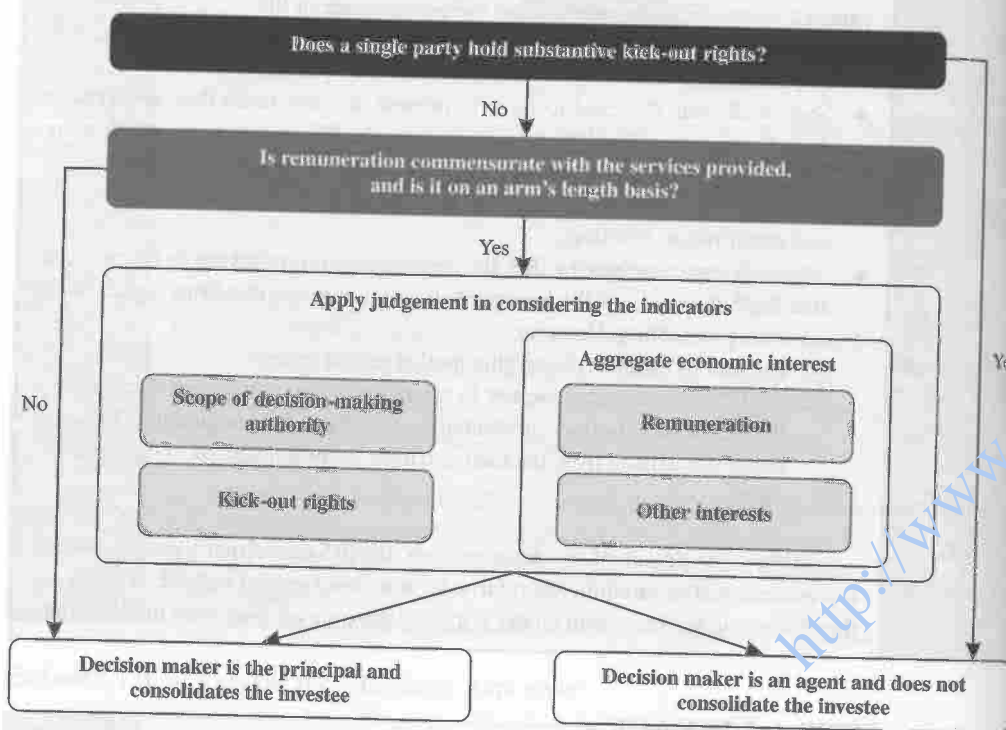


- If the decision maker has the power to direct the activities of the investee that it manages to generate returns for itself, then it is a principal.
- If the decision maker is primarily engaged to act on behalf and for the benefit of another party or parties, then it is an agent and does not control the investee when exercising its decision-making authority. However, a decision maker is not an agent simply because other parties can benefit from the decisions that it makes.
- In determining if the decision maker is acting as principal or agent, it considers the overall relationship between itself and other parties. [IFRS 10.18, B58]

2.5.280.40 The following diagram illustrates the steps that a decision maker follows in analysing whether it is acting as a principal or an agent, which is explained throughout this section. [IFRS 10.B58–B72]



2.5.280.50 As indicated in the above diagram, two tests are determinative regardless of other indicators.

- If a single party holds substantive kick-out rights – i.e. the decision maker can be removed without cause – then the decision maker is an agent. In that case, the linkage test is failed and the decision maker does not consolidate the investee. This is regardless of the level of remuneration.
- If the decision maker's remuneration is not commensurate with the services provided, or the terms and conditions are not on an arm's length basis, then the decision maker is the principal. In that case, the linkage test is met and the decision maker consolidates the investee. [IFRS 10.B65, B69]

2.5.280.60 Theoretically, the linkage analysis is always relevant when applying the control model, but similar to the variability test (Step 3 of the control model – see 2.5.210) only in some cases will any detailed analysis be required.

2.5.280.70 The linkage analysis will require more in-depth consideration:

- in assessing whether a fund manager has control (see 2.5.350); and
- if there is otherwise explicit delegation of power (see 2.5.290).

2.5.280.80 Outside of these circumstances, the default presumption is that the linkage test is met. For example, when an investee is controlled by voting rights, the decision maker's exposure to variability of returns will generally be correlated with its power over the investee. [IFRS 10.BC142]

2.5.280.90 However, there may be certain other circumstances in which the linkage analysis requires more detailed consideration. For example, due to local laws, equity interests in some investees in a country need to be held by an entity domiciled in the same country. In this case, a foreign investor willing to invest in this country may enter into an agreement with the holding entity, whereby the local holding entity agrees to act solely for the benefit and interest of, and on behalf of, the foreign investor. This local holding entity may be an agent of the foreign investor and therefore fail the linkage test. For a discussion of special relationships in the context of the control model as a whole, see 2.5.400.

2.5.290 Application to decision makers other than fund managers

2.5.290.10 In applying the linkage test, the decision maker considers the overall relationship between itself and other parties, including the following factors:

- the scope of its decision-making authority over the investee (see 2.5.300);
- kick-out rights (see 2.5.310); and
- its aggregate economic interest, comprising (see 2.5.320):
 - its remuneration for the services provided; and
 - its exposure to variability of returns because of other interests that it holds in the investee. [IFRS 10.B60–B61]

2.5.290.20 The objective of the linkage test is to determine whether the decision maker (who has already met the power and variability tests in the control model) can use its power to affect its returns. In making the assessment, different weightings are applied to each of the factors depending on particular facts and circumstances. [IFRS 10.B60–B61]

2.5.290.30 Therefore, it appears that the practical objective of the linkage test is to assess whether the balance of evidence is sufficient to conclude that there is a link between power and returns for the decision maker. It is not necessary for every indicator to be conclusive, and in some assessments there may be positive and negative indicators. In addition, it appears that understanding the purpose and design of the investee (see 2.5.60) is an important consideration in determining the weighting to be applied to each factor; this is because purpose and design is a key factor in analysing power and returns, which are the subject of the linkage analysis.

2.5.290.40 The investor treats the decision-making rights delegated to its agent as held by the investor directly. [IFRS 10.B59]

2.5.300 Scope of decision-making authority

2.5.300.10 When assessing the scope of its decision-making authority, the investor considers the following:

- the activities that are permitted according to the decision-making agreement(s) and specified by law; and
- its level of discretion. [IFRS 10.B62]

2.5.300.20 Before analysing linkage, it has already been established that the decision maker has power over the relevant activities of the investee. Therefore, in general this test does not provide a clear indication of whether a decision maker is acting as principal or agent.

2.5.310 Strength of kick-out rights

2.5.310.10 As noted in 2.5.280.50, if a single party holds substantive rights to remove the decision maker without cause, then this is sufficient to conclude that the decision maker is an agent. However, if more than one party needs to act together to remove the decision maker, then this fact alone is not sufficient to conclude that the decision maker is an agent or that the removal rights are not substantive. Such rights are considered in the overall evaluation of whether the decision maker is acting as a principal. The more parties that need to agree to remove the decision maker, the less weighting that is placed on that factor – i.e. the rights are assessed on a sliding scale if not held by a single party. [IFRS 10.B64–B65]

2.5.310.20 For example, if the decision maker can be removed without cause by simple majority and there are only three other investors (e.g. only two votes are needed to remove the decision maker), then the removal rights are much more likely to be substantive and carry more weight than if there are 30,000 other investors (e.g. 15,001 votes are needed to remove the decision maker). [IFRS 10.B64–B65]

2.5.310.30 Rights that restrict the decision maker's discretion are considered in a manner similar to kick-out rights. Consequently, if the decision maker needs to obtain approval from a small number of parties to make its decisions, then generally it is an agent. [IFRS 10.B66]

2.5.310.40 The greater the number of parties required to act together to exercise removal or similar rights, and the greater the magnitude and variability associated with the decision maker's economic interests, the less weighting is placed on this factor. [IFRS 10.B65]

2.5.310.50 Consideration of the rights held by other parties includes rights exercisable by the investee's board of directors or other governing body and their effect on the decision-making authority. For example, when the board of directors is independent of the decision maker, it may in effect act as a central mechanism through which investors act collectively. Such a mechanism is more likely to be substantive and, if so, would overcome any presumption that the rights of a large number of parties required to act together is not substantive. [IFRS 10.B23(b), B67]

2.5.310.60 When assessing whether removal rights are substantive, the guidance in 2.5.100 is relevant. Questions may arise in respect of removal rights that are exercisable for only a limited period of time. In assessing whether such removal rights are substantive, an entity would need to consider the time period for which the rights are exercisable – especially in respect of when relevant decisions are to be made. [IFRS 10.B66]

2.5.310.70 For further discussion of kick-out rights, see 2.5.370. Although this discussion is in the context of fund managers, the points made are generally applicable in other circumstances.

2.5.320 Aggregate economic interest

2.5.320.10 The decision maker's aggregate economic interest in an investee comprises any remuneration for services rendered plus any exposure to variability through other interests. The greater the magnitude of, and variability associated with, the decision maker's aggregate economic interest, the greater the likelihood that the decision maker is acting as principal. [IFRS 10.B72(a)]

2.5.320.20 Remuneration and other interests held may be considered in aggregate because, if the level of remuneration/other interests alone resulted in a principal conclusion, then the same conclusion would be reached when assessed in aggregate; conversely, if the assessment did not result in a principal assessment on a stand-alone basis, then the remuneration/other interests would still be required to be tested as part of a larger aggregate.

2.5.320.30 Outside of the funds sector, which is the basis for the examples in IFRS 10, the assessment of the decision maker's aggregate economic interest is more likely to require significant judgement. For example, returns may be more difficult to identify and evaluate because of their nature – e.g. synergies.

2.5.320.40 For further discussion of the 'aggregate economic interest', see 2.5.360.

2.5.330 Remuneration

2.5.330.10 As indicated in 2.5.280.50, for the decision maker to be an agent, its remuneration needs to be 'at market'. This means that the remuneration needs to:

- be commensurate with the services provided; and
- include only terms, conditions or amounts customarily present in arrangements for similar services and level of skill negotiated on an arm's length basis. [IFRS 10.B69]

2.5.330.20 If the remuneration meets these two criteria, then the decision maker can be, but is not necessarily, an agent. This is because the other factors also need to be considered. [IFRS 10.B70]

2.5.330.30 For decision makers other than fund managers, significant judgement could be required in determining whether remuneration is at market – e.g. if the parties are related parties.

2.5.340 Exposure to variability of returns through other interests

2.5.340.10 If the decision maker holds other interests in an investee – e.g. an investment – then this may indicate that it is a principal. The term 'other interests' is not defined in IFRS 10, but it appears that it means any involvement that gives rise to a variable return for the decision maker as defined by IFRS 10 (see 2.5.210.30). This is because the linkage test is about determining whether the decision maker is using its power to affect its returns from its involvement with the investee – e.g. synergies achieved by the decision maker through its involvement in the investee – which is a wider concept than just the returns of the investee itself. The standard itself also gives the example of a guarantee provided by the decision maker in respect of the performance of the investee. [IFRS 10.B71]

2.5.340.20 As a result, the assessment of returns cannot be undertaken solely on a quantitative basis. Instead, in many cases a qualitative assessment will be required, with all sources of returns included in the assessment. This analysis is also consistent with Board's rejection of developing a model that would specify a particular level of returns that would result in an agency relationship. This decision was made to avoid encouraging structuring to achieve a particular accounting outcome. [IFRS 10.BC143-BC142]

2.5.340.30 As part of the assessment, the decision maker also considers whether its exposure to variability of returns is different from that of the other investors, and if so, whether this might influence its actions. [IFRS 10.B72(b)]

2.5.350 Application to fund managers

2.5.350.10 KPMG's publication *IFRS Practice Issues: Applying the consolidation model to fund managers* provides a more in-depth discussion of the application of IFRS 10 to fund managers than this chapter. This chapter summarises the key points included in that publication, and expands the discussion in 2.5.280-340 in the context of investment funds.

2.5.350.20 Fund managers generally have power over the relevant activities of the funds that they manage through their exercise of delegated power (see 2.5.90), and exposure to variability of returns through incentive fees and/or co-investment (see 2.5.210). Therefore, the link between power and returns is usually key for fund managers in assessing whether a fund manager has control over the fund.

2.5.350.30 Of the steps set out in 2.5.280.40, it appears that the linkage analysis for fund managers will come down to a combined assessment of just two indicators: aggregate economic interests and kick-out rights.

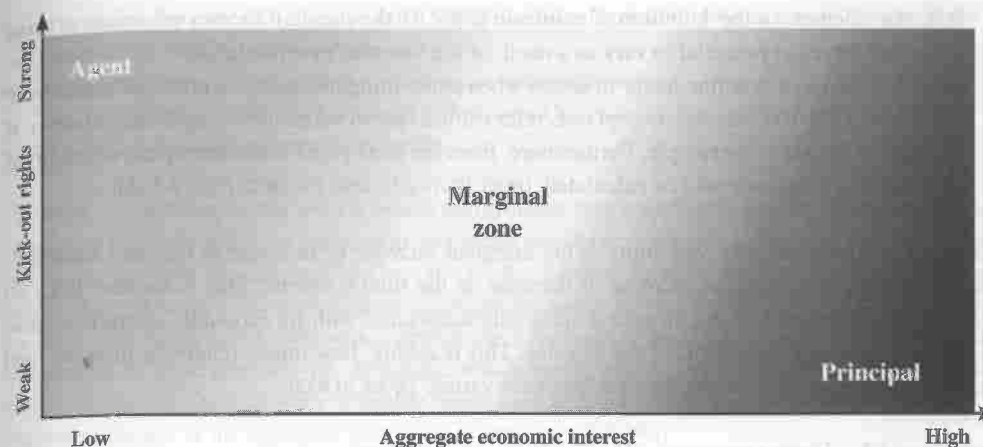
2.5.350.40 This is because:

- single party kick-out rights are rarely present in the funds sector;
- a fund manager's remuneration is generally at market if there is sufficient investment from independent investors;
- the scope of decision-making authority is not a distinguishing factor because the fund manager has all of the discretion within the designed activities of the fund; and
- as noted in 2.5.320.20, remuneration and other interests do not need to be tested separately.

2.5.350.50 The two indicators (aggregate economic interests and kick-out rights) are required to be considered together. Therefore, the stronger the kick-out rights, the more aggregate economic interest can be accepted while still being an agent. Conversely, the weaker the kick-out rights, the less aggregate economic interest can be accepted while still being an agent.

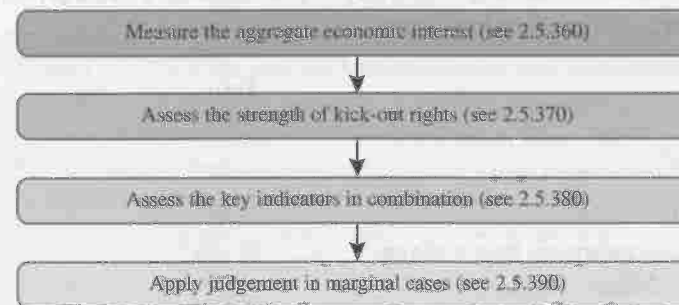
2.5.350.60 The chart below provides a way of visualising a general scheme for the result of combining different strengths of each indicator.

- In the grey zone, the combination of strong kick-out rights and low aggregate economic interest suggests that the fund manager is an agent.
- In the black zone, the combination of weak kick-out rights and high aggregate economic interest suggests that the fund manager is a principal.
- In the marginal zone, the combination does not give a clear outcome.



2.5.350.70 For those cases that fall into the marginal zone, the fund manager will need to consider certain other aspects of these indicators to determine if it is an agent or a principal. The question of where the central, marginal zone starts and finishes is not clear; there are no 'bright lines'.

2.5.350.80 The rest of this section summarises the key steps in the linkage analysis for a fund manager.



2.5.360 Aggregate economic interest

2.5.360.10 The first key indicator is the aggregate economic interest, comprising remuneration and other interest in aggregate. It appears that this amount is simply the sum of remuneration and other interests. [IFRS 10.B72(a)]

2.5.360.20 IFRS 10 requires an evaluation of the magnitude of, and variability associated with, its economic interests relative to the total variability of returns of the investee. This evaluation is made primarily on the basis of returns *expected* from the activities of the investee but should not ignore the decision maker's *maximum* exposure to variability of returns. [IFRS 10.B72]

2.5.360.30 On this basis, it appears that the key measure is the 'variability of expected returns', for the following reasons.

2.8.70.30 Generally, an entity applies a change in accounting policy retrospectively (i.e. as if the new accounting policy had always been applied), including any income tax effect. This is done by adjusting the opening balance of each affected component of equity for the earliest prior period presented and the other comparative amounts disclosed for each prior period presented. [IAS 8.22]

2.8.70.40 If it is impracticable to determine the period-specific effects for one or more prior periods presented (see 2.8.90), then the entity restates the opening balances of assets, liabilities and equity for the earliest period for which retrospective application is practicable. [IAS 8.24]

2.8.70.50 If it is impracticable to determine the cumulative effect at the beginning of the current period of a change in accounting policy (see 2.8.90), then the entity restates the comparative information prospectively from the earliest date practicable. Nevertheless, a change in accounting policy is permitted even if it is impracticable to apply the policy prospectively for any prior period. [IAS 8.25.27]

2.8.70.60 The financial statements include disclosure regarding the change in accounting policy, including the reasons why applying a voluntary change in accounting policy provides reliable and more relevant information. [IAS 8.29]

2.8.80 ERRORS

2.8.80.10 Errors result from the misapplication of policies or the misinterpretation of facts and circumstances that exist at the end of the reporting period. Examples include mathematical mistakes, fraud (see 2.9.70) and oversight. [IAS 8.5]

2.8.80.20 Financial statements containing material errors, or immaterial errors made intentionally to achieve a particular result in the financial statements, do not comply with IFRS. Potential current-period errors are corrected before the financial statements are authorised for issue. Material prior-period errors are corrected by restating the comparative information presented in the financial statements for that subsequent period. [IAS 8.41]

2.8.80.30 The correction of a material prior-period error is made by either:

- restating the comparative amounts for the prior period(s) presented in which the error occurred; or
- restating the opening balances of assets, liabilities and equity for the earliest prior period presented if the error occurred before the earliest prior period presented. [IAS 8.42]

2.8.80.40 IAS 8 requires material prior-period errors to be corrected by restating the opening balance of equity and comparatives unless this is impracticable. [IAS 8.43]

2.8.80.50 If it is impracticable to determine the period-specific effects for one or more prior periods presented (see 2.8.90), then the entity restates the opening balances of assets, liabilities and equity for the earliest period for which retrospective restatement is practicable. [IAS 8.44]

2.8.80.60 If it is impracticable to determine the cumulative effect at the beginning of the current period of an error on all prior periods (see 2.8.90), then the entity restates the comparative information to correct the error prospectively from the earliest date practicable. [IAS 8.45]

EXAMPLE 3 – CORRECTING AN ERROR

2.8.80.70 During 2013, Company X discovered that prepayments of 400 made during 2011 had not been recognised in profit or loss as the related expenses were incurred. The prepayments should have been recognised as an expense of 100 in 2011; 250 in 2012; and 50 in 2013. The misstatement is material.

Extract from draft 2013 financial statements before correction of the error

	DRAFT 2013	2012
<i>Extract from statement of profit or loss and OCI</i>		
Revenue	6,000	4,000
Expenses	(5,500)	(3,600)
Net profit	500	400
<i>Extract from statement of changes in equity</i>		
Opening retained earnings	14,400	14,000
Current-year net profit	500	400
Closing retained earnings	14,900	14,400

2.8.80.80 The opening balance of retained earnings is adjusted and comparatives are restated when practicable to reflect the correction of the error. The restatement should reflect any tax effects, which are ignored for the purposes of this example.

Extract from final 2013 financial statements after correction of the error

	2013	2012 RESTATED
<i>Extract from statement of profit or loss and OCI</i>		
Revenue	6,000	4,000
Expenses	(5,550)	(3,850)
Net profit	450	150
<i>Extract from statement of changes in equity</i>		
Opening retained earnings as reported previously		14,000
Correction of an error related to previous years (note reference)		(100)
Opening retained earnings (restated)	14,050	13,900
Current-year net profit	450	150
Closing retained earnings	14,500	14,050

2.8.80.90 In restating the comparatives, the adjustment will be included in the appropriate line item of the statement of profit or loss and OCI in the usual way (see chapter 4.1). For example, if the expense in Example 3 were insurance of X's head office and X classified its expenses by function, then the expense would normally be included in administrative expenses. In addition, the financial statements will include full disclosure regarding the error and the adjustments made to correct it. [IAS 8.49]

2.8.80.100 Although it is not mentioned specifically in IAS 8, the standard's implementation guidance shows the restated comparative financial statements with the heading 'restated'. In our view, this is necessary to highlight for users the fact that the comparative financial statements are not the same as the financial statements previously published. [IAS 8.IG]

2.8.80.110 In Example 3, the component of equity affected by the error was retained earnings. If the error affects more components of equity, then the effect on each component of equity is disclosed separately. [IAS 1.106(b)]

2.8.90 IMPRACTICABILITY OF RETROSPECTIVE APPLICATION

2.8.90.10 The retrospective application of changes in accounting policies (see 2.8.50) and the restatement of material errors (see 2.8.80) are required, unless they are impracticable. Guidance is given on when retrospective application or restatement will be impracticable. [IAS 8.5, 50]

2.8.90.20 Retrospective application or restatement is done using only information that:

- would have been available in preparing the financial statements for that earlier period; and
- provides evidence of circumstances that existed on the date(s) when the transaction or event occurred. [IAS 8.52]

2.8.90.30 Other information – e.g. information that uses the benefit of hindsight – may not be used. [IAS 8.53]

2.8.90.40 Retrospective application or restatement is impracticable when it requires:

- significant estimates to be made that cannot, after making every reasonable effort, distinguish information that may be used from information that may not; or
- information regarding transactions or events that is not available to the entity after making every reasonable effort to retrieve the necessary information. [IAS 8.50, 52]

2.8.90.50 In such cases, the financial statements are adjusted as at the beginning of the earliest period from which retrospective adjustment is practicable.

2.8.90.60 If an entity presents any accompanying financial information in respect of prior periods (e.g. historical summaries), then in our view an inability to restate all of the periods presented in the historical summaries or other prior-period information is not a reason to conclude that none of the comparative information required by IFRS would be restated.

EXAMPLE 4 – INABILITY TO RESTATE ALL PERIODS IN HISTORICAL SUMMARIES

2.8.90.70 Company X prepares a 10-year historical summary as accompanying financial information to its annual report. As a result of a change in accounting policy, X attempts to adjust the historical summary for the entire 10-year period, but concludes that it is impracticable to restate beyond the last 4 years. Therefore, X restates the affected financial information as far back as practicable, being the last 4 years of the financial summary. [IAS 8.23]

2.8.100 ACCOUNTING ESTIMATES

2.8.110 Changes in accounting estimates

2.8.110.10 Estimates are an essential part of financial reporting and changes therein are accounted for in the period in which the change occurs. For example, a change in the estimate of recoverable receivables is accounted for in the period in which the change in estimate is made. Disclosure of the nature and amount of such changes is required (see 4.1.180). [IAS 8.32–33, 39–40]

2.8.110.20 In some cases, it can be difficult to determine whether a change represents a change in accounting policy or a change in estimate. In such cases, the change is treated as a change in estimate and appropriate disclosure is given. In our view, when an entity changes its method of measuring the cost of inventory (see 3.8.280) – e.g. from FIFO to weighted-average – this is a change in accounting policy notwithstanding the fact that both methods measure cost. [IAS 8.35]

2.8.110.30 A change in the estimate of the useful life or method of recognising the depreciation or amortisation of property, plant and equipment (see 3.2.140) or an intangible asset (see 3.3.210) is accounted for prospectively as a change in estimate by adjusting depreciation or amortisation in the current and future periods. [IAS 8.32, 36, 16.51, 61, 38.104]

EXAMPLE 5 – ACCOUNTING FOR CHANGES IN ESTIMATES

2.8.110.40 Company C acquired a printing machine at the beginning of 2009 and its useful life was estimated to be 10 years. At the end of 2012, the carrying amount of the machine was 240. At the beginning of 2013, C revised the estimated useful life downwards to a further 2 years from that date. Therefore, the carrying amount of 240 is depreciated over the next 2 years. In addition, the decrease in useful life may indicate that the carrying amount of the machine is impaired (see 3.10.110).

2.8.110.50 A change in estimate is different from the correction of an error because an error results from the misapplication of policy or misinterpretation of existing facts and circumstances. Changes in accounting estimates result from new information or new developments. An estimate takes into account all existing facts and circumstances, but changes over time as those facts and circumstances change or as the entity obtains more experience and/or knowledge. If an objective determination cannot be made of whether a change is a change in estimate or the correction of an error, then in our

3.12.150.50 At the date on which the obligation can be measured reliably, both the intangible asset and the corresponding liability should be recognised at the same amount, being the present value of the expected future payments to the local residents and businesses as compensation for the loss in the value of their property.

3.12.150.60 The estimate of the costs of compensation may change over time. In our view, changes in the carrying amount of the liability, except for the unwinding of the discount recognised in profit or loss, should be accounted for as an adjustment to the carrying amount of the intangible asset.

3.12.160 Future events

3.12.160.10 Future events are reflected when measuring a provision if there is sufficient objective evidence that they will occur. For example, a technological development that would make decommissioning less expensive would be considered if there is evidence that the new technology will be available. In our view, an intention to reduce an obligation via negotiation or to avoid it by declaring bankruptcy is a future event that should not be anticipated. [IAS 37.48]

EXAMPLE 3E – MEASURING PROVISION – FUTURE INTENTION TO REDUCE OBLIGATION

3.12.160.20 Parent M owns 100% of Subsidiary G. As at 31 December 2013, G has net assets of 10. At its 2013 year end, M determines that its present estimate of G's environmental remediation obligation needs to be increased by 50. M is required by the legislation to fund G's exposures. M determines that it will not fund G's deficit in the future, such that the net assets of G will not be sufficient to fund the full obligation. G intends to enter into negotiations with the relevant authorities to reduce, or be exempted from, the remediation obligation. If those negotiations fail, then G intends to start bankruptcy proceedings.

3.12.160.30 We believe that the measurement of G's obligation, both in G's own financial statements and in M's consolidated financial statements, should not be limited to G's net assets. Instead, we believe that G should recognise the full amount of the revised estimate of its environmental obligation. M should continue to consolidate G, including its full obligation, until it no longer controls G – e.g. after any bankruptcy proceedings have removed M's control (see 2.5.760).

3.12.170 Gains

3.12.170.10 Gains from the expected disposal of assets are not considered when measuring a provision. [IAS 37.51]

3.12.170.20 Therefore, if a provision is recognised for a restructuring (see 3.12.230), then gains on the related sale of any assets are not considered in measuring the provision. As a result, restructuring costs are likely to be recognised earlier than the gain on the related sale of assets.

EXAMPLE 3F – MEASURING PROVISION – EXPECTED GAIN ON SALE OF RELATED ASSET

3.12.170.30 Company K commits to a restructuring to outsource its distribution activities. This will involve closing one of its warehouses and cancelling leases of equipment used in the warehouse. K expects to sell the closed warehouse for a gain that exceeds the cancellation penalties on the equipment leases. The provision for the lease cancellation costs is not reduced by the expected gain from the sale of the warehouse.

Associated costs

3.12.180.10 Provisions are measured based on what an entity would rationally pay to settle or transfer the obligation. IFRS does not provide much guidance on the types of costs to be included in the measurement of a provision. However, the accrual of costs that need to be incurred to operate in the future is prohibited. [IAS 37.18, 36]

3.12.180.20 In our view, anticipated incremental costs that are directly related to the settlement of a provision should be included in the measurement of the provision to the extent that a third party who assumes the liability would require compensation. This is likely to be the case when the incremental costs are probable and can be estimated reliably.

3.12.180.30 Incremental costs are those in addition to normal operating expenses. Therefore, we believe that costs that are not incremental should not be included in the measurement of a provision, even if there is a reasonable basis for allocating a portion of these costs to the settlement of the provision. For example, costs to be incurred irrespective of a specific claim, such as salaries of employees in the claims department, are future operating costs; therefore, we believe that they should be excluded from the measurement of a provision.

3.12.180.40 In our view, the above principle applies to both external and internal costs. However, internal costs are less likely to be incremental and therefore would not normally be included in the measurement of a provision.

EXAMPLE 3G – MEASURING PROVISION – IDENTIFYING DIRECTLY RELATED INCREMENTAL COSTS

3.12.180.50 Company G maintains a risk management department that handles damage claims. The costs of the department are unlikely to be incremental for any one claim and therefore should not be included in the measurement of the provision for expected claims. However, if G engages an external adviser to negotiate the settlement of a specific matter, then this cost is incremental and would normally be included in the measurement of the related provision.

REIMBURSEMENTS

3.12.190.10 Reimbursements (such as insurance recoveries, indemnities, warranties) are recognised as a separate asset when recovery is virtually certain. The amount recognised is limited to the amount of the related provision. [IAS 37.53]

EXAMPLE 4A – REIMBURSEMENT – SETTLEMENT AMOUNT EXCEEDS PROVISION

3.12.190.20 One of Company M's customers has established a claim against M for 300 in respect of a defective product that the customer bought from M. M can recover the cost of the defect and a penalty of 12% from the supplier. The supplier has confirmed that it will pay 336 ($300 + (300 \times 12\%)$) to M as soon as M has paid the customer. M should recognise a provision for the claim of 300.

3.12.190.25 Since the reimbursement is virtually certain, it should be recognised as a separate asset. However, the amount recognised should not exceed the amount of the provision recognised for the claim – i.e. 300. The expense and the reimbursement may be netted in profit or loss; however, the asset and the provision are not netted in the statement of financial position and are presented gross. M discloses the unrecognised reimbursement of 36 in the notes to the financial statements. [IAS 1.34]

3.12.190.30 An obligation and the related recovery are often recognised at the same time. However, if the party that will make the reimbursement cannot be identified, then the reimbursement is generally not virtually certain and cannot be recognised.

3.12.190.40 If the only uncertainty regarding the recovery of an insured loss is the amount of the recovery, then in our view the reimbursement will often qualify to be recognised as an asset.

EXAMPLE 4B – REIMBURSEMENT – SETTLEMENT AMOUNT UNCERTAIN

3.12.190.45 Company Y has recognised a provision for environmental contamination that it is obliged to clean up. Y's insurance company has confirmed that the accident that caused the contamination is an insured event, but has not yet finalised the settlement amount. We believe that Y should recognise its best estimate of the reimbursement, not exceeding the amount of the provision, as a separate asset.

3.12.190.50 In some cases, compensation for lost revenue may be received in non-cash form – e.g. as a non-financial asset. In our view, the difference in nature of the compensation does not result in different accounting outcomes and non-cash compensation should be treated in the same manner as cash compensation – i.e. it should be recognised when the event occurs that gives rise to the claim for compensation and the compensation becomes receivable.

EXAMPLE 4C – REIMBURSEMENT – COMPENSATION RECEIVED IN NON-CASH FORM

3.12.190.55 Company B is a railway operator and it has a delivery contract with Company G, which builds trains. The contract includes a clause for compensation for delivery delays of any committed purchases of railway cars on a fixed date. B agrees to accept spare parts free of charge in lieu of cash compensation if delays in delivery occur. In this scenario, we believe that B should recognise compensation for delays as delays occur and the compensation becomes receivable. The amount of compensation recognised then would become B's cost basis for the spare parts.

3.12.190.60 In certain cases, obligations can be settled by a parent company on behalf of its investee.

EXAMPLE 4D – REIMBURSEMENT – OBLIGATION SETTLED BY PARENT

3.12.190.65 Company G manufactures and sells complex customised equipment and guarantees to reimburse its customers in the case of product malfunction. At the end of 2013, G receives a claim for 100 from one of its customers, but it does not have sufficient funds to settle this claim. G's parent, M, agrees to settle the claim on behalf of G without requiring further reimbursement by G.

3.12.190.70 In our view, the fact that M assumes the obligation without requiring further reimbursement does not exempt G from the requirement to recognise a liability arising from a contractual obligation. Therefore, G should recognise a provision in respect of the customer's claim of 100. When M agrees to settle the claim on behalf of G without requiring further reimbursement and acts in its capacity as shareholder, G should treat this reimbursement as an increase in equity for the shareholder contribution (see 1.2.80).

3.12.190.80 If a seller is contractually obliged to indemnify the acquirer for a specific liability assumed in a business combination, then IFRS 3 requires the acquirer to recognise an asset at the same time, measured using the same measurement basis as the related liability. For further discussion of indemnification assets under IFRS 3, see 2.6.110. [IFRS 3.27]

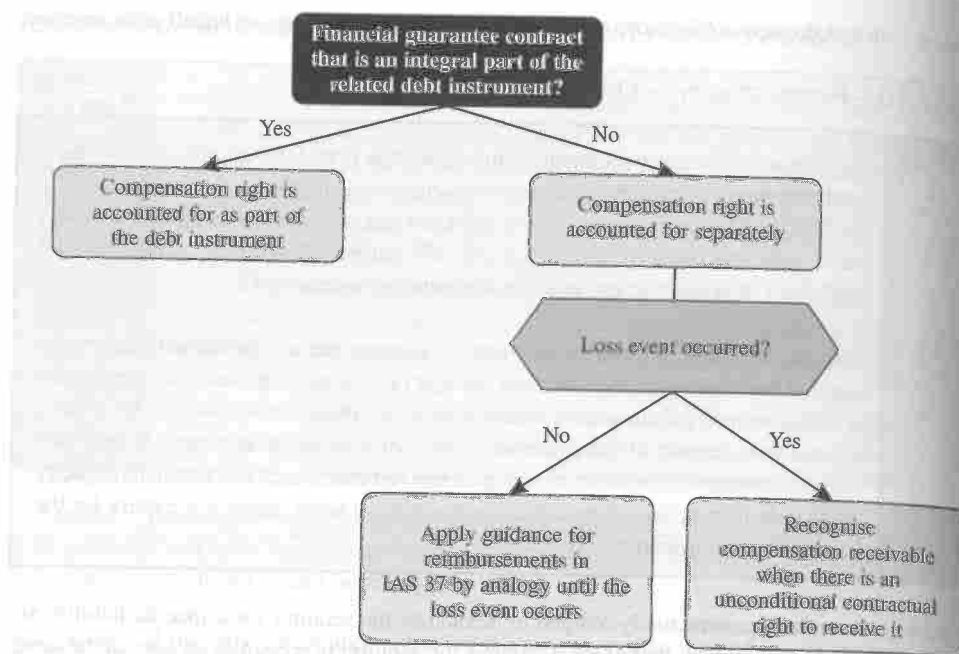
3.12.195 Compensation for impairment of an asset or lost revenue

3.12.195.10 Under insurance contracts, the policyholder is compensated if a specified uncertain future event (an insured event) adversely affects the policyholder (see 8.1.20). An entity may hold an insurance contract under which it is compensated in some circumstances for the impairment of an asset or for lost revenue. The question arises how to account for that compensation right. The first step is to determine which standard to apply or analogue to. IAS 39 specifically excludes insurance contracts held from its scope and IFRS 4 does not address the accounting for insurance contracts by policyholders, other than the holders of reinsurance contracts (see 7.1.40–50 and 8.1.10). In our view, determining which standard to apply or analogue to depends on whether the compensation right is:

- a right under a financial guarantee contract, and if so whether that financial guarantee contract is an integral part of another financial instrument (see 7.1.50); or
- a right under another type of insurance contract – e.g. compensation for impairment of property, plant and equipment or compensation for lost profits. [IFRS 4.2–4, A, IAS 39.2(e)]

3.12.195.15 We believe that compensation that is not related to a provision (e.g. for impairment of an asset, for lost revenue) is not a reimbursement right in the scope of IAS 37.

3.12.195.20 A contract that requires payment in circumstances other than reimbursing the holder for a loss that it incurs, because a specified debtor fails to make payment when it is due in accordance with the original or modified terms of a debt instrument, is not an insurance contract. It is a credit derivative that is accounted for in accordance with IAS 39 (see 7.1.40.30 and 50.10).



3.12.196 Compensation right under a financial guarantee contract that is an integral element of the related debt instrument

3.12.196.10 If the compensation right under an insurance contract is a financial guarantee contract that the holder determines is an integral element of the related debt instrument, then in our view the compensation right should not be accounted for separately from the related debt instrument. The holder should consider the effect of the protection when determining the fair value of the instrument, in estimating the expected cash receipts and when assessing any impairment losses in respect of the debt instrument (see 7.1.80).

3.12.197 Other compensation rights

3.12.197.10 If the compensation right under an insurance contract is either a financial guarantee contract that the holder determines is not an integral element of the related debt instrument or is a right under another type of insurance contract, then in our view the accounting for this compensation right would depend on whether the loss event that creates a right for the entity to assert a claim has occurred at the end of the reporting period.

3.12.198 Other compensation rights when the loss event has occurred

3.12.198.10 IAS 16 provides specific guidance on compensation for the impairment of property, plant and equipment (see 3.2.370). In our view, a consistent approach should be applied to other insurance contracts that compensate the holder for a loss event related to asset impairment or lost revenue/profit. Therefore, if the loss event that creates a right for the entity to assert a claim has occurred, then we believe that the entity recognises a receivable for the compensation when it has an unconditional contractual right to receive the compensation. The compensation receivable should be measured

based on the amount and timing of the expected cash flows discounted at the rate that reflects the credit risk of the insurer. We believe that an entity would have an unconditional contractual right to receive compensation if:

- the entity has an insurance contract under which it can make a claim for compensation; and
- the loss event that creates a right for the entity to assert a claim at the end of the reporting period has occurred and the claim is not disputed by the insurer. [IAS 16.65–66]

EXAMPLE 5A – COMPENSATION – CLAIM FOR LOST PROFITS

3.12.198.20 Company P has an insurance policy that allows it to claim for lost profits in the event of one of its key machines breaking down. Under the terms of the insurance contract, the amount of compensation is 10 for each full day that the machine is out of order. The machine breaks down on 1 October 2013 and P estimates that the machine will be out of order for the next six months. The amount of 10, being compensation receivable, is accrued for each working day that the machine has been out of order, because the loss event that creates a right for P to assert a claim occurs at the end of each working day.

EXAMPLE 5B – COMPENSATION – CLAIM FOR DAMAGE TO ASSET

3.12.198.30 Company Q's building burns down and Q claims compensation for the impaired building under its fire insurance policy that covers this loss. The impairment of the building is recognised when the fire occurs. A receivable for the compensation is recognised when Q has an unconditional contractual right to receive compensation – i.e. when the damage has occurred – assuming that the loss event is not disputed by the insurer (e.g. by asserting arson, which is not covered by the insurance) (see 3.2.370).

3.12.199 Other compensation rights when the loss event has not occurred

3.12.199.05 In our view, a recognised impairment loss for which there is not yet a contractual right to assert a claim is similar in nature to a provision. A provision is a liability that is a present obligation arising from a past event, of uncertain timing or amount; an impairment recognised in advance of the event that allows an entity to assert a claim is an insured loss related to a past event, but there may be uncertainty about the timing or amount of the actual final loss. In some cases (e.g. a fire), there will be no timing gap between recognition of the impairment and the related loss event. In other cases (e.g. financial guarantee contracts), there may be a timing gap between recognition of the impairment and the related loss event (e.g. when the impairment is estimated on a collective basis for a portfolio of contracts, whereas the loss event that creates a right for the entity to assert a claim is specifically identified in the financial guarantee contract as being the delinquency or bankruptcy of a specific debtor).

3.12.199.10 If the loss event that creates a right for the entity to assert a claim at the end of the reporting period has not occurred, but an impairment of an asset has been recognised for accounting purposes, then in our view the compensation right is accounted for by analogy to the guidance for reimbursements in IAS 37 because that is the guidance in IFRS dealing with the most similar issue (see 2.8.10). [IAS 8.11, 37.53]

3.12.199.20 Therefore, we believe that no net gain should be accrued when there is no current right to assert a claim under the insurance contract. During the period between initial recognition of the compensation right and the occurrence of the loss event that creates a right for the entity to assert a claim, the amount of the compensation right recognised should be limited to the difference between the impaired carrying amount of the asset and the amount that the carrying amount of the asset would have been had the impairment not been recognised. [IAS 37.53]

3.12.199.30 In our view, if the impairment loss recognised includes items not covered by the insurance contract, then the asset recognised for the compensation should be limited to the impairment loss covered by the insurance contract. For example, an impairment loss recognised on an available-for-sale financial asset (see 7.6.470) may include not only a credit loss covered by a financial guarantee contract, but also other fair value changes that have occurred. We believe that only the credit portion of the impairment loss covered by the financial guarantee contract should be considered when recognising and measuring the asset for the compensation right.

3.12.199.40 When the loss event that creates a right for the entity to assert a claim occurs, the entity applies the treatment discussed in 3.12.198. This involves recognising the amount of compensation that the entity is entitled to receive as a receivable to the extent that it has an unconditional contractual right to receive compensation. Any difference between the carrying amount of the previously recognised compensation right and the compensation receivable is recognised in profit or loss.

EXAMPLE 5C – COMPENSATION – INSURED LOSS EVENT NOT YET OCCURRED

3.12.199.50 On 1 January 2011, Bank N bought a five-year zero-coupon bond issued by Company B. The following facts are relevant for this example.

- The bond matures on 31 December 2015 and on this date B is due to pay N 100. The bond is classified as a loan and receivable in N's financial statements and its amortised cost-based carrying amount before impairment is 83 as at 31 December 2013.
- In December 2013, B's credit rating declines, reflecting recently disclosed operating losses and liquidity shortfalls.
- On 15 December 2013, N enters into a financial guarantee contract with insurer C, a third party. Under the terms of the financial guarantee contract, C will pay N up to 100 if B has not paid the full 100 to N by 31 January 2016.
- If B pays N less than the 100 owed, then C will pay N the difference between 100 and the amount received from B. If, after any payment from C to N, B subsequently repays any amount to N, then N is required under the terms of the contract to pay this amount to C. Therefore, under the terms of the contract, C will not compensate N for an amount greater than the loss incurred by N related to contractual payments due under the terms of the debt instrument.
- At 31 December 2013, the original effective interest rate on the bond is 10% and the appropriate discount rate for C is 5%, because C has a lower credit risk. As at 31 December 2013, N estimates that, as a result of past events, B will repay only 70 out of the 100.

3.12.199.60 N accounts for the impairment and the related compensation right as follows.

N's 2013 financial statements

- N recognises an impairment loss of 25 on the bond ($83 - (70 \times 0.909 \times 0.909)$). This is based on the revised expected cash flows discounted at the original discount rate of 10% for N. The new amortised cost of the bond is 58.
- N recognises a compensation right of 25. The compensation right is measured based on the expected cash flows of 30 on 1 February 2016, discounted at the appropriate discount rate of 5% for C. The asset, which otherwise would be 27 ($30 \times 0.952 \times 0.952$), is limited to the amount of the recognised impairment loss of 25 – i.e. no net gain is accrued.

N's 2014 financial statements

- N accretes interest at 10% – i.e. the original effective interest rate – on the carrying amount of the bond (58) and recognises 6 of interest, assuming that N's expected cash flows from collection of the bond remain unchanged. N also accretes interest at 5% on the compensation right and remeasures the compensation right to reflect additional recovery rights related to interest on the impaired portion of the bond. This calculation is illustrated below for the year to 31 December 2014.
 - The amortised cost of the bond as at 31 December 2014 is 64, reflecting accretion of interest by N at 10% on the carrying amount of the bond after impairment (58). N reflects 6 of interest income in 2014.
 - N calculates what the amortised cost of the bond would have been if it had not been impaired. This amount is 91 (100×0.909). Therefore, as at 31 December 2014, the amount of the compensation right recognised is limited to 27 ($91 - 64$, or 25×1.1). In the absence of the imposed limit the compensation right would have been 29 (27×1.05).
 - Therefore, N recognises income of 2 ($29 - 27$) related to remeasuring the compensation right. The increase in compensation right of 2 recognised is greater than the accretion of the compensation right of 25 at the 5% rate appropriate for C (26 , or 25×1.05). This is because N is also recognising an increase in the amount recoverable for interest that N would have accreted on the impaired portion of the loan.

3.12.200 Environmental and similar funds

3.12.200.10 Funds may be set up to assist contributors to the fund to meet their decommissioning or rehabilitation obligations. If a contributor does not have control, joint control or significant influence over the fund, then the contributor should recognise the right to receive compensation from the fund as a reimbursement right (see 3.12.190). [IFRIC 5.9]

be attributed over the entire service period but rather split into two distinct periods, with the change accounted for prospectively.

EXAMPLE 9C – DEFINED BENEFIT OBLIGATION – ATTRIBUTION OF BENEFITS FOLLOWING PLAN AMENDMENT

4.4.400.90 A defined benefit plan offers different benefit accrual rates for different groups of participants – e.g. one category accrues a benefit of $\frac{1}{60}$ of the final salary per year whereas the other accrues a benefit of $\frac{1}{50}$. From 1 January 2013, the plan is amended to offer all members benefits at the more advantageous accrual rate of $\frac{1}{50}$ and this change applies prospectively – i.e. only to benefits earned after 1 January 2013. In our view, because the benefits earned in respect of service provided until 31 December 2012 are not affected by the amendment, the benefits should not be attributed over the entire working lives of members but instead should be attributed separately over two distinct periods of service – i.e. one before and one after the amendment.

4.4.410 Actuarial assumptions

4.4.410.10 Actuarial assumptions comprise the following.

- Demographic assumptions, such as:
 - mortality (see 4.4.420.10);
 - rates of employee turnover, disability and early retirement (see 4.4.420.20); and
 - the take-up of any benefit payment options available under the plan (see 4.4.440).
- Financial assumptions, such as:
 - future salary (see 4.4.430.30);
 - benefit levels (excluding any cost of the benefits to be met by employees or third parties) (see 4.4.430–490);
 - certain taxes payable by the plan (see 4.4.500); and
 - the discount rate (see 4.4.510). [IAS 19.76]

4.4.410.20 Actuarial assumptions represent the entity's best estimates of the variables that will determine the ultimate cost of settling the defined benefit obligation. They should be unbiased (neither imprudent nor excessively conservative) and mutually compatible – e.g. the economic relationship between increases in salaries and future inflation-linked pension increases should reflect the same expectations. [IAS 19.76–78]

4.4.410.30 The financial assumptions are based on current market expectations of future events – e.g. medical cost inflation – and are determined in nominal (stated) terms unless real (inflation-adjusted) terms would be more appropriate. [IAS 19.79–80]

4.4.420 Demographic assumptions

4.4.420.10 Mortality assumptions are determined with reference to the entity's current best estimate of the mortality of plan members both during and after employment. Existing mortality tables might therefore need to be adjusted for expected changes in mortality. [IAS 19.81–82, BC142]

4.4.420.20 Although an entity makes estimates of voluntary early retirements, it does not take into account future redundancies or other plan curtailments in determining the defined benefit obligation and the termination or curtailment is recognised (see 4.4.890).

Benefits

4.4.430.10 The calculation takes into account not only the stated plan benefits, but also any constructive obligations. Constructive obligations include those established by informal practices, which the entity has no realistic alternative but to continue, such as 'discretionary' inflationary increases in pensions that would be very difficult for an employer to stop granting. [IAS 19.87]

4.4.430.20 The actuarial assumptions take into account future benefit changes that are set out in the formal terms of a plan. This includes estimated future changes in state benefits that affect benefits payable under the plan and for which there is reliable evidence that the change will happen. [IAS 19.87]

4.4.430.30 The measurement of the defined benefit obligation reflects expected future salaries. Therefore, for average salary plans, the *projected* average salary rather than the current average salary is used in measuring the liability. Similarly, even if the plan benefits are expressed in terms of current salaries, expected future salaries are taken into account. [IAS 19.70, 87(b)]

4.4.430.40 Other future changes that the employer currently has a constructive obligation to make – e.g. inflation increases – are also reflected in the measurement of the obligation. However, future changes to the terms of a plan, as long as the employer does not have a constructive obligation to make these changes, are not anticipated in the measurement of the obligation. Therefore, if, for example, the terms of a plan are changed from covering a select group of employees to covering all employees, then the change is treated as a plan amendment that may give rise to a past service cost (see 4.4.870), or as a new plan, rather than as an actuarial loss. [IAS 19.89]

4.4.440 Optionality included in the plan

4.4.440.10 A plan may give its members the option to receive a lump-sum payment at retirement instead of ongoing payments. An assumption is made about the proportion of plan members who will select each form of settlement option available under the plan terms. Therefore, when the employees are able to choose the form of the benefit – e.g. lump-sum payment vs annual pension – the entity makes an actuarial assumption about what proportion will make each choice. As a result, an actuarial gain or loss will arise if the choice of settlement taken by the employee is not the one that the entity has assumed will be taken. [IAS 19.8, 76(a)(iv), 111]

EXAMPLE 10 – DEFINED BENEFIT OBLIGATION – OPTION TO CHOOSE LUMP-SUM PAYMENT OR ANNUAL PAYMENTS

4.4.440.20 Under the terms of its defined benefit pension plan, Company Z gives its employees the option to receive a lump-sum payment at retirement instead of ongoing payments. Z expects that none of its employees will opt for the lump-sum payment and therefore applies an assumption of zero in measuring its defined benefit obligation. Eventually, however, some employees elect to take that option. These lump-sum payments are not considered to be a settlement because a zero assumption is nevertheless

an assumption made about an issue that Z was required to consider, based on the terms of the arrangement. Therefore, they will result in an actuarial gain or loss.

4.4.450 *Performance targets or other criteria*

4.4.450.10 Certain pension promises may be based on achieving specific performance targets or other criteria. The actuarial assumptions include the best estimate of the effect of these variables on the cost of meeting the benefit promise – i.e. on the measurement of the defined benefit obligation. For example, the terms of a plan may state that it will pay reduced benefits or require additional contributions from employees if the plan assets are insufficient. Such criteria are reflected in the measurement of the defined benefit obligation, regardless of whether the changes in benefits resulting from the criteria either being or not being met are automatic or are subject to a decision by the entity, by the employee or by a third party such as the trustee or administrators of the plan. [IAS 19.88(c), BC150(c)]

4.4.460 *Risk-sharing arrangements*

4.4.460.10 The measurement of the defined benefit obligation takes into consideration risk-sharing features and contributions from employees or third parties that are not reimbursement rights.

4.4.470 *Sharing a surplus*

4.4.470.10 The terms of a plan may include specific surplus-sharing provisions or the terms of allocation may be defined in a separate agreement between the employer and the employees. For example, the terms of a plan may provide that if the plan has a surplus, then 30 percent of the surplus is allocated to employees and the remainder to the employer (see 4.4.700). The portion of the surplus allocated to the participants in the defined benefit plan is reflected in the actuarial assumptions about future benefit changes, because it is reflected in the formal terms of the plan. [IAS 19.88(b)]

4.4.480 *Limit on employer contributions*

4.4.480.10 Any limits to the contributions that an entity is required to make are included in the calculation of the ultimate cost of the benefit. The effect is determined over the shorter of the expected life of the entity and the expected life of the plan. [IAS 19.91]

4.4.490 *Employee and third party contributions**

4.4.490.10 Some defined benefit plans require employees or third parties to contribute to the cost of the plan. IAS 19 distinguishes between discretionary contributions and contributions that are set out in the formal terms of the plan, and provides guidance on accounting for both.

- Discretionary contributions by employees or third parties reduce service cost on payment of the contributions to the plan – i.e. the increase in plan assets is recognised as a reduction of service costs.
- Contributions that are set out in the formal terms of the plan either:
 - reduce service cost, if they are linked to service, by being attributed to periods of service or a negative benefit – i.e. the net benefit is attributed to periods of service; or
 - reduce remeasurements of the net defined liability (asset), if the contributions are required to reduce a deficit arising from losses on plan assets or actuarial losses (see 4.4.960). [IAS 19.87, 92–94]

Taxes payable by the plan

4.4.970 IAS 19 distinguishes between taxes payable by the plan on contributions relating to service before the end of the reporting period or on benefits resulting from that service, and all other taxes payable by the plan. An actuarial assumption is made about the first type of taxes, which are taken into account in measuring current service cost and the defined benefit obligation, because they are seen as part of the cost of providing the benefits. All other taxes payable by the plan are included in the return on plan assets and therefore form part of remeasurements (see 4.4.970). [IAS 19.8, 76(b)(iv)]

EXAMPLE 11 – DEFINED BENEFIT OBLIGATION – TAXES ON CONTRIBUTIONS RELATING TO SERVICE BEFORE THE END OF REPORTING PERIOD

4.4.500.20 Company Z has a defined benefit pension plan. The plan is required to pay a 10% tax on all contributions it receives – a ‘contributions tax’. Without considering the impact of investment earnings that might also fund the future benefits, the plan must receive contributions of 100 to retain sufficient post-tax plan assets to pay a benefit of 90, effectively increasing Z’s cost of the benefit. This type of tax is included in determining the defined benefit obligation at the end of each reporting period. Changes in the expected timing or amount of contributions tax payable will lead to actuarial gains and losses, which are recognised in OCI.

- 4.4.500.30 Estimating the amount of contributions tax payable to be included in the calculation of the defined benefit obligation involves making various assumptions, including the following:
- the expected timing of contributions tax payments, which might occur periodically over the employment period; and
 - the level of plan assets already held by the plan, because they limit the need for additional contributions and the related taxes.

4.4.510 *Discount rate*

4.4.510.10 The obligation for estimated future payments is measured on a discounted basis. The obligation is discounted using a high-quality corporate bond rate (see 4.4.520) or a government bond rate if there is an insufficiently deep high-quality corporate bond market (see 4.4.530). The currency and maturity of the bonds need to be consistent with the currency and maturity of the defined benefit obligation. [IAS 19.83]

4.4.520 *High-quality corporate bonds**

4.4.520.10 In our view, ‘high-quality’ should be interpreted as at least an AA (Standard & Poor’s rating) or Aa2 (Moody’s rating) bond, or equivalent from other ratings agencies.

4.4.520.20 We believe that consideration should be given to adjustments for downgrades subsequent to the end of the reporting period. In some cases, bonds that are included in data underlying a yield curve or bond-matching model (see 4.4.540.10) may be downgraded by a credit rating agency subsequent to the end of the reporting period so that the bonds no longer meet the criteria to be considered high-quality. In other cases, the market index may include corporate bonds that are no longer high-

quality. In either of these cases, the facts and circumstances should be evaluated to determine if there is an adjusting event or a non-adjusting event after the end of the reporting period (see 2.9.20–30).

4.4.520.30 In our view, the incremental borrowing rate of an entity is not an appropriate rate to use because it reflects the credit quality of the entity. [IAS 19.84, BC134]

4.4.530 *Deep market*

4.4.530.10 In our view, an entity in a country without a sufficiently deep high-quality corporate bond market cannot construct a synthetic equivalent using a bond market in another country's currency and notional or actual currency swaps. We believe that the hierarchy specified in the standard which requires a default to the government bond rate, means that the government bond rate should be used. IAS 19, however, is not specific about what level of government should be used to determine the appropriate government bond rate. [IU 06-05]

4.4.530.20 In our view, if an entity operates in a country in which a sufficiently deep high-quality corporate bond market does not exist locally, then the entity may be able to determine a discount rate with reference to high-quality corporate bond yields in other countries sharing the same currency. [IU 06-05]

4.4.530.30 If bonds with a maturity that matches the maturity of the defined benefit obligation are not available, then an appropriate discount rate is estimated by extrapolating interest rates on shorter-term bonds using the yield curve and considering any available evidence about likely longer-term interest rates. [IAS 19.86]

4.4.540 *Determining a discount rate in changing market conditions*

4.4.540.10 Approaches to determining an IAS 19 discount rate may vary from entity to entity. In our experience, the prevalent methods are a yield curve approach, a bond-matching model or a market index approach under which an entity selects a representative discount rate from a published index representing high-quality corporate bonds (see 4.4.520).

4.4.540.20 In our experience, entities generally determine discount rates for defined benefit plans using methodologies and data sources that are consistent from period to period. It may be appropriate, in certain circumstances, to consider the appropriateness of previously used methodologies, especially in response to any significant changes in market conditions. In our view, a change in the method used to select a discount rate may be appropriate when that change results in a more reliable estimate. We believe that this would be a change in an accounting estimate as opposed to a change in accounting policy in accordance with IAS 8. If an entity changes its approach to determining a discount rate, then it provides disclosures under IAS 8. In such cases, an entity discloses the nature and amount of a change in an accounting estimate that affects the current period or is expected to have an impact on future periods. [IAS 8.39]

4.4.540.30 In our view, any adjustments and changes to the previously used methodologies require assessment. We believe that it may be appropriate for an entity to exclude certain bonds from those to be included in a yield curve, a bond-matching model or a market index to more reliably reflect changing market conditions – e.g. by excluding 'outlier' bonds from an index. Such adjustments should be made on an objective and rational basis. For example, some entities express this in terms of the number of standard deviations of a bond's yield compared with the median or mean.

4.4.540.40 We believe, however, that certain approaches would not be appropriate – e.g. weighting the yields on outlier bonds differently from those on bonds deemed to be more representative of the overall market, because such weighting would be arbitrary and, accordingly, would not be consistent with the measurement requirements of IAS 19. Similarly, eliminating bonds issued by financial institutions solely on the basis that they are issued by financial institutions may be difficult to support because these bonds are an integral part of the market; however, if the elimination of bonds issued by such entities is a consequence of the use of a systematic and rational method of eliminating outliers, then this might be acceptable. Additionally, we believe that averaging observed bond yields for some period of time – e.g. a period before and after the end of the reporting period – would be inconsistent with the requirement to determine an appropriate discount rate with reference to market yields at the end of the reporting period. [IAS 19.83]

PLAN ASSETS

Criteria for qualifying as plan assets

4.4.560.10 'Plan assets' comprise:

- assets held by a legally separate fund that exists solely to pay or fund employee benefits, which:
 - can be used only to pay or fund employee benefits;
 - are not available to the entity's creditors (even in the case of bankruptcy) (see 4.4.570); and
 - cannot be returned to the entity except as reimbursement for employee benefits paid (see 4.4.580) or if the fund is in surplus (see 4.4.840); and
- qualifying insurance policies (see 4.4.660). [IAS 19.8]

4.4.560.20 In our view, if an entity controls the voting rights of shares contributed to and held by the fund, then this does not preclude the shares from qualifying as plan assets; however, the entity would take into account the lack of voting rights when determining the fair value of the shares (see 4.4.620).

4.4.560.30 Although there is no explicit requirement in IFRS about the nature of plan assets that can be held, there may be such requirements in local pension regulations, which may have to be considered.

Restriction on availability

4.4.570.10 In our view, the restriction on the availability of the assets to creditors of the entity applies both to claims arising from liquidation or similar court proceedings and from normal operations.

4.4.570.20 In our view, the protection from claims of other parties to the assets should not be capable of being overridden by other contracts (e.g. mortgages) or legislation and the assets should be prevented legally from being made available to the entity or its creditors under any circumstances, other than for permitted purposes (see 4.4.560).

Reimbursement for benefits paid

4.4.580.10 The definition of plan assets refers to the return of plan assets to the reporting entity for benefits that have already been paid. Therefore, in our view the definition of plan assets is not met if an entity has the ability to receive reimbursement in advance, before the reimbursable benefit payments are made. It is possible that a reimbursement right asset might arise in those circumstances (see 4.4.640). [IAS 19.8, 116–119]

4.5.960.30 In another example, an award of options is granted with a non-market performance condition and a service condition, but the vesting period automatically accelerates if the non-market performance condition is met during the period of required service. The award vests at the end of the service period regardless of whether the non-market performance condition is met. In addition, the options are exercisable at the same fixed date. Such an award contains two vesting alternatives.

- **Vesting alternative 1:** The period from the grant date until the date that the service condition is met. This would occur if the non-market performance condition is not met before the service condition is met.
- **Vesting alternative 2:** The period from the grant date until the date that the non-market performance condition is met before the date that the service period is completed. This is because vesting is automatically accelerated if the non-market performance condition is satisfied before the service condition.

4.5.960.40 In our view, when accounting for such a share-based payment award, an entity should determine which vesting alternative to account for based on its assessment of which vesting alternative is the most likely outcome. This is because under IFRS 2 an entity generally accounts for the most likely outcome (see 4.5.960.10). In the example in 4.5.960.30, if an entity's initial assessment was that the most likely outcome was that the non-market performance condition would be met before the end of the service period, then it would estimate the expected vesting date for vesting alternative 2. As long as the entity believes that the non-market performance condition will be met before the service condition, then it should base its accounting on its best estimate of the expected vesting period. If subsequent information indicates that the length of vesting alternative 2 differs from the previous estimate, then the length of the vesting period is revised and the entity adjusts the recognised share-based payment cost on a cumulative basis in the period in which the estimate is revised.

4.5.960.50 If an entity's assessment of the most likely outcome changes, then we believe that the accounting should switch to the alternative vesting period (see 4.5.1160.20). The share-based payment cost recognised in the period of the change in estimate would adjust the cumulative cost recognised to the amount that would have been recognised if the new estimate had always been used.

4.5.970 Determination of the type of equity instruments granted

4.5.980 Employee share purchase plans

4.5.980.10 In an ESPP the employees are usually entitled to buy shares at a discounted price. The terms and conditions can vary significantly and some ESPPs include option features. [IFRS 2.1617]

4.5.980.20 In our view, the predominant feature of the share-based payment arrangement determines the accounting for the entire fair value of the grant. That is, depending on the predominant features, a share purchase plan is either a true ESPP or an option plan. All terms and conditions of the arrangement should be considered when determining the type of equity instruments granted and judgement is required.

4.5.980.30 Options are characterised by the *right*, but not the *obligation*, to buy a share at a fixed price. An option has a value (i.e. the option premium) since the option holder has the benefit of any future gains and has none of the risks of loss beyond any option premium paid. The value of an option is determined in part by its duration and by the expected volatility of the share price during the

term of the option. In our view, the principal characteristic of an ESPP is the right to buy shares at a discount to current market prices. ESPPs that grant short-term fixed purchase prices do not have significant option characteristics since they do not allow the grant holder to benefit from volatility. We believe that ESPPs that provide a longer-term option to buy shares at a fixed price are, in substance, option plans, and should be accounted for as such. [IFRS 2.B4-B41]

EXAMPLE 19 – SHARE OPTION PLAN VS ESPP

4.5.980.40 Employees are entitled to buy shares at a fixed price from the date of communication of the plan until two years later. Whether the predominant feature in this agreement is the option feature requires judgement based on all of the terms and conditions of the plan. In the absence of other indicators, we believe that this effectively is an option and should be accounted for as an option plan and not as an ESPP.

4.5.980.50 Whether a plan is a true ESPP or an option plan affects the determination of the grant date, the number of instruments to account for and the measurement of the grant-date fair value. For example, on 1 January 2013 Company T grants the right to buy shares at a 20 percent discount to its share price. This grant is made to 1,000 of its employees; 700 employees buy shares. If the substance of the offer is an ESPP, then grant date is the date when the employees accept the offer (e.g. February 2013) and recognition is based on the 700 employees accepting the offer. However, if, in an alternative scenario, the substance of the offer is an option grant, then grant date is not dependent on the explicit acceptance by the employees and is therefore already achieved on 1 January 2013. Recognition is based on the 'option' instruments granted to the 1,000 employees assuming that the award vests and not on the 700 employees that exercise their options (e.g. at the end of a two-year vesting period).

4.5.990 Share purchases funded through loans

4.5.990.10 Share purchase arrangements can be structured in many different ways and all terms and conditions should be analysed when determining the type of equity instruments granted. Consider the following example of a share-based payment arrangement that is structured as a share purchase arrangement.

- The employees received a right to and did buy shares immediately.
- At the same time, the employees received a loan for the amount of the exercise price. The loan accrues interest at a market rate.
- The employees receive a right to settle the loan in full by tendering the shares bought, either directly or via a right to put the shares back at original purchase price plus market interest.

4.5.990.20 In the example in 4.5.990.10, the put option feature on the shares removes any risk for the employee for share price decreases while all rewards above the market rate of interest are retained. In our view, this plan is, in substance, an option and the transaction should be accounted for as such. In general, we believe that it is difficult to support recognition of shares and the loan as outstanding when the shares were paid for by a loan from the issuer to the buyer. If the substance of a share purchase arrangement is an option, then neither the shares nor the loan are outstanding until the options are exercised by paying the exercise price for the shares or the put option expires. Ac-

cordingly, until exercise of the options, the shares issued to employees are treated as treasury shares and no loan receivable from the employees is recognised until this time.

4.5.1000 Determining the assets to which the entity has recourse for loan repayment

4.5.1000.10 In assessing whether shares paid for by a loan from the issuer are in substance a grant of options, an entity should consider whether it has full recourse to the employees in respect of the balance of the loan. For example, if the share price falls below the outstanding balance of the loan, then does the entity have recourse to the personal assets of the employee, and will it pursue collection of the full loan balance?

4.5.1000.20 In our view, it is appropriate to account for the transaction as the issue of shares and a loan receivable only when it can be clearly demonstrated that the entity has and will pursue full recourse to the employees in respect of the loan. [IU 11-05]

4.5.1000.30 Whether the entity has full recourse to the employees in respect of the loan should be assessed based on all of the terms and conditions of the arrangement. We believe that for the loan to be considered full recourse, it should be documented as a full recourse loan and there should be no evidence that would indicate otherwise – e.g. a past history of the entity waiving all or a portion of similar loans. The following are examples of indicators that may support the conclusion that a loan is full recourse.

- The loan is reported by the entity to a credit agency in the same manner as commercial loans.
- The entity requests financial information from the employee to assess their ability to repay the loan.
- The entity has an ongoing process for monitoring the collectibility of the loan.
- If applicable, the entity has a past history of collection in full of other employee loans (e.g. housing loans).

EXAMPLE 20 – ENTITY HAS RECOURSE TO ALL ASSETS OF EMPLOYEE

4.5.1000.40 Company C issues shares to its employees at the market price on the date of issue and the purchases are funded through a loan provided by the entity to its employees. C has recourse to all of the employees' assets, not just the shares bought with the loan. If C achieves a two-year cumulative EPS growth target of 15%, then 25% of the loan balance will be waived – i.e. the share purchase price will be reduced retrospectively by 25%. C has the intent and ability to pursue full collection of the outstanding loan balance and a past practice of collecting loans from employees.

4.5.1000.50 In Example 20, we believe that the arrangement is an issue of shares and a loan (e.g. the loan is full recourse and therefore the arrangement is not in substance an option grant but rather should be treated as a share purchase). The employee may earn a discount to the share price subject to the achievement of a non-market performance condition. This is because the employee receives a waiver of 25 percent of the share price if a cumulative EPS target is met. In our view, the potential retrospective adjustment to the share purchase price is a share-based payment and not an employee benefit under IAS 19. This is consistent with the example in IFRS 2 of a reduction in the exercise price of an option

as a result of achieving a non-market performance condition – i.e. the shares ultimately can be bought by the employees at a discount from the purchase price specified originally. [IFRS 2.IG.Ex4]

4.5.1000.60 We believe that because the employee receives equity instruments (i.e. shares that may be bought at a discount) and does not receive a payment based on the price (or value) of the entity's shares or other equity instruments, the share-based payment in Example 20 should be classified as equity-settled (see 4.5.460.10).

4.5.1000.70 In our view, since the structure in Example 20 is viewed as a share purchase, the loan receivable should be accounted for separately from the share-based payment and should be recognised and measured in accordance with the financial instruments standards. Under those standards, the initial and subsequent measurement of the loan should reflect the likelihood of the employee receiving a discount as a result of the achievement of the non-market performance condition (see 7.6.60 and 4.4.1290).

4.5.1000.80 If the loan issued to the employee does not bear interest at a market rate, then in our view the low-interest loan is a benefit conveyed to the employees that could be accounted for in accordance with IFRS 2. In some cases, such a loan is available only for financing share purchases, which suggests that the loan is an integral part of the share-based payment arrangement and should be accounted for under IFRS 2. However, it might also be appropriate to account for the discount as an employee benefit (see 4.4.1290) separately from the share-based payment, particularly if similar loans are available for other purposes.

4.5.1000.90 In other arrangements, a share purchase by employees may be funded only partially through a loan from the entity – e.g. the entity issues a loan to employees for 70 percent of the market price of its shares and the employee is required to pay in cash the remaining 30 percent of the purchase price. The entity has recourse only to the shares and the employees receive a right to settle the loan by tendering the shares bought, either directly or via a right to put the shares back to the entity. If the market price of the shares is less than the amount of the loan when the shares are to be tendered to the entity, then the entity receives the shares at settlement of the loan in full – i.e. the entity accepts the risk that its share price will decrease by greater than 30 percent. If the cash payment by the employee represents substantially all of the reasonably possible losses – based on the expected volatility of the shares – then in our view the fact that the loan has recourse only to the shares does not preclude accounting for the transaction as the issuance of shares and a loan. This is because, subsequent to the date of issuance, the employee is not only able to benefit from increases in the entity's share price, but is also at risk for substantially all of the reasonably possible decreases in the share price.

4.5.1010 Accounting for interest and dividends in a grant of share options

4.5.1010.10 As a consequence of treating a share purchase funded through a non-full-recourse loan as an option, an issue arises over how to account for the share purchase, the loan issued, any interest on the loan and any dividends on the shares.

4.5.1010.20 In our view, the share purchase, loan issue, interest and dividends should be accounted for in accordance with the substance of the arrangement. If the share purchase funded through a non-full-recourse loan is in substance a share option, then we believe that neither the loan nor the shares

should be recognised as outstanding and the repayment of the loan by the employee should be treated as the payment of the exercise price.

4.5.1010.30 Consequently, we believe that interest is not accrued over the vesting period but recognised only as part of the exercise price when it is received. Interest therefore decreases the grant-date fair value of the option due to an increased exercise price. The right to receive dividends should also be taken into account in estimating the grant-date fair value of the option (see 4.5.1080.10) – i.e. the entitlement increases the grant-date fair value compared with an option without dividend entitlement. [IFRS 2.B31]

4.5.1010.40 However, we believe that forfeitable dividends declared but not paid out before exercise of the option should be recognised only when the loan amount, reduced for the dividends, becomes a recognised receivable on exercise. This is because the obligation to pay the dividends only reduces the unrecognised receivable due from the employee rather than being a liability in its own right; this treatment is different from dividends declared on unvested shares (see 4.5.1100.20). In our view, the entity should choose an accounting policy, to be applied consistently, of either recognising the dividends by netting the amount with the proceeds from the exercise price or recognising a separate distribution in equity.

4.5.1020 *Free shares*

4.5.1020.10 In some share-based payment arrangements, employees are entitled to shares for no cash consideration; however, the grant is conditional on the fulfilment of specified vesting conditions. If the holders of such shares have the same rights as holders of shares not subject to a vesting condition, then the value of the shares granted is equal to the value of vested shares. However, if the holders of such shares are not entitled to dividends during the vesting period, then an adjustment is required for the expected future dividends that will not be received by employees.

4.5.1030 *Measurement*

4.5.1040 *Determining the fair value of equity instruments granted*

4.5.1040.10 Share-based payment transactions with employees are measured with reference to the fair value of the equity instruments granted. [IFRS 2.11]

4.5.1040.20 The fair value of the equity instruments granted is determined as follows.

- If market prices are available for the equity instruments granted, then the estimate of fair value is based on these market prices.
- If market prices are not available for the equity instruments granted, then the fair value of equity instruments granted is estimated using a valuation technique. [IFRS 2.16–17]

4.5.1050 *No track record of market price*

4.5.1050.10 In many situations, a market price for equity instruments (e.g. share options) will not exist because equity instruments issued to employees often have terms and conditions (e.g. vesting conditions) different from those of instruments traded in the market; therefore, a valuation technique is used. A valuation technique requires estimation of a number of variables, including the expected future volatility of the entity. In our view, if no equity instruments of the entity are traded, then an implied volatility should be calculated – e.g. based on actual experience of similar entities that have

traded equity instruments. We believe that an entity, even one without a historical track record (e.g. a newly listed entity), should not estimate its expected volatility at zero. In rare cases, an entity may be unable to estimate, at grant date, expected volatility and therefore the fair value of the equity instruments cannot be measured. In such rare cases, the use of the intrinsic value may be required (see 4.5.800). [IFRS 2.B4, B26–B30]

4.5.1060 *Non-vesting conditions that the employee can choose to meet*

4.5.1060.10 Common examples of non-vesting conditions that the employee can choose to meet are certain non-compete agreements, transfer restrictions after vesting, savings conditions or a requirement to hold shares. Post-vesting restrictions are included in the grant-date measurement of fair value to the extent that the restriction affects the price that a knowledgeable, willing market participant would pay for that share. [IFRS 2.B3, IG.Ex9A, IU 11-06]

EXAMPLE 21 – SHARE-BASED PAYMENT WITH POST-VESTING RESTRICTION

4.5.1060.20 Company Z grants shares to employees conditional on one year of service. After the service period, the employees are entitled unconditionally to the shares. However, under the arrangement, they are not allowed to sell the shares for a further five-year period. The five-year restriction on the sale of the shares is a post-vesting restriction, which is a non-vesting condition (see 4.5.690.10), and is taken into account in the grant-date fair value measurement.

4.5.1060.30 In our view, it is not appropriate to determine the fair value of equity instruments issued only to employees and subject to post-vesting restrictions, based on an approach that looks solely or primarily to an actual or synthetic market consisting only of transactions between an entity and its employees and in which prices, for example, reflect an employee's personal borrowing rate. This is because the objective of IFRS 2 is to estimate the fair value of an equity instrument and not the value from the employee's perspective. We believe that factors that affect only the employee's specific perspective of the value of the equity instruments are not relevant to estimating the price that would be set by a knowledgeable, willing market participant. Therefore, hypothetical transactions with actual or potential market participants willing to invest in restricted shares should be considered. [IFRS 2.B3, B10, BC168, IU 11-06]

4.5.1070 *Dividends*

4.5.1070.10 The treatment of expected dividends in measuring the fair value of the equity instruments depends on whether the employee is entitled to dividends. [IFRS 2.B31]

4.5.1070.20 If the employees are not entitled to dividends declared during the vesting period, then the fair value of these equity instruments is reduced by the present value of dividends expected to be paid compared with the fair value of equity instruments that are entitled to dividends. [IFRS 2.B34]

4.5.1070.30 If the employees are entitled to dividends declared during the vesting period, then in our view the accounting treatment depends on whether the dividends are forfeitable – i.e. whether dividends have to be paid back if vesting conditions are not met. [IFRS 2.B32]

EXAMPLE 6 – CALCULATION OF WEIGHTED-AVERAGE NUMBER OF SHARES OUTSTANDING

DATE	TRANSACTION	SHARES ISSUED	TREASURY SHARES (SEE 5.3.70)	SHARES OUTSTANDING
1 January 2013	Balance at beginning of year	1,500	(250)	1,250
31 March 2013	Purchase of treasury shares for cash	-	(250)	1,000
30 June 2013	Issue of new shares to settle a liability	1,000	-	2,000
31 December 2013	Balance at end of year	2,500	(500)	2,000


Note
The weighted average number of ordinary shares outstanding for 2013 is calculated as:
 • 1,562.5 shares – i.e. $(1,250 \times 3/12) + (1,000 \times 3/12) + (2,000 \times 6/12)$; or
 • 1,562.5 shares – i.e. $((1,250 \times 12/12) + (250 \times 9/12) + (1,000 \times 6/12))$

5.3.60.30 Shares are usually considered outstanding for purposes of determining the weighted-average number of ordinary shares outstanding from the date the corresponding consideration is receivable. For example, ordinary shares issued:

- for cash are included when the cash is receivable;
- for an asset other than cash are included from the time the asset is recognised;
- to settle a liability are included from the settlement date;
- on conversion of a debt instrument are included from the date that interest ceases to accrue;
- in lieu of interest or principal on other financial instruments are included from the date that interest ceases to accrue;
- on the voluntary re-investment of dividends are included from the date the dividends are re-invested;
- as compensation for services received are included as the services are rendered;
- as consideration in a business combination are included from the acquisition date; and
- on mandatory conversion of a convertible instrument are included from the date that the contract is entered into. [IAS 33.21–23]

5.3.60.35 The timing of the inclusion of ordinary shares is determined by the terms and conditions attaching to their issue after taking due consideration of the substance of any contract associated with their issue. [IAS 33.21]

EXAMPLE 7 – POTENTIAL ORDINARY SHARES – OPTIONS VESTED BUT UNEXERCISED

	<p>5.3.60.40 A company with a 31 December year end has share options outstanding with its employees. The options were issued three years ago with an exercise price equal to the market price of the company's shares at that time (i.e. the options represent potential ordinary shares). All vesting conditions were satisfied during the</p>
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year; however, the employees have not yet exercised their options. Although all vesting conditions were met during the year, the options are still potential ordinary shares outstanding (see 5.3.120.10) at the year end and therefore the shares are not considered outstanding for the purposes of basic EPS.

Treasury shares

5.3.70 Treasury shares are not treated as outstanding ordinary shares and are therefore deducted from number of shares outstanding. In consolidated financial statements, treasury shares include own shares that are held by a consolidated subsidiary (see 7.3.460). [IAS 33.IE2]

5.3.70.12 Similar considerations apply to own shares held by an entity's employee benefit plan. Assets held by employee benefit plans may include an entity's own shares (see 4.4.630) and, if consolidated, the entity's own shares are regarded as treasury shares.

5.3.70.15 IFRS 10 excludes from its scope post-employment benefit plans or other long-term employment benefit plans to which IAS 19 applies (see 4.4.320 and 4.5.2080.10). Therefore, if an entity's own shares are qualifying plan assets held by an employee benefit plan and are netted against the employee benefit obligation in accordance with IAS 19, then these shares are not treasury shares. Accordingly, in our view these shares would be considered outstanding for the calculation of EPS. However, if shares held by the plan do not meet the definition of plan assets, then they are presented as treasury shares, even though the plan is not consolidated by the employer (see 4.4.630); therefore, in our view they would not be considered as outstanding for the purposes of calculating EPS.

5.3.70.20 Because the net presentation requirement for employee benefit plans under IAS 19 does not apply to equity-settled share-based payment plans, the consolidation requirements apply to a vehicle established in connection with equity-settled share-based payment plans. When such a vehicle is required to be consolidated, shares of a reporting entity held by that vehicle would be treasury shares and not outstanding shares for the basic EPS calculation. [IAS 32.4(f), 33–34]

Contingently issuable ordinary shares

5.3.80 Contingently issuable ordinary shares are ordinary shares that are issuable for little or no cash or other consideration on the satisfaction of specified conditions in a contingent share agreement. Such contingently issuable ordinary shares are included in the calculation of the weighted-average number of shares outstanding for purposes of calculating basic EPS from the date that the conditions are met and not from any later date of actually being issued. [IAS 33.5, 24]

5.3.80.20 Shares that are issuable solely after the passage of time are not considered contingently issuable because the passage of time is a certainty. Instead, they are treated as outstanding for purposes of calculating basic EPS only from the date that the right to the shares comes into existence. [IAS 33.24]

5.3.80.30 Unvested shares and unvested employee share options that require only service for vesting cannot be contingently issuable shares. This is because their vesting is contingent only on the passage of time (see 5.3.85).

5.3.80.40 In contrast, unvested shares and unvested employee share options that do not only require service as a vesting condition, but instead include performance conditions or market conditions, are treated as contingently issuable shares and options if they are issuable for little or no cash or other consideration.

5.3.90 *Unvested shares and unvested employee share options*

5.3.90.10 Some unvested shares that require service as a vesting condition are not entitled to dividends during the vesting period. These unvested shares are included only in calculating diluted EPS (see 5.3.170 and 220). These shares are included in the calculation of basic EPS as the services are rendered and the vesting condition is met. As illustrated in Example 8, this averaging approach differs from the approach that is required when recognising share-based payment cost. [IAS 33.21(g), 24, 48]

EXAMPLE 8 – CONTRAST OF DENOMINATOR ADJUSTMENT FOR EPS AND GRADED-VESTING APPROACH FOR A SHARE-BASED PAYMENT



5.3.90.20 A share-based payment arrangement consists of 15,000 unvested shares granted to employees; the award vests ratably in three tranches of 5,000 after each year of service. We believe that, for the basic EPS computation for year 2 of the three-year service period, the weighted-average shares outstanding would include 5,000 shares being the first tranche that vested at the end of year 1 (the second tranche of 5,000 only vested on the last day of year 2; therefore, it carries a weighting of $(0/365)$ in year 2). This averaging approach differs from the graded vesting approach that is required when recognising share-based payment cost (see 4.5.920).

5.3.90.23 Conversely, if the entire award vests only on completion of three years' employment (i.e. no shares would be awarded if employment terminates before the end of the vesting period), then no shares would be included in the basic EPS computation until the end of the three-year service period.

5.3.90.25 However, if the unvested shares are entitled to non-forfeitable dividends during the vesting period, then in our view when calculating basic EPS, the numerator should be adjusted for these dividends and any undistributed earnings attributed to these unvested shares, in accordance with their participating rights, if any (see 5.3.50.40).

5.3.90.30 Unvested employee share options are excluded from the calculation of basic EPS. They are considered potential ordinary shares (see 5.3.190 and 220.10). Generally, such share options are included in the calculation of basic EPS once the option has been exercised. However, if shares are issuable for little or no other consideration on the exercise of the share options, then in our view an entity should bring the share options into the calculation of basic EPS from an earlier date, when the vesting conditions have been met. This is because a vested share option with little or zero exercise price is in substance similar to a vested ordinary share, and the entity will receive no further substantive consideration when the option is exercised. [IAS 33.21(g), 24, 48]

Partly paid shares

5.3.100.10 When ordinary shares are not fully paid, they are treated as a fraction of ordinary shares for the purposes of basic EPS. The fraction is calculated as the degree to which they are entitled to participate in dividends during the period relative to the dividend participation rights of a fully paid ordinary share. To the extent that partly paid shares are not entitled to participate in dividends during the period, such partly paid shares are treated as options or warrants (see 5.3.180). [IAS 33.A15]

Ordinary shares subject to recall

5.3.110.10 When ordinary shares are subject to recall, they are not considered as outstanding and are excluded from the calculation of basic EPS until the date that they are no longer subject to recall. [IAS 33.24]

5.3.110.15 However, for the purposes of calculating basic EPS, an adjustment to the numerator may be required for any dividends and undistributed earnings attributable to these shares (see 5.3.50.40). [IAS 33.10, 24, A13–A14]

5.3.110.20 In our view, shares that are subject to repurchase due to a written put option or a forward purchase contract should be excluded from the basic EPS calculation, similar to shares subject to recall (see 5.3.100.10). An adjustment to the numerator may be required for any dividends and undistributed earnings attributable to these shares (see 5.3.50.40). However, the calculation of diluted EPS may require adjustment for the written put or forward (see 5.3.170.110).

DILUTED EARNINGS PER SHARE

5.3.120.10 To calculate diluted EPS, an entity adjusts the profit or loss attributable to ordinary equity holders of the parent entity (numerator) and the weighted-average number of shares outstanding (denominator) used in the basic EPS calculation for the effects of all dilutive potential ordinary shares. Potential ordinary shares are financial instruments or other contracts that may entitle their holders to ordinary shares. Examples include:

- convertible debt or convertible preference shares (except for mandatorily convertible debt);
- share warrants or options; and
- shares that would be issued on satisfaction of certain conditions resulting from contractual arrangements, such as the purchase of a business that occurs before the end of the reporting period.

[IAS 33.30–31]

5.3.120.20 Potential ordinary shares that were cancelled, have lapsed or have been converted to ordinary shares during the reporting period are reflected in the diluted EPS calculation, if they are dilutive, from the first day of the reporting period (if they were in existence at that date) to the day that they lapse or are converted or cancelled. Potential ordinary shares issued during the reporting period are included in the diluted EPS calculation, if they are dilutive, from the day that they are issued. [IAS 33.36, 38]

5.3.120.30 The effects of potential ordinary shares are reflected in diluted EPS only when their inclusion in the calculation would decrease EPS, or increase the loss per share (i.e. would be dilutive), from continuing operations. [IAS 33.41]

5.11.160.20 E&E assets are treated as a separate class of assets for disclosure purposes. IFRS generally defines a 'class of assets' as a grouping of items that have a similar nature and use in an entity's operations. A policy of revaluation is applied to all assets in a class (see 3.2.300). [IFRS 6.21]

5.11.160.30 In our view, tangible and intangible E&E assets are two separate classes of assets. We believe that generally all tangible assets used for E&E will form a separate class and that a policy of cost or revaluation should be applied consistently to all assets in that class. We believe that it is acceptable to apply the revaluation model to tangible E&E assets and the cost model to intangible E&E assets. [IFRS 6.25]

5.11.160.40 In our experience, the revaluation model is rarely used for tangible E&E assets.

5.11.165 Statement of cash flows

5.11.165.10 An entity presents cash flows during the period classified by operating, investing and financing activities in the manner most appropriate to its business (see 2.3.20). When an entity elects to expense E&E expenditure as incurred (see 5.11.30), the related cash flows are classified as operating activities. Cash flows from investing activities include only expenditure that results in the recognition of an asset. [IAS 7.16]

5.11.170 IMPAIRMENT

5.11.170.10 IAS 36 is applied to measure, present and disclose the impairment of E&E assets (see chapter 3.10). [IFRS 6.18]

5.11.170.20 However, relief is provided from the general requirements of IFRS in assessing whether there is any indication of impairment for E&E assets. Also, the level at which any impairment assessment is performed is specified and may be at a more aggregated level than is required for non-E&E assets. The assessment of impairment is then performed in accordance with general impairment requirements. [IFRS 6.18–19]

5.11.180 Indicators

5.11.180.10 E&E assets are assessed for impairment only when facts and circumstances suggest that the carrying amount of an E&E asset may exceed its recoverable amount, and on the transfer of E&E assets to development assets. Unlike other assets, there is no requirement to assess whether an indication of impairment exists at the end of each reporting period until an entity has sufficient information to reach a conclusion about the technical feasibility and commercial viability of extraction. [IFRS 6.17–18, BC39]

5.11.180.20 IFRS 6 includes industry-specific examples of facts and circumstances that, if one or more are present, indicate that an entity should test an E&E asset for impairment. One such indicator is that an entity's right to explore in the specific area has expired or will expire in the near future, and is not expected to be renewed. [IFRS 6.20]

5.11.180.30 'Near future' is not defined under IFRS. In our view, it should be a period sufficiently short such that no significant doubt exists about whether the area can be developed and any reserves

extracted so as to recover the carrying amount of E&E assets before the right to explore lapses. In our view, the recoverable amount should be measured for any areas for which the rights to explore are due to expire within 12 months of the end of the reporting period if the rights are not subject to a perfunctory renewal right. Other E&E assets are reviewed against the following list of indicators.

- Substantive expenditure on further exploration and evaluation activities in the specific area is neither budgeted nor planned.
- The entity has not discovered commercially viable quantities of mineral resources as a result of E&E activities in the area to date, and the entity has decided to discontinue such activities in the specific area.
- Even if development is likely to proceed, the entity has sufficient data indicating that the carrying amount of the asset is unlikely to be recovered in full from successful development or by sale.

5.11.180.40 These indicators are based on management information or intentions and decisions with respect to a given area of exploration.

5.11.180.50 In our view, the identification of the specific area being monitored is likely to be a significant factor in the frequency with which indicators exist, and therefore when it is necessary to review the recoverable amount of E&E assets. In our experience, it may be preferable for the level at which indicators are monitored and the level of E&E assets for which the recoverable amount is reviewed (see 5.11.200) to be consistent.

5.11.180.60 The list of impairment indicators is not exhaustive, and there may be additional facts and circumstances that suggest that an entity should review E&E assets for impairment. Such indicators may include, for example, significant adverse changes in commodity prices and markets or changes in the taxation or regulatory environment. In assessing whether an entity has sufficient cash to fund future planned or budgeted substantive exploration and evaluation, the entity's capacity to raise cash is considered if cash is not currently on hand.

5.11.190 Level of testing

5.11.190.10 An entity chooses an accounting policy, to be applied consistently, for allocating E&E assets to CGUs or groups of CGUs in assessing E&E assets for impairment. [IFRS 6.21]

5.11.190.20 An entity may be able to identify E&E assets for internal management purposes at a low level – e.g. at the level of a specific geological structure thought to contain hydrocarbons or a contiguous ore body. Although an entity may make an accounting policy choice to assess impairment at such a low level, there is no requirement to do so. Instead, entities are permitted to combine one or more CGUs in testing E&E assets for impairment (see chapter 3.10). [IFRS 6.21–22]

5.11.190.30 Entities should consider the level of impairment assessment to avoid assets being carried forward that would, if they were not aggregated with other assets, be impaired. For example, continuing to aggregate E&E costs for an area that will not be developed with other CGUs may result in knowingly carrying forward costs associated with assets even though a decision has been taken not to develop those mineral resources. In our view, a policy of recognising an impairment loss in respect of capitalised costs that relate to a specific area identified as not being capable of being developed into a producing asset is consistent with the encouragement to consider additional indicators of impairment, and may therefore be appropriate.

5.11.190.40 As seen in 5.11.190.20, an entity is permitted to aggregate CGUs to form a group of units in testing E&E assets for impairment. However, the grouping cannot be at a level of aggregation larger than that of the operating segment to which the CGU belongs (see 5.2.50). [IFRS 6.21]

5.11.190.50 In our view, the requirement that each CGU (or group of CGUs) may not be larger than an operating segment is not considered in absolute terms, such as segment profit or loss or total assets. Instead, we believe that impairment testing may not be performed at a level that results in the aggregation of E&E assets or CGUs belonging to different operating segments.

5.11.190.60 The identification of CGUs or groups of CGUs requires judgement and may be one of the most difficult areas of impairment testing for E&E assets. Its interaction with the indicators of impairment based on a specific area requires consideration.

5.11.190.70 On determining an accounting policy for allocating E&E assets to CGUs or groups of CGUs, the policy should be applied consistently from period to period for the same types of assets. A change in accounting policy is permitted only if the criteria for a voluntary change in accounting policy are met (see 5.11.340).

5.11.200 Recoverable amount

5.11.200.10 If facts and circumstances suggest that the carrying amount of a CGU or group of CGUs comprising E&E assets exceeds its recoverable amount, then the entity measures the recoverable amount of the CGU. Recoverable amount is the higher of fair value less costs of disposal and value in use. [IFRS 6.18, IAS 36.18]

5.11.200.20 Many entities are likely to first determine the value in use of a potentially impaired asset, because the underlying information – i.e. cash flows based on management's estimates – will be more readily available than for fair value less costs of disposal. Only if this assessment highlights a potential impairment loss will the entity then be required to determine fair value less costs of disposal. For further discussion of measuring impairment, see 3.10.180–350.

5.11.210 Value in use

5.11.210.10 Cash flow projections to determine value in use are generally based on budgets approved by management that do not exceed five years (see 3.10.230). For most extractive activities, detailed budgets are prepared covering a period significantly in excess of five years – typically for the estimated field or mine life – which is generally based on resource and reserve reports; therefore, the period could be 20 years or more. In our view, if these budgets are considered reliable, then cash flow projections may be based on these longer budget periods. [IAS 36.33, 35]

5.11.210.20 When assessing impairment using a value-in-use model, future cash flows are estimated for the asset in its current condition (see 3.10.250). In the case of an asset that is not yet ready for use, which includes an E&E asset or related CGU, estimates include cash outflows expected to be incurred to bring the asset into use. [IAS 36.42, 44]

5.11.220 Reversals

5.11.220.10 Partial or full reversals of impairments of assets, other than impairments of goodwill, are recognised if there is a change in the estimate of the recoverable amount (see 3.10.420). [IAS 36.110]

5.11.230 PRE-EXPLORATION EXPENDITURE

5.11.230.10 Entities are required to identify and account for pre-exploration expenditure separately from E&E expenditure.

5.11.240 Identifying pre-exploration expenditure

5.11.240.10 Pre-licence costs are excluded from the scope of E&E costs. In our view, this exclusion implies that E&E activities commence on the acquisition of legal rights to undertake exploration activities in a certain area. [IFRS 6.5(a)]

5.11.240.20 Activities that take place before the acquisition of an exploration licence are pre-exploration, and will need to be identified separately. Pre-exploration expenditure typically includes the acquisition of speculative seismic data and expenditure on the subsequent geological and geophysical analysis of this data.

5.11.240.30 A formal process of bidding for licences may help the separate identification of activities that precede obtaining the licence. However, in some regions the licence process is less formal. For example, in certain areas in Africa a significant amount of E&E activity might commence while the formalities of obtaining a licence and government approval are being finalised, based on a valid expectation of a licence being granted. In our view, if the grant of the licence is subject only to administrative processes that are not substantive, then the licence may be deemed to have been granted. It is necessary to consider the nature of the regulatory approval in each case, because this determination is a matter of fact rather than accounting policy. Accordingly, it may be appropriate in some circumstances to capitalise E&E expenditure incurred before obtaining the licence, subject to an entity's accounting policy for such expenditure (see 5.11.30).

5.11.250 Accounting for pre-exploration expenditure

5.11.250.10 The recognition and measurement of pre-exploration expenditure is not addressed by IFRS. Therefore, an entity should choose an accounting policy, to be applied consistently, using the hierarchy for selecting accounting policies (see 2.8.20).

5.11.250.20 Pre-exploration expenditure generally cannot be associated with any specific mineral resources, because it is usually speculative in nature – e.g. costs incurred in reassessing previous seismic data. In our view, such expenditure should be expensed as incurred. [IFRS 6.BC13]

5.11.250.30 There may be some cases in which expenditure incurred in the pre-licence phase gives rise to an item that is an asset, even though it relates to E&E activities – e.g. the purchase of seismic data or analysis from a third party. [IFRS 6.BC13]

5.11.250.40 In addition, to the extent that pre-licence prospecting and exploration costs give rise to proprietary information that the entity has the ability to control, these costs may qualify for recognition as an intangible asset (see 3.3.30).

5.11.260 DEVELOPMENT EXPENDITURE

5.11.260.10 Entities identify and account for development expenditure separately from E&E expenditure.

5.11.270 Identifying development expenditure

5.11.270.10 IFRS does not contain a definition of development activities or expenditure in the context of extractive activities. From an accounting point of view, the term 'development' in the context of research and development is defined as "the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use". One example of development expenditure for accounting purposes is costs related to the design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production. [IAS 38.8, 59]

5.11.270.20 In the extractive industries, 'development' often refers to the phase in which the technical feasibility and commercial viability of extracting a mineral resource have been demonstrated and an identified mineral reserve is being prepared for production – e.g. construction of access to the mineral reserves. In our view, these development activities are more akin to the construction of an asset to be used in commercial production than to expenditure incurred as part of development activities for accounting purposes. [IFRS 6.5(b)]

5.11.270.30 A significant factor in determining technical feasibility and commercial viability is likely to be the existence of proven and probable reserves. Entities make such assessments based on either their in-house, operators' or third party reserve evaluations. In our view, in assessing commercial viability an entity will need to consider whether it has access to adequate resources to proceed with development activities.

5.11.280 Accounting for development expenditure

5.11.280.10 Once the technical feasibility and commercial viability of extracting a mineral resource are demonstrable, expenditure related to the development of that mineral resource should not be recognised as E&E assets. IFRS does not prescribe when the technical feasibility and commercial viability of extracting a mineral resource are demonstrable. [IFRS 6.5(b), 10]

5.11.280.20 IFRS does not specify requirements for costs incurred on the development and extraction of mineral resources and an entity should therefore choose an accounting policy, to be applied consistently, using the hierarchy for selecting accounting policies (see 2.8.20).

5.11.280.30 If an entity identifies an (accounting) development phase once E&E activities have concluded, then it can generally identify an intangible asset and demonstrate that the asset will generate probable future economic benefits. In our view, to the extent that an entity incurs expenditure of an (accounting) development nature, the capitalisation of that expenditure as an intangible asset may be appropriate. [IFRS 6.BC27]

5.11.280.40 Alternatively, an entity may conclude that there is no (accounting) development phase between the determination of technical feasibility and commercial viability, and activities that are in preparation for production or extraction of a specific mineral reserve. In this case, it may be appropriate to capitalise development expenditure as part of the cost of an item of property, provided that those costs otherwise qualify as part of cost.

5.11.290 Reclassifying exploration and evaluation assets

5.11.290.10 When the technical feasibility and commercial viability of extracting a mineral resource are demonstrable, an entity:

- stops capitalising E&E costs for that area;
- tests recognised E&E assets for impairment; and
- ceases classifying any unimpaired E&E assets (tangible and intangible) as E&E. [IFRS 6.17]

5.11.290.20 For E&E assets reclassified to development assets, an entity chooses an accounting policy, to be applied consistently, to classify such assets either as tangible or intangible development assets. Intangible E&E assets may be reclassified into tangible development assets or intangible development assets and vice versa.

5.11.300 Identifiable exploration and evaluation assets

5.11.300.10 Identifiable tangible assets that cease to be classified as E&E assets are generally classified as tangible development assets – e.g. a vehicle that will be used in production. Identifiable intangible E&E assets – e.g. an exploration licence – may continue to be classified as an intangible asset, or may be reclassified as a tangible asset if the intangible asset is considered to be integral to the tangible development asset and the tangible element of the asset is more significant.

5.11.310 Non-identifiable exploration and evaluation assets

5.11.310.10 Generally, when commercial and technical feasibility are demonstrable, a specific mineral reserve will have been identified for development. In our experience, mineral reserves are classified as either property assets (i.e. tangible) or intangible assets. In our view, an entity should choose an accounting policy, to be applied consistently, to classify mineral reserves either as tangible or as intangible assets. In our experience, mineral reserves, and by association the non-identifiable E&E assets, tend to be classified as tangible development assets.

5.11.310.20 Mineral reserves are excluded from the scope of both the intangible assets standard (IAS 38) and of the property, plant and equipment standard (IAS 16), and they are not in the scope of any other standard. Therefore, an entity chooses an accounting policy for mineral reserves by applying the hierarchy for selecting accounting policies (see 2.8.20). The limited relief from this hierarchy introduced by IFRS 6 (see 5.11.30) does not apply to mineral reserves that are not subject to E&E activities. The selected accounting policy is applied consistently. [IFRS 6.3–4, IAS 16.3(c)–(d), 38.7]

5.11.320 Depreciation (amortisation)

5.11.320.10 On reclassification of E&E assets, an entity depreciates (amortises) the resulting tangible development assets (and intangible development assets with a finite life) over their useful lives. For both tangible and intangible development assets, the units-of-production method may be an appropriate method.

5.11.320.20 IFRS provides no specific guidance on how the units-of-production calculation should be performed. Specifically, there is no guidance on the reserves, or reserves and resources, measurement to be used in determining the ratio of current period production to total estimated production. For ex-

ample, factors that would affect the measured reserves include the degree of probability used to assess the physical quantity of minerals in place and the economic assumptions used to assess the portion of this that can be commercially extracted. The relevant unit of measure may also be an area of judgement – e.g. using the amount of ore produced or the quantity of minerals contained in that ore. Accordingly, the basis of calculation is a matter of judgement such that the method used reflects the pattern in which the future economic benefits associated with the asset are consumed. The choice of measurement basis may also have implications for the cost base used in the units-of-production calculation.

5.11.320.30 For further discussion of the use of reserve and resource estimates in preparing financial statements, see 5.11.400.

5.11.330 **Impairment testing**

5.11.330.10 Before reclassification, E&E assets are assessed for impairment and any impairment loss is recognised in profit or loss. This impairment assessment is required regardless of whether facts and circumstances indicate that the carrying amount of the E&E asset is in excess of its recoverable amount. In our view, E&E assets can continue to be tested as part of the CGUs in which they have previously been included, as described in 5.11.170. This is because we believe that these assets are E&E assets to which the special aggregation relief applies. [IFRS 6.17]

5.11.330.20 Other than as described in 5.11.330.10, the impairment test on reclassification of E&E assets is performed in accordance with the general impairment testing requirements (see chapter 3.10). This will require an entity to develop additional accounting policies for allocating assets to CGUs and assessing recoverable amounts for these assets.

5.11.340 **CHANGES IN ACCOUNTING POLICIES**

5.11.340.10 IFRS 6 provides some relief from the requirements for a voluntary change in accounting policy (see 2.8.70). However, this modification relates only to E&E expenditure. Changes in accounting policies for pre-exploration activities and development expenditure are subject to the general requirements of IFRS for changes in accounting policy (see 2.8.50). [IFRS 6.13]

5.11.340.20 An entity may change its existing IFRS accounting policy for E&E expenditure if, and only if, the change makes the financial statements more relevant to the economic decision-making needs of users and no less reliable, or more reliable and no less relevant to those needs, judged by the criteria for voluntary changes in accounting policies (see 2.8.70). [IFRS 6.13]

5.11.340.30 In our view, the criteria in 5.11.340.20 prohibit entities from changing between certain policies used in current practice. For example, we believe that this requirement precludes entities in the oil and gas industry that account for exploration and development activities under IFRS using the successful-efforts method from changing to the full-cost method (see 5.11.370). Successful-efforts accounting refers to a practice of capitalising costs on a field-by-field basis with an assessment of commercial viability of the fields performed on a periodic basis. We believe that such a change in policy is not considered to result in more relevant and/or reliable information to the users of the financial statements because it may result in the capitalisation of unsuccessful costs – e.g. costs related to dry wells that do not represent future economic benefits.

5.11.340.40 Similarly, a mining company that currently expenses E&E costs is, in our view, precluded from changing to a policy of capitalisation of *all* such costs. This is because, without the temporary exemption from the accounting policy hierarchy, it is difficult to demonstrate the probability of future economic benefits from E&E expenditure. We therefore believe that such a change in policy is not considered to result in more relevant and/or reliable information to the users of the financial statements.

5.11.340.50 Conversely, we believe that a change in policy from the full-cost method to one based on the successful-efforts method or from capitalisation of all E&E expenditure to expensing (at least some) costs as incurred would be acceptable. In our view, expensing many such costs is more consistent with the Conceptual Framework because it is difficult to demonstrate that these costs meet the definition of an asset. Expensing these costs as incurred may therefore be viewed as more reliable.

5.11.350 **STRIPPING COSTS**

5.11.350.10 IFRS contains no specific guidance on the accounting for stripping costs incurred in the pre-production phase of surface mining. In our experience, pre-production stripping costs in surface mining are generally capitalised and amortised over the productive life of the mine under the units-of-production method.

5.11.350.20 Stripping costs incurred in the production phase of surface mining activities are in the scope of IFRIC 20. Such costs that give rise to benefits in the form of inventory produced are accounted for in accordance with IAS 2 (see chapter 3.8). However, production stripping costs that improve access to ore to be mined in the future are recognised as a non-current asset ('stripping activity asset') if, and only if, all of the following criteria are met.

- It is probable that the future economic benefit will flow to the entity.
- The entity can identify the component of the ore body to which access has been improved.
- The costs related to the stripping activity associated with that component can be measured reliably. [IFRIC 20.6, 8–9]

5.11.350.30 If the costs of the stripping activity asset vs inventory produced are not separately identifiable, then costs are allocated based on a relevant production method – e.g. based on the actual vs expected volume of waste extracted. [IFRIC 20.13]

5.11.350.40 The stripping activity asset is accounted for as a component of the existing asset of which it is a part – i.e. as a component of the mining assets. Therefore, the classification and measurement of the stripping activity asset is in line with that existing asset. [IFRIC 20.14]

5.11.350.50 The stripping activity asset is depreciated or amortised on a systematic basis over the expected useful life of the identified component of the ore body that becomes more accessible as a result of the stripping activity. The units-of-production method is applied unless another method is more appropriate. The expected useful life of the identified component of the ore body will differ from the life of the mine, except in limited circumstances when the stripping activity provides access to the whole of the ore body. [IFRIC 20.15–16]