. The premium paid on the contract is Rs50,000.

This is an example of a highly tailored or customised policy that provides the entity protection against an adverse impact on earnings due to poor production caused by poor monsoon in Punjab, irrespective of whether the rest of India has a good monsoon or not. Hence, the contract is an insurance contract and is scoped out of IAS 39. It should be noted that even if the farming entity's loss due to poor production is less than Rs1m, the entity would receive Rs1m as stipulated in the contract. The definition of an insurance contract does not limit the payment by the insurer to an amount equal to the financial impact of the adverse event. [IFRS 4 App para B13].

If, on the other hand, the sum of Rs1m was paid if the average rainfall was below 400mm during the months of June, July and August and it would be payable irrespective of whether the farming entity in Punjab had suffered any damage, the contract would be accounted for as a derivative instrument. This is because payment is made following the change in average rainfall which is a non-financial variable that is not specific to the holder of the contract and hence one of the variables considered in the definition of financial risk.

Loan commitments

6.1.37 Loan commitments are firm commitments to provide credit under specified terms and conditions. [IAS 39 BC15]. They are usually entered into by financial institutions such as banks for providing loans to third parties at a specified rate of interest during a fixed period of time. Such a commitment is a derivative, since it has no initial net investment, it has an underlying variable (interest rate) and it will be settled at a future date. In effect, the lender has written an option that allows the potential borrower to obtain a loan at a specified rate.

6.1.38 The following loan commitments are within IAS 39's scope:

- Loan commitments that the entity designates as financial liabilities at fair value through profit or loss. This may be appropriate, for example, if the entity manages risk exposures related to loan commitments on a fair value basis. [IAS 39 para 4(a)].
- An entity that has a past practice of selling the assets resulting from its loan commitments shortly after origination should apply IAS 39 to all its loan commitments in the *same class*. The term 'same class' is not explained in the standard, but we believe that a commitment to provide borrowing facilities to a corporate entity is not in the same class as a commitment to provide residential mortgage loans, because of differing risk return profiles. [IAS 39 para 4(a)].
- Loan commitments that can be settled net in cash or by delivering or issuing another financial instrument. These loan commitments are derivatives. A loan commitment is not regarded as settled net merely because the loan is paid out in instalments (for example, a mortgage construction loan that is paid out in instalments in line with the progress of construction). [IAS 39 para 4(b)].
- Commitments to provide a loan at a below-market interest rate (see chapter 9). [IAS 39 para 4(c)].

6.1.39 Loan commitments that are not within IAS 39's scope should be accounted for in accordance with IAS 37. Where events make such a loan commitment an onerous contract, the contract falls within IAS 37's scope and a liability exists that should be recognised. However, all loan commitments, whether scoped in or out of IAS 39, are subject to IAS 39's derecognition provisions and to IFRS 7's disclosure requirements. [IAS 39 para 2(h); IFRS 7 para 4].

Contracts to buy or sell non-financial assets

6.1.40 Contracts to buy or sell non-financial items are, in general, not financial instruments. Many commodity contracts are of this type. However, if such contracts can be settled net in cash or by exchanging another financial instrument, they fall within the scope of IAS 32, IFRS 7 and IAS 39 as if they were financial

instruments (derivatives). This is so, unless the contracts were entered into and continue 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 (often referred to as 'own use' purchase or sale exception). [IAS 32 paras 8-10; IFRS 7 para 5; IAS 39 para 5]. In other words, if the own use exception is met, the contract must not be accounted for as a derivative (that is, the application of the own use exception is not a choice).

Contracts that can be settled net

6.1.41 There are various ways in which a contract to buy or sell a non-financial asset can be settled net in cash, including when:

- The terms of the contract permit either party to settle net in cash or another financial instrument or by exchanging financial instruments. Net settlement means that the entity will pay or receive cash (or an equivalent value in other financial assets) to and from the counterparty, equal to the net gain or loss on the contract on exercise or settlement.
- The ability to settle the contract net is not explicitly stated in the contract, but the entity has a practice of settling similar contracts net in cash (whether with the counterparty, by entering into offsetting contracts or by selling the contract before its exercise or lapse). For example, a futures exchange permits an entity to enter into offsetting contracts that relieves the entity of its obligation to make or receive delivery of the non-financial asset.
- For similar contracts, the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery to generate a profit from short-term fluctuations in price or dealer's margin. An example is an exchange that offers a ready opportunity to sell the contract.
- The non-financial asset that is the subject of the contract is readily convertible into cash.

[IAS 32 para 9; IAS 39 para 6].

6.1.42 Where the second and third bullet points above apply, the entity's activities make it clear that the contracts cannot qualify for 'normal' purchase or sale exception. Accordingly, such contracts are within the scope of the financial instrument standards. Other contracts that can be settled net should be evaluated to determine whether they qualify for the exception. For example, to qualify for the exception, a contract's terms must be consistent with the terms of an entity's normal purchases or sales; that is, the quantity specified in the contract must be expected to be used or sold by the entity over a reasonable period in the normal course of business. Other factors that may be relevant in determining whether or not the contract qualifies for the exception may include the locations to which delivery of the items will be made, the period of time between entering into the contract and delivery and the entity's prior practices with regard to such contracts.

source of ineffectiveness. Changing the designation of a derivative from a hedging instrument to a hedging instrument occurs at inception of the new hedging relationship.

Portions and proportions of a hedging instrument

6.8.60 There is normally a single fair value measure for a hedging instrument in its entirety and the factors that cause changes in fair value are co-dependent. Thus, a hedging relationship is designated by an entity for a hedging instrument in its entirety. It follows that a derivative instrument cannot be split into components representing different risks with each component designated as the hedging instrument. The only exceptions permitted are:

- separating the interest element and the spot price of a forward contract and
- separating the intrinsic value and time value of an option contract and designating as the hedging instrument only the change in intrinsic value of an option.

These exceptions are permitted because the intrinsic value of the option and the premium or discount on the forward can generally be measured separately.

[IAS 39 para 74].

Example 1 – Definition of a forward contract

For hedging purposes, entity A enters into the following derivative instruments:

- A fixed to fixed cross-currency swap.
- A floating to floating cross-currency swap.
- A floating to fixed cross-currency swap.

Entity A's management wishes to designate only the spot element of these derivatives as hedging instruments in separate hedging relationships.

Paragraph 74 of IAS 39 allows an entity to designate the spot element of a derivative as a hedging instrument provided the derivative is a forward contract. A simple forward contract is a contract to exchange a fixed amount of a financial or non-financial asset on a fixed future value date or dates beyond the spot value date. For the purposes of applying paragraph 74 of IAS 39, the term 'forward contract' should be interpreted as being any derivative instrument that is a simple forward contract or that may be constructed using only a series of simple forward contracts. Forward contracts may be settled by gross delivery of the financial asset in return for cash, or on a net basis at each settlement date.

The fixed to fixed cross-currency swap entered into by entity A constitutes a forward contract under paragraph 74 of IAS 39 provided that the settlements on each leg of the swap occur on the same dates in the future (that is, there is no timing mismatch between the two legs of the swap).

However, the other derivatives (the floating to floating cross-currency swap and the floating to fixed cross-currency swaps) are not forward contracts since they cannot be constructed using only simple forward contracts.

Example 2 – Splitting a written swaption into components

Entity A, whose functional currency is euro, issues 30-year fixed-rate debt. At the same time entity A enters into an interest rate derivative with a third party with the following terms: entity A receives 7% fixed and pays 5% fixed for 7 years. After 7 years, the counterparty has the option to require entity A to enter into a pay fixed 5%, receive LIBOR interest rate swap with a maturity of 23 years. (Economically, entity A has sold the counterparty a swaption on a 23 year swap with 7 years until exercise date and with premium payments spread over 7 years).

Entity A proposes to split the derivative into separate components, one of which is an on-market receive fixed, pay variable interest rate swap. It would designate this component as a hedge of the first seven years of interest rate exposure under the fixed rate debt. The remaining component would be treated as a trading derivative.

Entity A cannot split the derivative into its components, because of the requirements of paragraph 74 of IAS 39 and paragraph IG F1.8 of IAS 39 so any attempt to designate it as a hedging instrument would be likely to fail the prospective effectiveness requirements.

In addition the combined instrument is a written option and cannot be designated as a hedging instrument under paragraph AG94 of IAS 39 (see para 6.8.75).

6.8.61 The fair value of a foreign exchange forward contract is affected by changes in the spot rate and by changes in the forward points. The latter derives from the interest rate differential between the currencies specified in the forward contract. Changes in the forward points may give rise to ineffectiveness if the hedged item is not similarly affected by interest rate differentials unless only the spot component of the forward is designated as the hedging instrument (see para 6.8.208 below).

6.8.62 The fair value of an option can be divided into two portions: the intrinsic value, which is determined in terms of the difference between the strike price and the current market price of the underlying (as described in more detail below); and the time value, which is the option's remaining value and depends on the volatility of the price of the underlying, interest rates and the time remaining to maturity. When the option is used to hedge the one-sided risk on a non-optional position, changes in the option's time value will not be offset by an equivalent change in the value or cash flows of the hedged item (for more details about hedging of portions see para 6.8.23). IAS 39 does not specify how the intrinsic value of an option is determined. Intrinsic value can be defined based on the spot rate. For example, for an interest rate cap that is used to hedge the exposure to interest rates on floating rate debt, the intrinsic value may be deferred by projecting all future cash flows on the cap at the current spot rate and discounting the result using the zero-coupon curve. If the current spot rate is below the market rate, the cap is 'out of the money' in all periods. Alternatively, the intrinsic value could be defined using

the forward rate curve. The projected cash flows would be calculated using the forward rates. In that case the cap may be in the money in some periods when the current spot rate is below the strike price.

The intrinsic value of a European option (that is, an option which is settled at the end of its term) may be defined as discounted where the difference between

- the strike price of the option's underlying specified in the option and
- the market price of the underlying

is discounted to present value.

The intrinsic value may also be defined as undiscounted – that is, simply as the absolute difference between the strike price and market price of the underlying asset.

The intrinsic value of an American style option may be defined as the difference between the undiscounted spot price on the day when it is determined and the strike price specified in the option contract. This is because the American style option can be exercised at any time.

6.8.63 Generally, it may be advantageous to exclude the forward points and the time value of an option to improve effectiveness. However, this comes at a price – it will most probably increase the volatility in the income statement. This is because as the forward points or time value are not subject to hedge accounting, any changes in their fair value will be recognised as gains or losses in the income statement as they occur. If forward points were included in the hedge relationship, then they could generate ineffectiveness for example if the timing of the hedged forecast transaction changed and change in fair value of the forward was higher in absolute terms than change in fair value of the hedged cash flow (see para 6.8.129). [IAS 39 para 96].

6.8.64 A proportion of the entire hedging instrument, such as 50% of the notional amount, may be designated as the hedging instrument. [IAS 39 para 75]. The proportion that is not acting as a hedge is either treated as held-for-trading or designated as a hedging instrument in another hedge relationship.

Example – Proportions of derivatives as hedging instruments

Entity A, whose functional currency is the euro, enters into a US\$10m forward contract on 1 June 20X1 to hedge forecast future US\$-denominated sales in March 20X2. At the time of entering into the forward contract, only US\$8m of forecast sales are considered to be highly probable of occurring in March 20X2.

In this situation, entity A can designate 80% of the forward contract as a hedge of the highly probable future sales of US\$8m in March 20X2. The remaining US\$2m of the forward contract (20%) may either be designated as trading or as a hedging instrument in another hedge relationship. In other words, 20% of the total change in the fair value of the forward contract would be reported in profit or loss, or used as an offset in another hedge relationship.

A hedging relationship may not be designated for only a portion of the period during which a hedging instrument remains outstanding as illustrated in the example below. [IAS 39 para 75].

Example – Portion of the outstanding life of a derivative as a hedging instrument

An entity enters into a pay-fixed, receive-variable interest rate swap to hedge the cash flow exposure of a floating rate debt instrument. Both the swap and the debt instrument are entered into on the same date. The floating rate debt instrument has a term of 5 years and the swap has a term of 7 years.

The entity cannot designate the cash flows arising in the first 5 years of the 7 year swap as a hedging instrument. The swap's fair value derives from the present value of the net settlements over the entire 7 year period, not the first 5 years. Furthermore, the fair value of the swap cannot be time apportioned using linear interpolation, as the change in the swap's fair value per unit of time is non-linear.

However, the entity can designate the entire 7 year swap as a hedge of the 5 year debt, but ineffectiveness will arise because of timing mismatches and is likely to be so large (that is, outside the 80%-125% range, see para 6.8.165) as to prohibit hedge accounting.

On the other hand, if the swap's terms and the debt are reversed so that they are 5 years and 7 years respectively, the 5 year swap can be designated as a hedge of the first 5 years of the debt instrument. This is referred to as 'partial-term' hedging and is discussed in paragraph 6.8.32 above.

Hedging more than one risk with a single instrument

6.8.66 A derivative, such as a forward contract, swap or an option, is used as a hedging instrument to hedge a single risk (foreign currency, interest rate or equity price risk). However, entities may often use a single derivative such as a cross-currency swap (combined interest rate and currency swap) to convert a variable rate position in a foreign currency to a fixed rate position in the entity's functional currency. IAS 39 permits a single hedging instrument to be designated as a hedge of more than one type of risk provided that:

- The risks hedged can be identified clearly.
- The effectiveness of the hedge can be demonstrated.
- It is possible to ensure that there is specific designation of the hedging instrument and different risk positions.

[IAS 39 para 76].

6.8.67 If a single hedging instrument is used to hedge different risk exposures and each of these risk exposures are accounted for using different forms of hedge accounting (fair value hedge for one, cash flow hedge for the other), IFRS 7 requires separate disclosures for each type of hedge (see chapter 11). [IAS 39 IG para F1.12].

Example 1 -- Dual foreign currency forward exchange contract to hedge currency risk

Entity A's functional currency is the Japanese yen. Entity A has a 5 year floating rate US dollar liability and a 10 year fixed rate pound sterling denominated bond (an asset). The principal amounts of the asset and liability when converted into Japanese yen are the same. Entity A enters into a single foreign currency forward contract to hedge its foreign currency exposure on both instruments under which it receives US dollars and pays pound sterling at the end of 5 years.

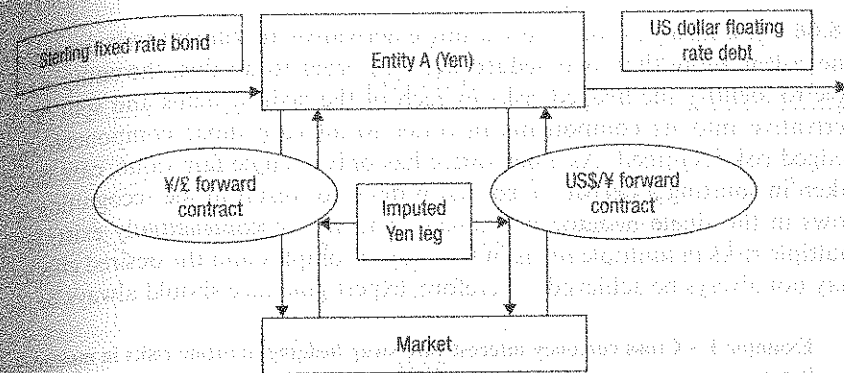
Entity A designates the forward exchange contract as a hedging instrument in a cash flow hedge against the foreign currency exposure on the principal repayments of both instruments. Since entity A's functional currency is Yen, it is exposed to US\$/¥ foreign currency risk on the floating rate liability and ¥/£ foreign exchange risk on the fixed rate asset.

IAS 39 permits a single hedging instrument to be designated as a hedge of multiple types of risk if three conditions stated in paragraph 6.8.66 above are met. In this example, the derivative hedging instrument satisfies all of these conditions, as follows:

- The risks hedged can be identified clearly. The risks are the exposures to changes in the forward exchange rates between US dollars and yen and yen and pound sterling respectively.
- The effectiveness of the hedge can be demonstrated. For the pound sterling bond, the effectiveness is measured as the degree of offset between the fair value of the principal repayment in pounds sterling and the fair value of the pound sterling payment on the forward exchange contract. For the US dollar liability, the effectiveness is measured as the degree of offset between the fair value of the principal repayment in US dollars and the US dollar receipt on the forward exchange contract. Even though the receivable has a 10-year life and the forward protects it for only the first 5 years, hedge accounting is permitted for only a portion of the exposure as described in paragraph 6.8.32 above.
- It is possible to ensure that there is specific designation of the hedging instrument and different risk positions. The hedged exposures are identified as the principal amounts of the liability and the note receivable in their respective currency of denomination.

[IAS 39 para IG F1.13].

It should be noted that in respect of the second point above, the US \$/£ forward is theoretically divided into two different derivatives. The Yen is imputed as the base currency for the two derivatives creating a synthetic US\$/Yen (receive US dollar, pay Yen) foreign currency forward and a synthetic ¥/£ (receive Yen, pay sterling) foreign currency forward. The synthetic Yen leg is defined in such a manner that the fair value of each synthetic forward contract is nil at the hedge's inception. This can be pictorially represented as follows:



Furthermore, it should be noted that the hedge accounting criteria must be satisfied for both the designated hedged risks. For instance, if effectiveness of the hedge can be demonstrated for US\$/¥ risk only and not ¥/£ risk, hedge accounting is not permitted. Similarly, if one of the hedged risks no longer exists or a hedge effectiveness test is failed for that risk during the term of the hedge then both hedges must be discontinued. This is because a derivative instrument must be fair valued and used as a hedging instrument in its entirety apart from the specific exemptions discussed in paragraph 6.8.60.

Example 2 -- Hedging a floating rate foreign currency debt with a floating rate cross currency interest rate swap

Entity A's functional currency is sterling. Entity A has issued a floating rate (3 month USD LIBOR) bond denominated in USD and on the same date entered into a cross currency swap to hedge the bond to floating rate (3 month Stg LIBOR) in sterling. So the swap (after the initial exchange of principal amounts) is to receive 3 month USD LIBOR plus USD principal, and to pay 3 month Stg LIBOR plus Stg principal.

Entity A wishes to designate the swap in its entirety as a cash flow hedge of the foreign exchange and interest rate risk on the bond so as to minimise ineffectiveness, including from currency basis. However, the swap can be designated as a cash flow hedge of spot foreign exchange risk only. All variability due to foreign exchange has been eliminated and the foreign exchange movements, including the effect of changes in currency basis, can be recognised in OCI.

As regards interest rate risk, this cannot be designated as being hedged as entity A's exposure to cash flow variability associated with interest rate changes has not been reduced. Rather entity A has merely exchanged one exposure to variable rates (3 month USD LIBOR) for another (3 month Stg LIBOR).

Under paragraph IG F5.5 of IAS 39 the hypothetical derivatives method can be used to measure the effectiveness of cash flow hedges. In the circumstances described, the USD leg of the hypothetical derivative would mirror the hedged debt and hence have a receive leg of receive 3 month USD LIBOR plus USD principal. However the sterling leg should be to pay sterling overnight rates plus sterling principal (that is, with daily resets) to exclude any interest rate risk. As a result of the sterling leg of the hypothetical derivative resetting daily, some ineffectiveness will arise. Entity A will need to assess whether this is so big as to prevent the use of hedge accounting.

11.170.6 Careful consideration is required as to whether the benefit is an 'other long-term benefit' or a 'post-employment benefit', because remeasurements are accounted for differently for each.

11.170.7 A plan with a promised return may be funded or unfunded and benefits may be vested or unvested. Where there is a promised return, this may be based upon plan assets or notional assets; see paragraph 11.112 for the measurement of plan assets. In some cases the related invested assets may not meet the definition of plan assets; an entity considers IAS 39 or IFRS 9 for the appropriate classification and measurement for such assets. The accounting for associated asset costs may differ depending on which standard the assets are accounted under. For plan assets, guidance for asset management costs is found in paragraph 130 of IAS 19. For non-plan assets, an entity follows the guidance in IAS 39 for costs associated with financial non-plan assets.

11.171 Plans that provide a combination of a fixed guarantee and benefits that depend on future returns on assets are sometimes described as 'defined contribution plans with a defined benefit underpin'. Such schemes should be accounted for under the higher of the defined benefit obligation relating to the fixed guarantee and the obligation arising from the variable return. The latter is determined using the approach set out above for variable schemes (see para 11.170).

Frequency of valuations

11.172 An entity is required to determine the present value of defined benefit obligation with sufficient regularity that the amounts recognised in the financial statements do not differ materially from the amounts that would be determined at the balance sheet date. [IAS 19 para 58]. Annual actuarial valuations are not required as at the balance sheet date. Indeed, IAS 19 does not require an entity to involve a qualified actuary at all in the measurement of the defined benefit obligation. Such a practice is merely encouraged. [IAS 19 para 59].

11.173 The employer's and the pension plan's financial statements may have different accounting periods. In practice, it is likely that at least two full actuarial valuations will be required for funded pension plans: one for IAS 19 accounting and one (on a funding basis) for the pension plan trustees. The funding valuation may use different, possibly more conservative, assumptions in relation to the liabilities. The IAS 19 valuation need not necessarily be done as at the employer's balance sheet date. In fact, a valuation as at an employer company's year end may not be available in time for the completion of the company's financial statements. It could, therefore, be done at an earlier date, or the same date as the valuation required by the trustees, as suits the employer's reporting timetable and then be updated as necessary to the employer's year end. For example, a company with a December year-end may have a pension plan with a March year end and obtain actuarial valuations as at 31 March. The full valuation would then have to be updated to each company year-end for any material transactions and other

material changes in circumstances (including changes in market prices and interest rates) [IAS 19 para 59].

11.174 An update is in effect an estimate of a full valuation. IAS 19 indicates that some aspects of the valuation should be updated at each balance sheet date of the reporting employer. For example, the financial assumptions underpinning the valuation of the plan liabilities should be updated to reflect changes in market conditions. Thus the discount rate should always be the current rate of return on an appropriate bond at the employer's balance sheet date. A change in the discount rate may also require other financial assumptions, such as the inflation assumption, to be updated. Other aspects of the valuation of the liabilities can be estimated from the previous full valuation by rolling the valuation forward and updating it for changes to the plan, such as benefit improvements. Assumptions that are not directly affected by changes in market conditions need not be updated annually.

11.175 Individual circumstances will dictate whether a full valuation is required in between the previous full valuation or whether an update is sufficient. If the latest full valuation was a long time ago and many changes have occurred since, the actuary may not be confident that an update will produce a reliable current estimate of the plan liabilities. In such circumstances, a full valuation may be appropriate.

11.176 The following example illustrates the considerations relevant to determining the appropriate frequency of actuarial valuations.

Example – Frequency of actuarial valuations

A UK-based multi-national group operates a large number of defined benefit pension plans in different countries. The pension plans include:

- A group pension plan, which provides generous benefits but is open only to UK employees. The pension cost recorded in respect of this plan is equivalent to 5% of the group's total employee cost and 10% of net profit.
- A US pension plan, which provides benefits only to US-based employees. The group's operations in the US are not significant and investment returns have been stable for a number of years.
- A Latin America pension plan, which provides pension and medical insurance benefits to all employees in Latin America. The operations in Latin America are material to the group and the stock markets in Brazil and Venezuela are extremely volatile. Venezuela is a hyper-inflationary economy.
- An Africa pension plan, which provides limited benefits to expatriate staff in Africa. The plan is unfunded and covers a limited number of employees. The group announced a benefit enhancement in the current year.
- A Benelux pension plan, which provides limited benefits to top up the state pension received by former employees in the Benelux region. The state pensions in these countries are inflation-linked and the group has never been required to make top-up payments.

Deciding on the frequency of valuations requires judgement. Factors to be taken into account include the size of the pension obligation, the volatility of the economic environment in which each plan operates, changes in plan benefits and the overall impact of employee benefit costs on the financial statements. The same frequency does not necessarily apply to all plans.

It will also be necessary to determine the extent of the valuation. Sometimes a full actuarial valuation will be necessary, but often it will be sufficient to update an existing valuation as described in paragraph 11.174.

In this example, management concluded that the following valuation frequency was appropriate for each of its plans:

- The cost of the group pension plan is material to the financial statements. Although both the economic environment in the UK and the benefit package are stable, the income statement is sensitive to changes in the employee benefit cost. Accordingly, the present value of the defined benefit obligation and the fair value of plan assets should be determined each year.
- The US pension arrangements are not significant and the economic environment is stable. The fair value of quoted plan assets and updates to the discount rate for example are determined every year, but a full valuation of the defined benefit obligation is obtained only every three years.
- The Latin America pension plan is significant and it operates against a volatile economic background. The scale of the changes in the economic environment that occur every year might have a profound effect on the actuarial assumptions. Accordingly, the present value of the defined benefit obligation and the fair value of plan assets should be determined every year.
- The pension obligation in Africa is not significant and the liability is unfunded. Hence, there are no plan assets to be valued. The group usually determines the fair value of the defined benefit obligation every three years. However, in view of the announcement of the benefit enhancement, it may be necessary to obtain a valuation in the current year.
- The Benelux pension plan is not significant. The defined benefit obligation exists, but is very small. There are no plan assets. Hence, the present value of the defined benefit obligation is determined every three years, unless there is a change in the state pension arrangements.

Interim reports

11.177 IAS 34 requires that an interim financial report should be prepared for a discrete period with items of income and expenses should be recognised and measured on a basis consistent with that used in preparing the annual financial statements. In addition, the entity's pension assets and liabilities should be measured in the same way as they would be at a year end.

11.178 For a defined contribution pension plan, the expense recognised in a period is equal to the contributions payable in respect of that period. Hence, defined contribution plans are treated in an interim financial report in the same

as in annual financial statements. However, the treatment of defined benefit plans is potentially more complicated.

11.179 Consistent with the discrete period principle, paragraph B9 of the illustrative examples to IAS 34 states that the pension cost for an interim period should be calculated on a year-to-date basis by using the actuarially determined pension cost rate as at the end of the previous year. The rate is adjusted for significant market fluctuations (for example changes in bond yields, expected market returns, inflation or asset values) since the previous year end and for significant curtailments, settlements, or other significant one-off events.

11.180 For the measurement of the defined benefit obligation, financial assumptions should be based on market expectations at the end of the reporting period for the period over which the defined benefit obligation is to be settled. [IAS 19 para 80]. The rate used to discount post-employment benefit obligations (both funded and unfunded) should be determined by reference to market yields at the end of the reporting period on high quality corporate bonds. [IAS 19 para 83].

11.181 There is no requirement to remeasure a net defined benefit liability (asset) for interim reporting purposes under IAS 19 and IAS 34. Judgement needs to be exercised in determining whether the net defined benefit liability (asset) needs to be remeasured at the end of an interim reporting period. [IAS 19 para BC59].

11.182 IAS 19 requires opening assumptions to be used for the purpose of calculating current service cost and net interest. Some could see this as a contradiction in that IAS 19 requires amounts to be updated when there is a significant change to the liability and to IAS 34, which states that significant market fluctuations should be adjusted for. However, if the service cost or net interest cost recognised in the income statement were to be updated in each interim period, then the cumulative full year amounts in those primary statements would not be the same as if the opening assumptions had been used throughout the annual period. Updating these amounts would lead to variations in the results based on how many interim periods each entity has, which would conflict with the 'year to date' principle in IAS 34.

11.183 Neither IAS 34 nor IAS 19 specify how frequently the assets and liabilities of a defined benefit plan should be revalued. This will depend on the specific pension plan and requires the exercise of professional judgement. However, IAS 19 does require an entity to determine the present value of the net defined liability (asset) with sufficient regularity that the amounts recognised in the financial statements do not differ materially from the amounts that would be determined at the balance sheet date. [IAS 19 para 58]. The impact of any remeasurements since the last valuation must be expected to be immaterial. However, in a volatile economic environment, which might impact both asset values and actuarial assumptions underlying the defined benefit obligation, it will be more difficult to reach such a conclusion and it may be necessary for an entity to obtain a valuation at each interim balance sheet date.

Example – Interim remeasurements

Entity A obtains actuarial valuations of its defined benefit pension obligations at annual intervals. An actuary performs a valuation in January 20X1 to determine the present value of the defined benefit obligation and the fair value of plan assets at 31 December 20X0, the entity's year-end.

The measurement procedures to be followed in interim reports should be designed to ensure that the resulting information, including the value attributed to the defined benefit obligation and plan assets, is sufficiently reliable. The preparation of interim financial reports may require a greater use of estimates than the preparation of annual reports. Extrapolation (a roll forward) of the latest actuarial valuation as adjusted for significant market fluctuations or other significant one-time events will often provide a reliable measurement for interim reporting purposes.

If entity A operated in volatile economic environments in which other actuarial assumptions such as interest rates are significantly changed during interim periods it may need to perform an interim remeasurement of their pension obligations.

An interim remeasurement of the net pension liability (asset) needs to be performed if a significant curtailment or settlement occurs.

11.184 Obtaining fair values of certain assets held by the pension plan, such as traded securities, is a relatively simple task for an entity to perform at the interim balance sheet date. However, obtaining fair values for other assets such as untraded securities and properties, or obtaining a present valuation of the liabilities of the pension plan could be costly and time-consuming tasks. Estimating these values accurately may involve the use of experts such as valuers, property surveyors or actuaries.

11.185 IAS 34 recognises that there will be a greater use of estimates by an entity when it is preparing an interim financial report than when it is preparing its annual financial statements. [IAS 34, para. 41]. Consequently, it may be appropriate for an entity to extrapolate a valuation that had been previously obtained for the purposes of calculating the appropriate net defined benefit liability (asset) for recognition in the interim financial report. [IAS 34 Illustrative example C para C4]. As discussed in paragraph 11.172, IAS 19 encourages, but does not require, the entity to involve a qualified actuary in the measurement of plan liabilities, so it may sometimes be appropriate at an interim reporting date for the entity's directors to perform this extrapolation exercise without actuarial assistance.

11.186 Interim reports are considered in greater detail in the Manual of Accounting – Interim financial reporting.

Restrictions on the amount recognised as a defined benefit asset

11.187 Sometimes, a net balance recognised in respect of a defined benefit pension plan may be an asset. Consistent with the principle that a pension plan surplus is regarded as an asset to the extent that the employer can gain an

economic benefit from it, IAS 19 contains a restriction over the amount that may be recognised. The amount recognised as an asset may not exceed its recoverable amount. This amount is measured as the lower of:

- the surplus in the defined benefit plan; and
- the asset ceiling, determined using the discount rate specified in paragraph 83 of IAS 19.

[IAS 19 para 64].

11.188 The application of this restriction is considered in the following example.

Example – Amount recognised as an asset

A defined benefit plan has the following characteristics at the balance sheet date.

	C'000
Present value of defined benefit obligation	(1,000)
Fair value of plan assets	1,200
Surplus determined in accordance with paragraph 57 of IAS 19 (see para 11.99)	200
Present value of available future refunds and reductions in future contributions	170

The amount that may be recognised as a net defined benefit asset in this example is C170,000, being the present value of available future refunds and reductions in future contributions.

11.189 IAS 19 contains no specific guidance concerning the measurement of the recoverable amount of a pension plan surplus. However, IFRIC 14 addresses:

- the amount of pension scheme surpluses that entities can include as a defined benefit asset in their balance sheets, in particular when refunds or reductions in future contributions should be regarded as 'available'; and
- when a minimum funding requirement may give rise to additional liabilities.

IFRIC 14 may lead to an increase in liabilities even when a scheme is in deficit under IAS 19. This happens where contributions to reduce an existing deficit under a funding requirement may not be recoverable once they are made. If a defined benefit plan is in deficit and there is no minimum funding requirement, then IFRIC 14 is not relevant. If a plan is in surplus, and the employer has an unconditional right to the surplus, it can recognise an asset, there is no need to consider the impact of any minimum funding requirement.

11.190 Statutory minimum funding requirements exist in many countries to improve the security of the post-employment benefit promise made to members of an employee benefit plan. Such requirements normally stipulate a minimum

Interest and penalties on uncertain tax positions

13.81 An entity might incur interest or penalties in relation to taxation, for example, where uncertain tax positions have been successfully challenged by the tax authorities. IAS 12 does not specifically address the treatment of uncertain tax positions or associated interest and penalties. The liability for the uncertain tax position is for a tax based on taxable profits, and is therefore an income tax liability. This liability is recognised and measured under IAS 12 (see further para 13.74).

13.82 There is a strong argument that interest and penalties differ from income tax liabilities, because they are not measured and settled by the tax authorities on the basis of taxable profits. This suggests that interest and penalties should be recognised, measured and presented as provisions under IAS 37, and classified as finance or other operating expense, respectively, in the income statement. This is because:

- such obligations are not based on taxable profits and so they fall outside IAS 12's scope; and
- the economic substance of reducing or delaying a tax payment is no different from other financing arrangements. Interest that increases with time and in substance a financing cost of the liability is interest expense; and penalties represent operating costs.

13.83 Practice varies with regard to these items. In some cases, interest and penalties are accounted for as if they are within IAS 12's scope either because they are rolled up into a lump sum settlement and cannot be separated from the taxes, or as a matter of accounting policy. Any associated charge is normally included within the tax line in the income statement, and the liability is included within the income tax liability on the balance sheet.

13.84 The accounting policy for interest and penalties applies to both interest payable (and any related penalties) and to interest recoverable (and any related damages). For interest and damages recoverable, a contingent asset cannot be recognised under IAS 37 until it is 'virtually certain'; but uncertain tax assets are recorded under IAS 12 on the basis of the amount expected to be recovered. IAS 37 establishes a higher threshold for recognition than IAS 12; so an entity's accounting policy will determine when interest and damages recoverable will be recognised.

13.84.1 The accounting policy used to recognise, measure and classify interest and tax-related penalties or damages should be disclosed clearly in the financial statements, and applied consistently.

Other expenses associated with taxation

13.85 An entity might incur expenses that are indirectly linked to the income tax expense, such as fees payable to tax consultants that are based on a percentage of savings made under a specific tax scheme. These fees are not 'tax expense' under IAS 12.

Accounting for deferred tax

Introduction

13.86 Most transactions and events recorded in the financial statements have a tax consequence, which can be immediate or deferred. Often, income is taxable and expenses are deductible for tax purposes when incurred. However, the taxation or deduction for tax purposes might be delayed to a later period (for example, when cash flows occur under the transaction). Also, the recovery or settlement of an asset or liability might have tax consequences.

13.87 Where transactions and events have occurred by the balance sheet date, future tax consequences cannot be avoided; the entity might have to pay less or more tax than if those transactions and events had not happened. Therefore, management recognises the tax effects of all income and expenditure, gains and losses, assets and liabilities in the same period in which they are recognised themselves and not in the period in which they form part of taxable profit. This matching of transactions and events with their tax effects gives rise to current tax; it also gives rise to deferred tax assets and liabilities.

13.88 An asset recorded in the financial statements is realised, at least for its carrying amount, in the form of future economic benefits that flow to the entity in future periods; this is the basis for the balance sheet liability method used by IAS 12. When such benefits flow to the entity, they give rise to amounts that may form a part of taxable profits. The asset's tax base (see para 13.111 onwards) can be deducted in determining taxable profits in either the same or a different period. When the asset's carrying amount is greater than its tax base, the amount of the future taxable economic benefits is greater than the amount allowed as a deduction for tax purposes; as a result, it gives rise to a deferred tax liability in respect of taxes payable in future periods. For assets and liabilities within subsidiaries, branches, associates and joint ventures, the principle extends to the tax consequences of recovering the reporting group's investments in those entities, when the reporting group has control over that recovery and expects such recovery to occur in the foreseeable future.

13.89 The balance sheet liability method can instead be viewed as a valuation adjustment approach; under this approach, management needs to provide for deferred tax to ensure that other assets are not valued at more than their economic (that is, post-tax) values to the business. Management should provide

for deferred tax to reflect the fact that the economic value to the business of an asset is not the market value of, say, C150. Rather it is the market value of C150 less the present value of the tax that would be payable on selling the asset for C150. In theory, the appropriate method for recognising deferred tax provided for as a valuation adjustment rather than as a liability might be to net the tax provision against the asset's carrying amount. However an entity's results and position are more clearly communicated if tax effects are shown separately from the items or transactions to which they relate.

General principles

13.90 A deferred tax liability or asset is recognised if the *recovery* of the carrying amount of an asset or the settlement of a liability will result in higher (or lower) tax payments in the future than if that *recovery* or settlement had no tax consequences. [IAS 12 para 10]. A deferred tax liability or asset is recognised for all such tax consequences that have originated but have not reversed by the balance sheet date. Exceptions to this general principle are discussed later in this chapter.

13.91 The word 'recovery' in italics above is particularly relevant for measuring deferred tax liabilities that arise on assets. An entity generally expects to recover the carrying amount of an asset through use, through sale, or through use and subsequent sale. Tax authorities might levy different rates of tax depending on whether the asset is recovered through use (income tax) or through sale (capital gains tax). Also, some assets are revalued for tax purposes (increase due to indexation to eliminate the effects of inflation) only if the asset is sold. Therefore, the manner in which the entity expects, at the balance sheet date, to recover the asset directly affects the amount of tax that is payable in future, and this should be reflected in the measurement of deferred tax at the balance sheet date (see further para 13.170 onwards). Other measurement issues are considered in paragraph 13.165 onwards.

13.92 Deferred tax income or expense should be reported in profit or loss if it relates to items that are themselves reported in profit or loss. For transactions and other events recognised outside profit or loss, any related tax effects are also recognised outside profit or loss. Presentation of deferred tax in performance statements or equity is considered in paragraph 13.286 onwards.

13.92.1 The approach to determining deferred tax can be summarised as follows:

- Consider the entity's structure (for example, a company/corporation or a partnership; a parent or a subsidiary) and the tax jurisdictions that apply to the entity.
- Calculate current income tax.

Current tax payable to the taxation authorities is calculated based on the tax legislation in the relevant territory. Accounting for current tax is addressed in paragraph 13.42 onwards.

- Determine the tax base.
 - The tax base reflects the tax consequences arising from the manner in which management expects, at the balance sheet date, to recover or settle the carrying amount of an asset or liability.

In simple situations, an asset's tax base equals the future deductible amounts when the asset's carrying amount is recovered. A liability's tax base equals its carrying amount less future deductible amounts. If there are no tax consequences of recovery, there is no deferred tax. Tax bases for assets are addressed in paragraph 13.111 onwards, and for liabilities in paragraph 13.120 onwards.

- Calculate temporary differences.
 - Temporary difference is defined as the difference between an asset or liability's carrying amount and its tax base. Temporary differences are addressed in paragraph 13.93 onwards and summarised in paragraph 13.106.

Consider the exceptions to recognising deferred tax on temporary differences.

Three exceptions relating to temporary differences arise in the following situations:

- Initial recognition of goodwill arising in a business combination (for deferred tax liabilities only) (see para 13.158 onwards).
- Initial recognition of an asset or liability in a transaction that is not a business combination and does not affect accounting profit or taxable profit (see para 13.162 onwards).
- Investments in subsidiaries, branches, associates and joint ventures, but only where certain criteria apply (see para 13.233 onwards for individual financial statements and para 13.253 onwards for consolidated financial statements).

- Assess deductible temporary differences, tax losses and tax credits for recoverability.

A deferred tax asset is recognised to the extent that it is *probable* that taxable profit will be available against which a deductible temporary difference or unused tax losses or tax credits can be utilised (see para 13.128 onwards).

- Determine the tax rate that is expected to apply when the temporary differences reverse; and calculate deferred tax.

Deferred tax is measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates

and tax laws that have been enacted or substantively enacted by the balance sheet date (see para 13.165 onwards).

Measurement of deferred tax reflects the tax consequences that follow from the manner that management expects, at the balance sheet date, to recover or settle the carrying amount of an asset or liability (see para 13.170 onwards).

■ Recognise deferred tax.

Deferred tax is calculated by multiplying the temporary difference by the tax rate.

■ Consider the presentation and offsetting of current and deferred tax.

The requirements for presenting current and deferred tax are addressed in paragraph 13.278 onwards. The rules for offsetting current and deferred tax assets and liabilities are addressed in paragraph 13.281 onwards.

■ Disclose details of current and deferred tax.

Disclosure requirements relating to current and deferred tax are addressed in paragraph 13.290 onwards.

Temporary differences

13.93 The concept of temporary differences is central to the calculation of deferred taxes under IAS 12. Temporary differences are defined as differences between the carrying amount of an asset or liability and its tax base (see para 13.107 onwards). [IAS 12 para 5]. The term 'temporary difference' is used because ultimately all differences between the carrying amounts of assets and liabilities and their tax bases will reverse. An entity might delay the reversal of temporary differences by delaying the events that give rise to those reversals; for example, it might defer indefinitely the sale of a revalued asset. The carrying amount of assets and liabilities will always be recovered or settled. So the key questions are when and not whether temporary differences will reverse; and to what extent, on reversal, this will result in taxable or tax deductible amounts in future years. All such tax consequences will crystallise at some point. If the recovery of an asset has no tax consequences, the tax base is equal to the carrying amount and there is no temporary difference (see further para 13.111).

13.94 The following are examples of temporary differences:

- An item of income or expenditure is included in accounting profit of the period, but recognised in taxable profit in later periods. For example, income receivable might be accrued in the financial statements in one year, but it is taxed in the next year when received. Similarly, management might make provisions for restructuring costs in the financial statements in one period, but those costs would qualify for tax deduction in a later period when the expenditure is incurred.

- An item of income or expenditure is included in taxable profit of the period, but recognised in accounting profit in later years. For example, development expenditure might be tax deductible in the year in which it is incurred, but it is capitalised and amortised over a period for financial reporting purposes. Similarly, income received in advance might be taxed in the period of receipt, but treated in the financial statements as earned in a later period.

- Where assets are acquired and liabilities assumed in a business combination, these are generally recognised at their fair values; but no equivalent adjustment is made for tax purposes (see para 13.238).

- Assets are revalued and no equivalent adjustment is made for tax purposes (see para 13.208).

- Goodwill arises in a business combination (see para 13.158).

- An asset or liability's tax base on initial recognition differs from its initial carrying amount; for example, when an entity benefits from non-taxable government grants related to assets (see para 13.162).

- The carrying amount of investments in subsidiaries, branches and associates or interests in joint ventures differs from the tax base of the investment or interest (see para 13.253).

- An entity's non-monetary assets and liabilities are measured in its functional currency, but the taxable profit or tax loss (and so the tax base of its non-monetary assets and liabilities) is determined in a different currency (see para 13.274).

[IAS 12 paras IN2, 18].

[The next paragraph is 13.96.]

13.96 Not all of the temporary differences listed above give rise to deferred tax assets or liabilities. Some are specifically exempted from recognition in the standard (see further para 13.157 onwards).

13.97 The carrying amounts of assets and liabilities used to calculate the temporary differences are determined from the entity's balance sheet. The applicable carrying amount is generally a question of fact; but judgement might be needed to determine the appropriate carrying amounts for use in deferred tax calculations that are based on the dual manner of recovery (see further para 13.172.2). Where applicable, the carrying amounts of assets are included in the computation of temporary differences net of any provision for doubtful debts or impairment losses. Similarly, the carrying amounts of liabilities, such as debts recorded at amortised cost, are included net of any issue costs. The carrying amounts of assets and liabilities in consolidated financial statements are obtained from the consolidated balance sheet. The tax base is determined by reference to a consolidated tax return in jurisdictions that require such a return; and by reference to the tax returns of each individual group entity in other jurisdictions. [IAS 12 para 11].

■ The amount by which the value assigned to the key assumption changes, after adjusting values of other assumptions for consequential changes, in order for the CGU's recoverable amount to be equal to carrying amount.

[IAS 36 para. 134].

18.297.1 The above disclosure does not reflect the original amendment to IAS by IFRS 13 that required the disclosure of the recoverable amount of a unit group of units containing goodwill or indefinite-lived intangible assets (regardless of whether an impairment had been recognised or reversed). This requirement was removed by a subsequent limited scope amendment – but see paragraph 18.7 from the effective date of the subsequent amendment.

18.297.2 Some additional disclosures are required for entities that calculate value less costs of disposal using discounted cash flow projections:

- The period over which management has projected cash flows.
- The growth rate used to extrapolate cash flow projections.
- The discount rate(s) applied to the cash flow projections.

Example – Disclosures of growth rates and discount rates

Entity Z has 2 CGUs – wholesale and retail. After having performed the impairment test for goodwill, management is comfortable that the recoverable amount is higher than the carrying amount, that is, no impairment has to be recognised.

However, goodwill is material, so management asks what disclosure is needed.

The following is an example of good key assumptions disclosure:

Key assumptions used for value-in-use calculations:

	Wholesale				Retail			
	Euro	US	UK	Other	Euro	US	UK	Other
Gross margin	60%	59%	60%	56%	58%	56%	58%	55%
Growth rate	1.8%	1.8%	1.8%	1.9%	1.1%	1.3%	1.1%	1.4%
Discount rate	10.5%	10%	11%	12.8%	11.5%	11%	11.8%	13.5%

These assumptions have been used for the analysis of each CGU within the business segment.

Management determined budgeted gross margin based on past performance and its expectations for the market development. The weighted average growth rates used are consistent with the forecasts included in industry reports. The discount rates used are pre-tax and reflect specific risks relating to the relevant segments. The impairment charge arose in a wholesale CGU in country B (included in 'Other countries' segment

summary) following a decision to reduce the manufacturing output allocated to these operations. This was as a result of a re-definition of the group's allocation of manufacturing volumes across all CGUs in order to benefit from advantageous market conditions. Following this decision, the group re-assessed the depreciation policies of its property, plant and equipment in this country and estimated that their useful lives will not be affected. No other class of asset other than goodwill was impaired. The discount rate used in the previous years for the wholesale CGU in country B was 12.0%.

18.298 The disclosures outlined in paragraph 18.297 are a formidable list of disclosures. The last of them is a type of sensitivity analysis and has precedents in the type of sensitivity analysis that companies often give when disclosing details of financial instruments, for example the effect of a 1% increase or decrease in interest rates or foreign exchange rates. Similar variances might affect values attributed to assumptions in an impairment calculation. It also recognises that changes in one variable might affect other variables, increasing or decreasing the overall effect on the calculation.

Example – Sensitivity analysis

Management has carried out an impairment test and has discovered that the recoverable amount is higher than the carrying amount, but only by a small amount (recoverable amount is 3% higher than carrying amount). Therefore, a sensitivity analysis was done where the following parameters were changed in the calculation of the recoverable amount:

	Original assumption		Sensitivity analysis
Gross margin:	25%	->	24%
Growth rate:	5%	->	4%
Discount rate:	12%	->	11%

It was determined that each of the changes would separately lead to an impairment, since the recoverable amount would then be lower than the carrying amount.

What should management disclose?

If there is little headroom a sensitivity analysis has to be performed. The sensitivity analysis has to be disclosed if a reasonably possible change in any key assumption would cause an impairment to arise.

Management should disclose the amount of headroom.

In addition, since the changes to the key assumptions that would lead to an impairment are minimal, they must be considered reasonably possible, so management should also disclose:

- The original assumptions and assumptions used in the sensitivity analysis.
- The amounts of changes that would result in impairment charges.

comparison of a CGU to similar companies whose financial information is publicly available provide a reasonable basis to estimate fair value. Under the market approach, fair value is calculated based on EBITDA multiples of benchmark companies comparable to the business of each CGU. Data for the benchmark companies was obtained from publicly available information.

Significant Assumptions

Weighting of Valuation Techniques

The Company weighted the results of the two valuation techniques noted above, consistently applied to each CGU, as follows: 60% income approach / 40% market approach except in one instance as noted below. The Company believes that given volatility in capital markets, it is appropriate to apply a heavier weighting to the income approach.

The fair value of one CGU, which is comprised of recently acquired investments, was weighted 100% to the income approach as management concluded that a market approach did not appropriately reflect its value. This CGU constituted less than 5% of total carrying value.

Growth

The assumptions used were based on the Company's internal budget. The Company projected revenue, operating margins and cash flows for a period of five years, and applied a perpetual long-term growth rate thereafter. In arriving at its forecasts, the Company considered past experience, economic trends such as GDP growth and inflation as well as industry and market trends. The projections also took into account the expected impact from new product initiatives, customer retention and efficiency initiatives, and the maturity of the markets in which each business operates.

Discount Rate

The Company assumed a discount rate in order to calculate the present value of its projected cash flows. The discount rate represented a weighted average cost of capital ("WACC") for comparable companies operating in similar industries as the applicable CGU, based on publicly available information. The WACC is an estimate of the overall required rate of return on an investment for both debt and equity owners and serves as the basis for developing an appropriate discount rate. Determination of the WACC requires separate analysis of the cost of equity and debt, and considers a risk premium based on an assessment of risks related to the projected cash flows of each unit.

Lower discount rates were applied to CGUs whose cash flows are expected to be less volatile due to factors such as the maturity of the market they serve and their market position. Higher discount rates were applied to CGUs whose cash flows are expected to be more volatile due to competition, or participation in less stable geographic markets.

Tax Rate

The tax rates applied to the projections were based on effective tax rates of comparable companies operating in similar industries as the applicable CGU, based on publicly available information. In certain circumstances, the effective tax rates, which ranged from 28% to 41% were below the statutory tax rates. Tax assumptions are sensitive to changes in tax laws as well as assumptions about the jurisdictions in which profits are earned. It is possible that actual tax rates could differ from those assumed.

The key assumptions used in performing the impairment test, by CGU, were as follows:

	Markets	West	All other
Discount rate	9.5%	7.5%	8.1%-11.5%
Perpetual growth rate	3.0%	2.0%	3.0%

The fair value for each CGU other than Markets was in excess of its carrying value. The excess ranged from 52% to 392% of the carrying value of the applicable CGU, except for one CGU whose fair value was in excess of its carrying value by only 13%. This CGU is comprised of recently acquired investments and constituted less than 5% of total carrying value. Based on sensitivity analysis, no reasonably possible change in assumptions would cause the carrying amount of any CGU to exceed its recoverable amount.

Table 18.7B – Disclosures relating to impairment reviews of goodwill allocated to CGUs

British American Tobacco p.l.c. – Annual Report – 31 December 2012

Intangible assets (extract)

Impairment testing for intangible assets with indefinite lives including goodwill

Goodwill of £10,793 million (2011: £11,120 million) is included in intangible assets in the balance sheet of which the following are the significant acquisitions: Rothmans Group £4,796 million (2011: £4,947 million); Imperial Tobacco Canada £2,477 million (2011: £2,533 million); ETI (Italy) £1,337 million (2011: £1,377 million) and ST (principally Scandinavia) £1,004 million (2011: £1,038 million). The principal allocations of goodwill in the Rothmans acquisition are to the cash-generating units of Eastern Europe, Western Europe and South Africa, with the remainder mainly relating to operations in the domestic and export markets in the United Kingdom and operations in Asia-Pacific.

In 2012 goodwill was allocated for impairment testing purposes to 14 individual cash-generating units (2011: 15 individual cash-generating units) – five in Asia-Pacific, five in the Americas, two in Western Europe and two in EEMEA. In 2011, the goodwill in respect of Turkey was allocated for impairment testing purposes to a third cash-generating unit in EEMEA but was fully impaired during that year (see note 3(g)).

The carrying amounts of goodwill allocated to the cash-generating units of Canada £2,477 million (2011: £2,533 million), Western Europe (includes Rothmans and other acquisitions) £3,738 million (2011: £3,646 million), Eastern Europe (includes Rothmans and other acquisitions) £889 million (2011: £914 million), South Africa £803 million (2011: £883 million), Australia (includes Rothmans and other acquisitions) £856 million (2011: £884 million), Singapore £538 million (2011: £530 million) and Malaysia £474 million (2011: £478 million) are considered significant in comparison with the total carrying amount of goodwill.

The recoverable amount of all cash-generating units has been determined on a value-in-use basis. The key assumptions for the recoverable amount of all units are the long-term growth rate and the discount rate. The long-term growth rate used is purely for the impairment testing of goodwill under IAS 36 *Impairment of Assets* and does not reflect long-term planning assumptions used by the Group for investment proposals or for any other assessments. The discount rate is based on the Group's weighted average cost of capital, taking into account the cost of capital and borrowings, to which specific market-related premium adjustments are made. These adjustments are derived from external sources and are based on the spread between bonds (or credit default swaps, or similar indicators) issued by the US or comparable governments and by the local government, adjusted for the Group's own credit market risk. For ease of use and consistency in application, these results are periodically calibrated into bands based on internationally recognised credit ratings. These assumptions have been applied to the individual cash flows of each unit as compiled by local management in the different markets.

The valuations use cash flows based on detailed financial budgets prepared by management covering a one-year period, with growth in year 2 of 6%. Cash flows for the years 3 to 10 are extrapolated from year 2 cash flows at 5% per annum, including 2% inflation, whereafter a total growth rate of 2% per annum (including 2% inflation) has been assumed. The extrapolated growth rates are considered conservative given the Group's history of profit and cash growth, its well balanced portfolio of brands and the industry in which it operates. The long-term real growth does not exceed the expected long-term average growth rate for the combined markets in which the cash-generating units operate. In some instances, such as recent acquisitions or start-up ventures, the valuation is expanded to reflect the medium-term plan of management, spanning five years or beyond.

Pre-tax discount rates of between 7.2% and 13.9% (2011: 7.2% to 18.0%) were used, based on the Group's weighted average cost of capital, together with any premium applicable for economic and political risks.

The pre-tax discount rates used for the cash-generating units which are significant in comparison with the total carrying amount of goodwill are 8.6% for Canada (2011: 8.8%), 9.3% for Western

Europe (2011: 8.6%), 8.9% for Eastern Europe (2011: 10.0%), 9.3% for South Africa (2011: 10.8%), 8.6% for Australia (2011: 8.6%), 7.2% for Singapore (2011: 7.2%) and 3.7% for Malaysia (2011: 9.3%). If discounted cash flows for cash-generating units should fall by 10% the discount rate was increased at a post-tax rate of 1%, there would be no impairment.

3 Profit from operations (extract)

(g) Goodwill impairment

In 2011, the Group impaired the remaining balance of the goodwill in respect of the Teles acquisition in 2008, amounting to £273 million. Although cost saving initiatives in the acquisition plan have been delivered successfully, the impairment charge arose as a result of further increases in excise announced by the Turkish government effective from October 2011 and an additional increase effective from January 2013. The excise increases to date have resulted in the growth of illicit trade and a loss of volumes and market share. Turkey remains an important strategic market for the Group. The basis for determining the recoverable amounts of goodwill explained in note 9.

Table 18.7C – Impairment testing of goodwill and sensitivity analysis disclosures

London Stock Exchange – Annual Report – 31 March 2012

Management believes goodwill allocated to FTSE International Ltd ('FTSE'), MillenniumIT and Turquoise CGUs is unlikely to be materially impaired under any reasonable changes to key assumptions. The excess of value in use over carrying value is determined by reference to the net book value as at 31 March 2012. Revenue and cost sensitivities assume a five per cent change in revenues or costs for each of the five years in the value in use calculations.

13. Intangible assets (extract)

Impairment tests for goodwill

Goodwill has been allocated for impairment testing purposes to the 11 cash generating units (CGUs) shown in the table below with the FTSE Group, acquired during the year, comprising one CGU.

The recoverable amounts of these CGUs have been determined based on value in use calculations, using discounted cash flow projections prepared by management covering the five year period ending 31 March 2017. Cash flows beyond this period are extrapolated using the estimated long term growth rates and applying the pre-tax discount rates referred to below.

The amount of the net book value of goodwill allocated to each CGU is set out below.

The amount of the net book value of goodwill allocated to each CGU is set out below.

	Net book value of goodwill			31 March 2012	Pre-tax discount rate used in value in use calculations
	31 March 2011	Additions	Foreign exchange		
	£m	£m	£m	£m	
Italian group:					
Issuer	19.4	—	(1.1)	18.3	12.4%
Equities Trading	65.4	—	(3.7)	61.7	12.7%
Derivatives Trading	29.3	—	(1.7)	27.6	12.6%
Fixed Income Trading	73.9	—	(4.2)	69.7	12.2%
Information Services	121.2	—	(6.8)	114.4	12.7%
Technology Services	14.3	—	(0.8)	13.5	13.5%
Post-Trade Services	383.7	—	(21.7)	362.0	13.3%
MillenniumIT:					
Software	0.9	—	(0.2)	0.7	21.6%
Enterprise Service Provider	0.8	—	(0.1)	0.7	19.8%
Turquoise	7.4	—	—	7.4	14.2%
FTSE		75.6	—	75.6	
	716.3	75.6	(40.3)	751.6	

Management has based its value in use calculations for each CGU on key assumptions about short and medium term revenue and cost growth, long term economic growth rates (used to determine terminal values) and pre-tax discount rates.

The values assigned to short and medium term revenue and cost growth assumptions reflect current trends, anticipated market developments, discussions with customers and suppliers, and management's experience, taking account of an expected recovery in underlying financial markets.

Long term growth rates (assumed to be 2.1 per cent for each of the Italian CGUs, 7.0 and 15.2 per cent for MillenniumIT's Software and Enterprise Service Provider CGUs respectively, and 3.0 per cent for Turquoise) represent management's internal forecasts based on external estimates of GDP and inflation for the 14 year period 1 January 2003 to 31 December 2016, and do not exceed the long term average growth rates for the countries in which the CGUs operate.

Pre-tax discount rates are based on a number of factors including the risk-free rates in Italy, Sri Lanka and the UK as appropriate, the Group's estimated market risk premium and a premium to reflect the inherent risks of each of the CGUs.

Based on the results of the impairment tests performed management believes there is no impairment of the carrying value of the goodwill in any CGU. In addition, no impairment of the Company's investments in subsidiary undertakings referred to in note 15 was considered necessary.

Value in use calculations for each CGU are sensitive to changes in short and medium term revenue and cost growth assumptions, long term growth rates and pre-tax discount rates. The impact on value in use of a change in these assumptions is shown below:

The FTSE Group was acquired only recently and, following a post acquisition review, no factors have been identified which would give rise to an impairment.

24.87 The issue concerns how the originator (or entity on whose behalf the SPE was created, which is sometimes called the sponsor or creator) should account for its interest in the SPE. The benefits and risks derived by an originator from its interest in an SPE are often indistinguishable from those that would arise had the entity been set up as the originator's subsidiary. Frequently, the creator of the SPE may in substance control it. [SIC 12 paras 1, 2]. Where an SPE is identified and is controlled by another entity, it is accounted for in the same way as subsidiaries, that is, by way of full consolidation by the controlling entity. [SIC 12 paras 1, 2, 8].

24.88 Control and consolidation questions are not decided solely by ownership under IFRS. Under IFRS, the key to determining whether an entity should consolidate another entity or an SPE is whether the parent (or the parent and its subsidiaries) *controls* the entity. Control is defined in IAS 27 as "the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities". [IAS 27 para 4]. Both IAS 27 and SIC 12 are predicated on the underlying principle of control. The principles in SIC 12 are no different from those in IAS 27; both statements are trying to establish which party has control over the financial and operating policies of another entity in order to gain benefits from those activities.

24.89 When considering which party controls an entity, it is necessary to analyse carefully all of the financial and operating policies that are of importance to the entity and who can control each of those policies.

24.90 In addition, it is often helpful to consider what control other parties to the transaction have either collectively or individually. It is not necessary for the controlling party to actually exercise its control; just having the power to exercise such control is sufficient.

24.91 The substance of the SPE and its relationship to the various parties that participate in it will determine which party has control and thus should consolidate the SPE.

24.92 Under IFRS, there is no specific definition of SPE. The common factors that identify an SPE are:

- Auto-pilot arrangements that restrict the decision-making capacity of the governing board or management.
- Use of professional directors, trustees or partners.
- Thin capitalisation, the proportion of 'real' equity is too small to support the SPE's overall activities.
- Absence of an apparent profit-making motive, such that the SPE is engineered to pay out all profits in the form of interest or fees.
- Domiciled in 'offshore' capital havens.
- Have a specified life.

exist for financial engineering purposes.

The creator or sponsor may transfer assets to the SPE, often as part of a derecognition transaction involving financial assets.

The presence of any of the features identified above does not automatically make an entity an SPE, nor does the absence of a feature or features mean that it is not an SPE.

SPEs are often created with legal arrangements that impose strict and sometimes permanent limits on the decision-making powers of their governing board, trustee or management over the SPE's operations. Often the agreement's provisions specify that the policy guiding the ongoing activities of the SPE cannot be modified, other than perhaps by its originators. These types of entity basically operate automatically with little or no interference once they have been created. The SIC describes this form of structure as operating 'on autopilot'. [SIC 12 para 1].

24.94 The originator frequently transfers assets to the SPE, obtains the right to use assets held by the SPE or performs services for the SPE, while other third parties provide the SPE's funding (for example, as in a securitisation scheme). The originator might in substance control the SPE by the way in which it derives benefits from the SPE's net assets. [SIC 12 para 2].

24.95 The originator's interest in the SPE might, for example, take the form of a debt instrument, an equity instrument, a contractual arrangement, a participation right, a residual interest or a lease. It matters little what the interest is in the entity. Some beneficial interests may simply provide the originator with a fixed or stated rate of return, while others give the originator rights or access to the SPE's future economic benefits. Generally, the originator retains a significant beneficial interest in the SPE's activities, even though it may own little or none of the SPE's equity. [SIC 12 para 3].

24.96 Control might arise through pre-determination of the auto-pilot mechanism even when the originator has less than 50% of the voting power of the SPE and can exist where the originator owns little or none of the SPE's equity. To determine whether the originator controls the SPE, it is necessary to consider carefully the factors discussed below and to make a judgment in the context of all the relevant facts. [SIC 12 paras 8, 9].

24.97 SIC 12 explains a number of situations that indicate there is a relationship whereby the originator controls the SPE. Control is presumed to exist where:

- The SPE's activities are being conducted on the entity's behalf according to its specific business needs, such that the entity obtains benefits from the SPE's operations.
- The entity has the *decision-making power* to obtain the majority of the benefits from the SPE's activities or initiated the creation of the SPE including setting up the 'autopilot' mechanism.