cash flows for each of the first five years and a total for the periods thereafter (as required under IAS 17) may be appropriate; in other circumstances presentation of other time bands (possibly more detailed) may be more relevant. For example, for a portfolio of 15- to 20-year leases, the requirements of IFRS 7 should lead a lessee to provide a more detailed maturity analysis than a single amount for the years beyond the fifth year. [IFRS 16:BC221]

9.2.9 *Additional information regarding the scope of lease activities*

9.2.9.1 General requirement to disclose additional information

In addition to the disclosures required under IFRS 16:53 to 58 (see **9.2.4** to **9.2.8**), a lessee is required to disclose additional qualitative and quantitative information about its leasing activities necessary to meet the disclosure objective in IFRS 16:51 (see **9.2.1**). This additional information may include, but is not limited to, information that helps users of financial statements to assess: [IFRS 16:59]

- the nature of the lessee's leasing activities;
- future cash outflows to which the lessee is potentially exposed that are not reflected in the measurement of lease liabilities. This includes exposure arising from:
  - variable lease payments (see **9.2.9.2**);
  - extension options and termination options (see **9.2.9.3**);
  - residual value guarantees (see **9.2.9.4**); and
  - leases not yet commenced to which the lessee is committed;
- restrictions or covenants imposed by leases; and
- sale and leaseback transactions (**9.2.9.5**).

In determining whether additional information about leasing activities is necessary to meet the disclosure objective in IFRS 16:51 (see **9.2.1**), a lessee should consider: [IFRS 16:B48]

- whether that information is relevant to users of financial statements. A lessee should provide additional information as specified in IFRS 16:59 (see above) only if that information is expected to be relevant to users of financial statements. In this context, this is likely to be the case if it helps those users to understand:
  - the flexibility provided by leases (e.g. if a lessee can reduce its exposure by exercising termination options or renewing leases with favourable terms and conditions);
  - restrictions imposed by leases (e.g. if the entity is required to maintain particular financial ratios);

  - sensitivity of reported information to key variables (e.g. to future variable lease payments);
  - exposure to other risks arising from leases; and
  - deviations from industry practice (e.g. unusual or unique lease terms and conditions that affect a lessee's lease portfolio); and
- whether that information is apparent from information either presented in the primary financial statements or disclosed in the notes. A lessee need not duplicate information that is already presented elsewhere in the financial statements.

IFRS 16 therefore requires a lessee to disclose any material entity-specific information that is necessary in order to meet the disclosure objective and is not covered elsewhere in the financial statements. IFRS 16 supplements this requirement with a list of user information needs that additional disclosures should address (see **9.2.9.2** to **9.2.9.5**), and with illustrative examples of disclosures (see **example 9.2.9.2** and **example 9.2.9.3**) that a lessee might provide in complying with the additional disclosure requirements. These examples are not exhaustive. Nonetheless, the Board thinks that the illustrative examples are useful in demonstrating that judgement should be applied in determining the most useful and relevant disclosures, which will depend on a lessee's individual circumstances. In the Board's view, this approach facilitates the provision of more relevant and useful disclosures by: [IFRS 16:BC225]

- discouraging the use of generic or 'boilerplate' statements; and
- enabling a lessee to apply judgement to identify the information that is relevant to users of financial statements and focus its efforts on providing that information.

9.2.9.2 Additional information relating to variable lease payments

Additional information relating to variable lease payments that, depending on the circumstances, may be needed to satisfy the disclosure objective in IFRS 16:51 (see **9.2.1**) could include information that helps users of financial statements to assess, for example: [IFRS 16:B49]

- the lessee's reasons for using variable lease payments and the prevalence of those payments;
- the relative magnitude of variable lease payments to fixed payments;
- key variables upon which variable lease payments depend and how payments are expected to vary in response to changes in those key variables; and
- other operational and financial effects of variable lease payments.

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The following example, which is reproduced from the illustrative examples accompanying IFRS 16, illustrates how a lessee with different types of lease portfolios might comply with these disclosure requirements regarding variable lease payments.

Example 9.2.9.2

Example disclosures – variable payment terms

[IFRS 16:IE9, Example 22]

Note: This example shows only current period information. IAS 1 *Presentation of Financial Statements* requires an entity to present comparative information.

Lessee with a high volume of leases with some consistent payment terms

Example 22A: a retailer (Lessee) operates a number of different branded retail stores – A, B, C and D. Lessee has a high volume of property leases. Lessee's group policy is to negotiate variable payment terms for newly established stores. Lessee concludes that information about variable lease payments is relevant to users of its financial statements and is not available elsewhere in its financial statements. In particular, Lessee concludes that information about the proportion of total lease payments that arise from variable payments, and the sensitivity of those variable lease payments to changes in sales, is the information that is relevant to users of its financial statements. This information is similar to that reported to Lessee's senior management about variable lease payments.

Some of the property leases within the group contain variable payment terms that are linked to sales generated from the store. Variable payment terms are used, when possible, in newly established stores in order to link rental payments to store cash flows and minimise fixed costs. Fixed and variable rental payments by store brand for the period ended 31 December 20X0 are summarised below.

	Stores	Fixed payments	Variable payments	Total payments	Estimated annual impact on total brand rent of a 1% increase in sales
	No.	CU	CU	CU	%
Brand A	4,522	3,854	120	3,974	0.03%
Brand B	965	865	105	970	0.11%
Brand C	124	26	163	189	0.86%
Brand D	652	152	444	596	0.74%
	6,263	4,897	832	5,729	0.15%

Refer to the management commentary for store information presented on a like-for-like basis and to Note X for segmental information applying IFRS 8 *Operating Segments* relating to Brands A - D.

Example 22B: a retailer (Lessee) has a high volume of property leases of retail stores. Many of these leases contain variable payment terms linked to sales from the store. Lessee's group policy sets out the circumstances in which variable payment terms are used and all lease negotiations must be approved centrally. Lease payments are monitored centrally. Lessee concludes that information about variable lease payments is relevant to users of its financial statements and is not available elsewhere in its financial statements. In particular, Lessee concludes that information about the different types of contractual terms it uses with respect to variable lease payments, the effect of those terms on its financial performance and the sensitivity of variable lease payments to changes in sales is the information that is relevant to users of its financial statements. This is similar to the information that is reported to Lessee's senior management about variable lease payments.

Many of the property leases within the group contain variable payment terms that are linked to the volume of sales made from leased stores. These terms are used, when possible, in order to match lease payments with stores generating higher cash flows. For individual stores, up to 100 per cent of lease payments are on the basis of variable payment terms and there is a wide range of sales percentages applied. In some cases, variable payment terms also contain minimum annual payments and caps. Lease payments and terms for the period ended 31 December 20X0 are summarised below.

	Stores	Fixed payments	Variable payments	Total payments
	No.	CU	CU	CU
Fixed rent only	1,490	1,153	–	1,153
Variable rent with no minimum	986	–	562	562
Variable rent with minimum	3,089	1,091	1,435	2,526
	5,565	2,244	1,997	4,241

A 1 per cent increase in sales across all stores in the group would be expected to increase total lease payments by approximately 0.6 - 0.7 per cent. A 5 per cent increase in sales across all stores in the group would be expected to increase total lease payments by approximately 2.6 - 2.8 per cent.

Lessee with a high volume of leases with a wide range of different payment terms

Example 22C: a retailer (Lessee) has a high volume of property leases of retail stores. These leases contain a wide range of different variable payment terms. Lease terms are negotiated and monitored by local management. Lessee concludes that information about variable lease payments is relevant to users of its financial statements and is not available elsewhere in its financial statements. Lessee concludes that information about how its property lease portfolio is managed is the information that is relevant to users of its financial statements. Lessee also concludes that information about the expected level of

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using the rate of exchange at that date. As discussed at **8.5.2.10**, foreign exchange differences arising on the subsequent retranslation of the lease liability are recognised in profit or loss, rather than as an adjustment to the right-of-use asset. If there have been modifications to the lease that would have resulted in adjustments to the right-of-use asset since commencement, retrospective application will require those adjustments to be reflected at the rate of exchange in effect at the date of modification. **8.7.3-1** addresses the accounting for a lease modification when the lease liability is denominated in a foreign currency.

Cumulative catch-up approach

If the lessee opts for the cumulative catch-up approach in accordance with IFRS 16:C5(b), it can choose on a lease-by-lease basis to measure the right-of-use asset either: [IFRS 16:C8(b)]

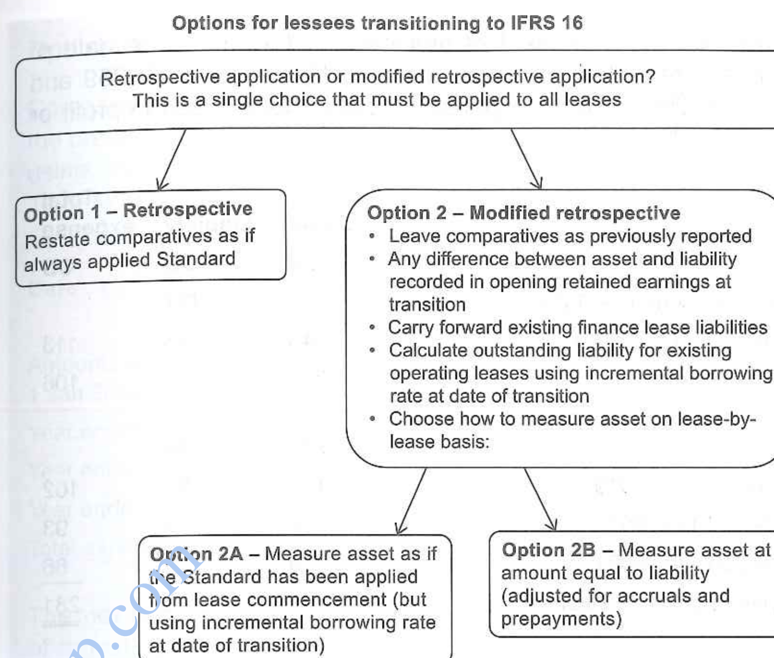
- retrospectively, as if IFRS 16 had been applied since the commencement date, but discounted using the lessee's incremental borrowing rate at the date of initial application; or
- at an amount equal to the lease liability, adjusted by the amount of any prepaid or accrued lease payments relating to that lease recognised in the statement of financial position immediately before the date of initial application.

For leases accounted for at transition under IFRS 16:C8(b)(i), because the carrying amount of the right-of-use asset is determined retrospectively, its measurement follows the same principles as those described above in the case of a full retrospective application of IFRS 16 (except that the lease payments used to determine the right-of-use asset are discounted using the lessee's incremental borrowing rate at the date of initial application). Accordingly, under IFRS 16:C8(b)(i), the carrying amount of the right-of-use asset reflects historical exchange rate(s).

For leases accounted for at transition under IFRS 16:C8(b)(ii), the carrying amount of the right-of-use asset is based on the lease liability at the date of initial application (which is itself translated at the spot exchange rate). Accordingly, the carrying amount of the right-of-use asset reflects the exchange rate in effect on the date of initial application, and it is not subsequently retranslated.

14.8 Illustration of application of lessee transition options

The main choices available to lessees regarding how to transition to IFRS 16 and bring assets and liabilities on-balance sheet (as described in detail at **14.5** and **14.6**) are summarised in the following decision tree.



14.8-1

Application of options available to lessees on transition to IFRS 16 – example

Applying these options to a simple example reveals the potential for differing impacts on the statement of financial position at transition and the subsequent expense recognised in the income statement.

Example facts:

- five-year lease, entered into on 1 January 2017;
- CU100 payable on second day of each year;
- 8 per cent discount rate on lease commencement;
- 12 per cent incremental borrowing rate at date of initial application (1 January 2019); and
- straight-line depreciation of the right-of-use asset is appropriate.

Option 1

The liability and asset are both calculated as if IFRS 16 had always been applied, with comparative amounts restated. The liability on the commencement date of the lease is calculated as the present value of the future rentals, discounted using a rate of 8 per cent.

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The impact on the statement of financial position as at the date of transition is a reduction in net assets of CU19 (asset of CU259 and liability of CU278), with an expense of CU281 recognised in profit or loss post-transition.

Date	Asset CU	Liability CU	Total expense CU
Lease commencement – 1 Jan 2017	431	431	
Year ended 31 Dec 2017	345	358	113
Year ended 31 Dec 2018	259	278	106
Amounts recognised at transition on 1 Jan 2019	259	278	
Year ended 31 Dec 2019	172	193	102
Year ended 31 Dec 2020	86	100	93
Year ended 31 Dec 2021	0	0	86
Total expense post-transition			281

Option 2A

Comparative amounts are not restated and the liability is calculated as the present value of the three outstanding rentals of CU100, discounted using the incremental borrowing rate at the date of transition of 12 per cent.

The asset is calculated as if IFRS 16 had always been applied, but using the incremental borrowing rate at the date of transition of 12 per cent.

Date	Asset CU	Liability CU	Total expense CU
Lease commencement – 1 Jan 2017	404		
Year ended 31 Dec 2017	323		
Year ended 31 Dec 2018	242		
Amounts recognised at transition on 1 Jan 2019	242	269	
Year ended 31 Dec 2019	161	189	101
Year ended 31 Dec 2020	81	100	92
Year ended 31 Dec 2021	0	0	81
Total expense post-transition			274

The impact on the statement of financial position as at the date of transition is a reduction in net assets of CU27 (asset of CU242 and liability of CU269), with an expense of CU274 recognised in profit or loss post-transition.

Option 2B

Comparative amounts are not restated and the liability is calculated as the present value of the three outstanding rentals of CU100, discounted using the incremental borrowing rate at the date of transition of 12 per cent. The asset is then set equal to the liability.

Date	Asset CU	Liability CU	Total expense CU
Amounts recognised at transition on 1 Jan 2019	269	269	
Year ended 31 Dec 2019	179	189	110
Year ended 31 Dec 2020	90	100	100
Year ended 31 Dec 2021	0	0	90
Total expense post-transition			300

The net impact on the statement of financial position as at the date of transition is nil (asset = liability) but the expense post-transition is CU300.

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Comparison of transition options

Overall, it can be seen that, in straightforward scenarios, Options 1 and 2A both reduce net assets on transition, although if the incremental borrowing rate at the date of transition is different to the discount rate the amount of the reduction will likely differ.

Option 2B leads to nil impact on net assets at transition but, because the asset is set higher than it otherwise would have been, the expense post-transition is higher than under Options 1 and 2A.

An advantage of Options 2A and 2B is that they don't require an entity to go back and determine what the discount rate would have been at lease commencement. For longer-term leases that began several years ago, this may result in significant time savings, albeit determining an incremental borrowing rate can still present its own challenges.

14.9 Sale and leaseback transactions before the date of initial application

An entity should not reassess sale and leaseback transactions entered into before the date of initial application to determine whether the transfer of the underlying asset satisfies the requirements in IFRS 15 to be accounted for as a sale. [IFRS 16:C16]

If a sale and leaseback transaction was previously accounted for as a sale and a finance lease, the seller-lessee should: [IFRS 16:C17]

on the temporary investment of the funds, pending their expenditure on the qualifying asset, should be deducted from the actual borrowing costs incurred to arrive at the borrowing costs eligible for capitalisation. [IAS 23:13]

5.2-1

Specific borrowing costs offset by investment income on excess funds – example

An entity borrows CU20 million to finance the construction of a factory. The funds are to be drawn down on a monthly basis in four equal amounts. Payment of construction costs occurs throughout each month, rather than coinciding with the draw-downs. During each month, the entity invests any excess funds drawn down in accordance with the financing arrangements in short-term bank deposits.

In its financial statements for the year, the entity should capitalise, as part of the cost of construction of the factory, the actual borrowing costs on the CU20 million borrowing (incurred during the period of construction) less the interest income derived from the temporary investments in bank deposits.

5.3 General borrowing costs

5.3.1 Issues arising when a qualifying asset is funded from general borrowings

When a qualifying asset is funded from a pool of general borrowings, the amount of the borrowing costs eligible for capitalisation is not so obvious. While the basic principle in IAS 23:10 (see 5.1) still applies, there may be practical difficulties in identifying a direct relationship between the particular borrowings utilised and the qualifying assets.

The following sections explain the approach required under IAS 23 which is to apply an appropriate capitalisation rate calculated by reference to the entity's 'general borrowings' to the expenditure on a qualifying asset.

5.3.2 General borrowings

5.3.2.1 Meaning of 'general borrowings' – impact of Annual Improvements to IFRS Standards: 2015 - 2017 Cycle

IAS 23 was amended in December 2017 by *Annual Improvements to IFRS Standards: 2015 - 2017 Cycle* to clarify that when an asset is ready for its intended use or sale, an entity treats any outstanding

borrowing made specifically to obtain that asset as part of its general borrowings. This clarification has been achieved by amending the wording of paragraph 14 of IAS 23 – see **5.3.2.2** and **5.3.2.3**, respectively, for the requirements applicable for entities that have adopted the December 2017 amendments and those that have not yet done so.

In the past, practice in respect of this issue was mixed and some entities interpreted the requirements of IAS 23:14 in line with the Board's clarification; such entities are not affected by the amendments because there is no change in their accounting policies. However, for entities that previously interpreted the wording of IAS 23:14 to the effect that funds borrowed specifically for the purpose of obtaining a qualifying asset are excluded from the general borrowing pool even after that qualifying asset is ready for its intended use or sale, the December 2017 amendments will require a change in accounting policy, to be applied prospectively with appropriate disclosures (see **5.3.2.4**).

5.3.2.2 Meaning of 'general borrowings' (for entities that have adopted the December 2017 amendments to IAS 23)

General borrowings are all borrowings of the entity that are outstanding during the period but excluding borrowings made specifically for the purpose of obtaining a qualifying asset until substantially all the activities necessary to prepare that asset for its intended use or sale are complete. [IAS 23:14]

Therefore, when funds are borrowed specifically for a qualifying asset, costs in relation to that borrowing are accounted for as specific borrowing costs (see **5.2**) until the asset is ready for its intended use or sale; if the borrowing remains outstanding after the related asset is ready for its intended use or sale, it becomes part of 'general borrowings' to which IAS 23:14 is applied.

5.3.2.3 Meaning of 'general borrowings' (for entities that have not yet adopted the December 2017 amendments to IAS 23)

General borrowings are the borrowings of the entity that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. [IAS 23:14]

5.3.2.4 Effective date and transition arrangements for the December 2017 amendments to IAS 23

The December 2017 amendments to IAS 23 are effective for annual reporting periods beginning on or after 1 January 2019, with earlier application permitted. If an entity applies the amendments for a period beginning before 1 January 2019, it is required to disclose that fact. The amendments are required to be applied to borrowing costs incurred on or

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costs capitalised should not exceed the actual borrowing costs incurred during that same period. [IAS 23:14]

5.3.5-1

Borrowing costs capitalised limited to the borrowing costs incurred in a group context

Because the amount of borrowing costs capitalised may not exceed the amount of borrowing costs actually incurred, 'notional' interest expenses may not be capitalised. This point has particular relevance for groups with centralised banking arrangements whereby the 'banking' entity charges or credits interest to the other group entities in respect of its balances with those entities. Interest charged by one member of a group to another cannot be capitalised in the consolidated financial statements except to the extent that it represents an interest expense actually borne by the group on external borrowings. Intragroup interest is eliminated on consolidation.

For example, a group consists of a parent, P, and two subsidiaries, S1 and S2. S1 is engaged in the construction of a power plant that is wholly financed by fellow subsidiary S2, which obtains the necessary funds through general bank borrowings. No intragroup interest is charged by S2 to S1. The terms of the loan from S2 to S1 specify that it is repayable on demand.

In the circumstances described, no interest should be capitalised in either of the individual financial statements of S1 or S2; S1 has incurred no borrowing costs, and S2 has no qualifying asset.

However, it will be appropriate to capitalise interest in the consolidated financial statements of P, provided that the amount capitalised fairly reflects the interest cost to the group of borrowings from third parties which could have been avoided if the expenditure on the qualifying asset had not been made.

5.3.6 *Investment income on excess funds borrowed generally*

5.3.6-1

Investment income on excess funds borrowed generally

When funds are borrowed generally, interest income earned on excess funds should not be offset against the interest cost in determining the appropriate capitalisation rate, nor in determining the limit on capitalisation by reference to the amount of borrowing costs incurred during the period.

5.3.7 *Assets funded from specified cash balances*

5.3.7-1

Assets funded from specified cash balances

When an entity has a general borrowing pool, it may nevertheless consider that expenditure on certain assets is met out of specified cash balances. In such circumstances, the question arises as to whether the entity is required under IAS 23:14 to capitalise 'deemed' borrowing costs in respect of the expenditure on such assets.

This question is not specifically dealt with in IAS 23. IAS 23:14 refers to "the extent that an entity borrows funds generally and uses them for the purpose of obtaining a qualifying asset". Therefore, it appears that to the extent that the asset is demonstrably not paid for out of borrowings (e.g. it is paid for out of the cash proceeds of an equity issue), there is no requirement to capitalise a deemed interest cost.

To understand this position, contrast the IAS 23 requirements with those of US GAAP, which state that the interest cost required to be capitalised is that which would theoretically have been avoided by using the funds expended to repay existing borrowings. Therefore, whenever an entity has a general borrowing pool, it is required to capitalise the borrowing costs that would have been avoided if the cash balances had been used to repay those borrowings.

Under IAS 23:14, there is no requirement to capitalise a 'deemed' interest cost, although it appears that adopting the approach required by US GAAP is also acceptable.

5.3.8 *Use of insurance proceeds to fund the reconstruction of an asset*

5.3.8-1

Use of insurance proceeds to fund the reconstruction of an asset – example

Company A had a factory that was destroyed by fire. Insurance proceeds have been received and lodged in a separate bank account and are being used to reconstruct the factory. Company A has a general borrowing pool.

Company A is not required to capitalise a deemed interest cost in respect of the reconstruction in these circumstances, even though it has a general borrowing pool. The construction of the replacement asset is a distinct event and should be assessed separately for the purpose of determining the appropriateness of capitalisation of borrowing costs.

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For example, Company A contracts a supplier to construct a property on Company A's land to Company A's specification based on architects' plans provided by Company A. Any payments made by Company A to the supplier are for the construction services provided by the supplier and, therefore, are directly related to the manufacture or construction of the property. Consequently, borrowing costs incurred by Company A during the construction period are eligible for capitalisation and should be capitalised as part of the cost of the asset.

Deposit secures place in a waiting list to acquire standard goods

IAS 23:7 states that "[a]ssets that are ready for their intended use or sale when acquired are not qualifying assets". In such cases, a deposit may primarily serve to secure Company A's place in a waiting list.

A common example is the manufacture of top-end cars when the customer may select from standard customisation options (e.g. paint colour, air conditioning, parking sensors). There is generally a waiting list for such cars. In order to secure its place in the waiting list and guarantee delivery of the new car, Company A may pay a substantial deposit when the order is placed. However, if it is clear that the deposit does not affect the total amount payable to the supplier for the car, any borrowing costs Company A incurs on the deposit do not qualify for capitalisation because they do not arise in relation to the manufacture of the car.

Note that if the payment of the deposit for an asset reduces the overall price that would otherwise have been payable for the asset, it is appropriate to recognise the implicit financing as part of the cost of the asset (see **4.3.2-3** in **chapter A7** for discussion and illustration).

The term 'activities' in this context is interpreted as having a broad meaning and should include all steps necessary to prepare the asset for its intended use. Such activities include initial technical and administrative work, such as activities associated with obtaining permits, prior to the commencement of the physical construction of the asset. [IAS 23:19]

The mere holding of an asset, however, without any associated development activities, does not entitle an entity to capitalise related borrowing costs. A typical example is the holding of land banks that are not undergoing activities necessary to prepare them for their intended use. Capitalisation of borrowing costs should only commence when such activities are being undertaken as part of a specific development plan to change an asset's condition. [IAS 23:19]

5.6.1.2 Commencement date of capitalisation prior to the date of application of IAS 23 (as revised in 2007)

5.6.1.2-1

Commencement date of capitalisation prior to the date of application of IAS 23 (as revised in 2007)

The requirements of IAS 23 (as revised in 2007) apply only to borrowing costs relating to qualifying assets for which the commencement date for capitalisation is on or after the date when an entity first applied that Standard (effective date 1 January 2009 or an earlier date designated by the entity). [IAS 23:27 & 28]

Therefore, when IAS 23(2007) was first adopted, qualifying assets for which the commencement date had already occurred (referred to below as 'pre-existing' qualifying assets) were not restated. In addition, any borrowing costs relating to such assets continue to be accounted for in accordance with the entity's previous accounting policy for borrowing costs until the end of the capitalisation period (see **5.6.3**), as follows.

- When an entity's previous accounting policy was to expense all borrowing costs when incurred, the entity should continue to expense all borrowing costs relating to pre-existing qualifying assets, including any borrowing costs incurred after the date when IAS 23(2007) is first applied.
- When an entity's accounting policy had always been to capitalise borrowing costs relating to qualifying assets, there was generally no change on application of the revised Standard. One exception may be if the entity took one of the scope exemptions discussed at **2.3**, having previously capitalised borrowing costs for such assets. In such cases, the new policy (of expensing borrowing costs for such exempt assets) is not applied to pre-existing qualifying assets, and borrowing costs relating to such assets, including any borrowing costs incurred after the date when IAS 23(2007) is first applied, continue to be capitalised in accordance with the previous version of the Standard.

5.6.2 Suspension of capitalisation

Capitalisation of borrowing costs should generally continue as long as the three conditions listed at **5.6.1.1** are met. If, however, the entity suspends activities related to development for an extended period, capitalisation of borrowing costs should also cease until such time as activities are resumed. [IAS 23:20] Such interruptions in development may occur, for example, due to cash flow difficulties or a desire to hold back development while the market is in depression, in which case the borrowing costs incurred

during the period of suspension are not considered to be a necessary cost of development and therefore cannot be capitalised. On the other hand, temporary delays that are necessary or expected in the process of getting an asset ready for its intended use, or which result from a natural delay such as adverse weather conditions that are common to the location, do not require the suspension of capitalisation. [IAS 23:21]

5.6.3 Cessation of capitalisation

5.6.3.1 Cessation of capitalisation – general

Borrowing costs should only be capitalised to the extent that they accrue during the period of production. In accordance with IAS 23:22, capitalisation should cease when substantially all of the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

An asset is normally ready for its intended use or sale when the physical construction of the asset is complete, even when routine administrative work is continuing. If minor modifications, such as the decoration of a property to the purchaser's specification, are all that are still outstanding, this indicates that substantially all the activities are complete. [IAS 23:23]

Capitalisation will therefore generally cease when the physical construction of an asset is complete, because at that stage the asset will be substantially ready for its intended use, notwithstanding that further time might be necessary to complete routine administrative work, market the asset or, in the case of an investment property, find a tenant.

5.6.3.2 Delay between completion of construction and obtaining regulatory consents

5.6.3.2-1

Delay between completion of construction and obtaining regulatory consents

Regulatory consents (e.g. health and safety clearance) are sometimes required before an asset is permitted to be brought into use. Management will normally seek to ensure that such consents are in place very close to the time frame for physical completion and testing, so that the consents do not slow down the commencement of operations. When a delay in obtaining consents, which prevents the start of operations, could have been avoided by the entity, this should be seen as abnormal and similar in effect to a suspension of development, so that capitalisation of borrowing costs should cease (see **5.6.2**). However, when it is not possible to avoid a delay

between physical completion and obtaining such consents (e.g. when it is not possible to apply for consents until after physical completion), capitalisation of borrowing costs will continue to be appropriate until the consents are obtained, i.e. until the asset is ready for its intended use. (See also **4.2.9-2** in **chapter A7** relating to approval for occupation for a self-constructed property.)

5.6.3.3 Completion of an asset is intentionally delayed

5.6.3.3-1

Completion of an asset is intentionally delayed

When the completion of an asset is intentionally delayed, continued capitalisation of borrowing costs is not permitted. For example, in the case of property development, it is customary for the developer to defer installation of certain fixtures and fittings and the decoration work until units are sold, so that purchasers may choose their own specifications. Such delays relate more to the marketing of units than to the asset construction process.

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5.6.3.4 Cessation of capitalisation for maturing inventories

5.6.3.4-1

Cessation of capitalisation for maturing inventories

For maturing inventories, it is sometimes difficult to determine when the 'period of production' ends, i.e. when inventories are being held for sale as opposed to being held to mature. For example, whisky is 'mature' after three years, but goes on improving with age for many more years. Provided that it is consistent with the entity's business model to hold such items so that they mature further, it would seem acceptable to continue to add borrowing costs to the value of such maturing inventories for as long as it can be demonstrated that the particular item of inventory continues to increase in value solely on account of increasing age, rather than because of market fluctuations or inflation. If this cannot be demonstrated, then the inventories should be regarded as held for sale and no further borrowing costs should be capitalised. (Note that, in some cases, items such as whisky may qualify for the exemption described at **2.3** for inventories that are manufactured, or otherwise produced, in large quantities on a repetitive basis.)

3.2.6 Identifying the functional currency of an investment fund

3.2.6-1

Identifying the functional currency of an investment fund

Some features common to investment funds include the following (the list is not exhaustive).

- Investors in the fund subscribe and redeem their investments in a specific currency. It may not be permitted, depending on the fund's policies or regulatory requirements, to subscribe or redeem such investments in any other currency.
- The fund may conduct its investment activities through subsidiaries set up in various jurisdictions to take advantage of tax treaties, double taxation agreements and concessions.
- The investment fund's policies may allow it to invest in various securities regardless of jurisdiction, industry or currency. Consequently, investment transactions and the related income and expenses may be denominated in several currencies.
- Investment management fees may be invoiced and received in a specific currency.
- Other costs of operating the fund may be denominated in the local currency of the jurisdiction in which the fund physically operates.

IAS 21:12 clarifies that, in determining the functional currency of an entity, management should consider the guidance in IAS 21:9 to 11 (see **3.2.2** to **3.2.4**) – giving IAS 21:9 priority before considering IAS 21:10 and 11.

IAS 21:12 also states that, when the indicators in IAS 21:9 to 11 are mixed and the functional currency is not obvious "management uses its judgement to determine the functional currency that most faithfully represents the economic effects of the underlying transactions, events and conditions".

In the context of an investment fund, IAS 21:9 does not seem immediately relevant and is difficult to apply because its factors are directed towards entities that provide goods and services. However, the same underlying principle can be applied to a fund with a mandate to buy and sell securities to generate a return for investors. Hence, the currency of the country whose competitive forces and regulations mainly determine the fund's revenue should be considered when determining the functional currency. In addition, the currencies in which the fund's labour costs and operating expenses are sourced and incurred should also be considered.

However, when a fund's functional currency is not obvious from the analysis above, consideration of the secondary indicators in IAS 21:10 (see **3.2.3**) may provide additional evidence. The currency in which the fund raises finance from investors (i.e. the investor's participation in a fund) and makes distributions to investors (e.g. on redemption) should be considered. The currency in which dividends on investments or interest inflows are received and retained will provide additional evidence of the functional currency.

The indicators in IAS 21:11 (see **3.2.4**) should also be considered if they are relevant to an investment fund (in a foreign operation).

3.2.7 Functional currency is the currency of a hyperinflationary economy

When the functional currency is the currency of a hyperinflationary economy, the entity's financial statements are restated in accordance with IAS 29 (see **chapter A37**). An entity cannot avoid restatement in accordance with IAS 29 by, for example, adopting as its functional currency a currency other than the functional currency determined in accordance with IAS 21 (such as the functional currency of its parent). [IAS 21:14]

3.2.8 Change in functional currency

3.2.8.1 Circumstances in which an entity's functional currency can be changed

As noted at **3.2.1**, the functional currency of an entity reflects the underlying transactions, events and conditions that are relevant to the entity. Accordingly, once determined, the functional currency can be changed only if there is a change to those underlying transactions, events and conditions. [IAS 21:13] For example, a change in the currency that mainly influences the sales prices of goods and services may lead to a change in an entity's functional currency. [IAS 21:36]

3.2.8.1-1

Impact of foreign currency borrowings on functional currency – example

Company K's functional currency is the euro. Company K accounts for its 43 per cent investment in Company M, a Mexican entity, using the equity method of accounting. Company M's functional currency is the Mexican peso. During the current year, Company M entered into a 200 million euro third-party borrowing denominated in euro. Most of Company M's operations, labour costs and purchases are denominated in the peso and incurred in the domestic market.

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It is not appropriate for Company M to change its functional currency from the peso to the euro. Because the majority of Company M's operations, sales, purchases, labour costs etc. are denominated in the Mexican peso, and Mexico is the country that drives the competitive forces and regulations of that entity, Company M should continue using the Mexican peso as its functional currency. Although, in accordance with IAS 21:10, a large third-party financing in a different currency may in some circumstances provide evidence to support a change in functional currency, greater weight must be given to the factors discussed in IAS 21:9 (sales, purchases, labour costs etc.). Accordingly, in the circumstances described, the new financing is not sufficient, in and of itself, to justify a change in the functional currency from the peso to the euro.

3.2.8.1-2

Change in functional currency – example

KI, located in Ireland, is a wholly-owned subsidiary of Company K. The US dollar is Company K's functional currency and KI has previously identified the euro as its functional currency. The functional currency was identified because KI's sales and purchases were denominated primarily in euro, as were all of KI's labour costs.

During the fourth quarter, KI's operations began to change. KI's sales decreased due to a loss of some sizable contracts while Company K's sales increased due to new significant contracts. Company K began using KI's manufacturing facilities in order to meet its sales orders. KI closed down its sales department because KI will no longer need to generate its own sales as more than 80 per cent will originate from Company K's operations. In addition, Company K has built a new facility to produce the materials needed in KI's manufacturing processes. As at the end of the reporting period, KI began receiving all materials from Company K instead of from outside suppliers.

Based on the changes in KI's business, KI expects cash inflows and outflows, except for wages, primarily to be denominated in US dollars.

IAS 21:36 states that "a change in the currency that influences mainly the sales prices of goods and services may lead to a change in functional currency". In addition, the changes in KI's activities may be such that they are now primarily an extension of the reporting entity, Company K, as discussed in IAS 21:11(a).

There is evidence to suggest that KI's functional currency may have changed. Firstly, the currency of revenues has changed from the euro to primarily the US dollar. This change does not appear to be temporary because the sales department has been closed down. Secondly, the currency of cash outflows for materials has also changed to the US dollar. Company K has built a new facility that will make these materials, so this change does not appear to be temporary either. Lastly, the position of KI's operations within Company K's overall operating strategy has changed, from a self-supporting, stand-alone operating entity to what is primarily a manufacturing facility of Company K.

3.2.8.2 Date at which change in functional currency is recognised

3.2.8.2-1

Date at which change in functional currency is recognised

A change in functional currency should be reported as of the date it is determined that there has been a change in the underlying events and circumstances relevant to the reporting entity that justifies a change in the functional currency. This could occur on any date during the year. For convenience, and as a practical matter, there is a practice of using a date at the beginning of the most recent period (annual or interim, as the case might be).

In accordance with IAS 21:35, when there is a change in an entity's functional currency, the entity applies the translation procedures applicable to the new functional currency prospectively from the date of the change.

In other words, all items are translated into the new functional currency using the exchange rate at the date of the change. The resulting translated amounts for non-monetary items are treated as their historical cost. Exchange differences arising from the translation of a foreign operation previously recognised in other comprehensive income are not reclassified from equity to profit or loss until the disposal of the operation (see **section 6**). [IAS 21:37]

See **5.8** for an example of a change in both the functional and the presentation currencies.

An entity should disclose when there has been a change in functional currency, and the reasons for the change (see **9.2**).

3.2.8.3 Change in functional currency – reassessment of liability/equity classification

A change in functional currency may lead to a reassessment of the liability/equity classification of a financial instrument (see **section 8** of **chapter B3** or, for entities that have not yet adopted IFRS 9, **section 8** of **chapter C3** for further discussion).

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3.3 Initial recognition of foreign currency transactions

3.3.1 Transactions to be recognised at spot rate at the date of the transaction

The functional currency amount at which transactions denominated in foreign currencies should initially be recognised will be determined by using the exchange rate appropriate to the transaction. This is the spot rate between the functional currency and the foreign currency at the date of the transaction. [IAS 21:21] The date of the transaction is the date on which the transaction first qualifies for recognition in accordance with IFRS Standards. [IAS 21:22]

See **3.3.3** for further guidance on the determination of the date of the transaction when an entity pays or receives consideration in advance in a foreign currency.

3.3.1-1

Initial recognition of purchase of inventories – example

An entity with a functional currency of sterling buys inventories for US$15,000. The spot rate is £1 = US$1.50. The inventories are measured at initial recognition at £10,000 (US$15,000/1.50).

3.3.2 Use of average rate that approximates the actual rate

For practical reasons, a rate that approximates the actual rate at the date of the transaction is often used. For example, an average rate for a week or a month might be used for all transactions in each foreign currency occurring during that period. If exchange rates fluctuate significantly, however, the use of the average rate for a period is inappropriate. [IAS 21:22]

3.3.2-1

Use of average rate on initial recognition

It is common practice for entities that engage in a large number of foreign currency transactions to fix, for a period, the rate of exchange used to measure those transactions in their accounting records and to disregard day-to-day fluctuations in exchange rates. When this approach is used, care must be taken to ensure that the carrying amount of non-monetary assets (e.g. inventories or property, plant and equipment) is not materially different from what it would have been if actual rates had been used for translation. The actual rates should be used if a material difference would arise compared to average rates (e.g. to measure large one-off transactions such as the acquisition of property, plant and equipment or if there is a significant and unexpected movement in exchange rates).

IAS 21 clearly acknowledges that some degree of approximation is acceptable. It will be a matter of judgement, on the basis of an entity's specific facts and circumstances, whether it is appropriate to derive an average rate for the entire year or whether the year should be analysed into shorter periods (e.g. quarterly periods, months or weeks) with an average rate determined for each.

3.3.3 IFRIC 22 Foreign Currency Transactions and Advance Consideration

3.3.3.1 IFRIC 22 – general

IFRIC 22 was published by the Board in December 2016 to clarify the appropriate exchange rate to use when the consideration for a transaction is denominated in a foreign currency and is paid or received in advance, giving rise to a non-monetary asset or non-monetary liability (e.g. a prepayment or accrual).

IAS 21 requires an entity to record a transaction denominated in a foreign currency, initially, at the spot rate "at the date of the transaction" which is defined in IAS 21:22 as "the date on which the transaction first qualifies for recognition in accordance with IFRSs" (see **3.3.1**). IFRIC 22 focuses on how to determine that date when an entity pays or receives consideration in advance in a foreign currency. In such circumstances, a non-monetary asset or non-monetary liability is generally recognised when the advance consideration is received – recognition of the related asset, expense or income comes later when recognition criteria are met in accordance with relevant IFRS Standards.

This issue arises frequently, for example in the context of foreign-currency denominated: [IFRIC 22:BC5]

- revenue from contracts with customers;
- purchases and sales of property, plant and equipment;
- purchases and sales of intangible assets;
- purchases and sales of investment property;
- purchases of inventory;
- purchases of services;

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3.3.3.4 Single payment in advance for purchase of a single item

3.3.3.4-1

Single payment in advance for purchase of a single item – example

Entity A, which has a functional currency of Japanese yen (JPY), enters into a contract to purchase a single item of inventory from Entity B on 1 August 20X3 for a fixed price of US$500 which is paid on 15 August 20X3. The inventory is delivered to Entity A on 30 September 20X3.

The exchange rate on 15 August 20X3 is US$1 = JPY90.

The exchange rate on 30 September 20X3 is US$1 = JPY95.

On 15 August 20X3, Entity A recognises a prepayment (non-monetary asset) using the exchange rate on that date as follows.

		JPY	JPY
Dr	Prepayment (US$500 × 90)	45,000	
Cr	Cash (US$500 × 90)		45,000

The prepayment is a non-monetary asset and consequently, in accordance with IAS 21:23(b), it is not subsequently retranslated (see **3.5.1**).

On 30 September 20X3, when the inventory is delivered, Entity A derecognises the prepayment and recognises inventory in the statement of financial position. In accordance with IFRIC 22:8 (see **3.3.3.3**), Entity A recognises inventory using the exchange rate at the date of initial recognition of the non-monetary asset (i.e. US$1 = JPY90) as follows.

		JPY	JPY
Dr	Inventory	45,000	
Cr	Prepayment		45,000

3.3.3.5 Multiple receipts for revenue recognised at a point in time

3.3.3.5-1

Multiple receipts for revenue recognised at a point in time – example

On 1 February 20X7, Entity G, which has a functional currency of South Korean Won (KRW), enters into a contract to deliver goods to Entity H on 1 March 20X7. The fixed contract price is £1,000, £400 payable on 15 February 20X7 and £600 payable on 15 March 20X7.

The exchange rate on 15 February 20X7 is £1 = KRW1,500.

The exchange rate on 1 March 20X7 is £1 = KRW1,800.

The exchange rate on 15 March 20X7 is £1 = KRW 2,000.

On 15 February 20X7, Entity G receives the first payment and recognises a non-monetary contract liability (deferred income) using the exchange rate on that date as follows.

		KRW	KRW
Dr	Cash (£400 × 1,500)	600,000	
Cr	Contract liability (£400 × 1,500)		600,000

The contract liability is a non-monetary liability and consequently, in accordance with IAS 21:23(b), it is not subsequently retranslated (see **3.5.1**).

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On 1 March 20X7, when the goods are delivered to Entity H, Entity G derecognises the contract liability and, in accordance with IFRIC 22:8 (see **3.3.3.3**), recognises revenue in profit or loss using the exchange rate at the date of initial recognition of the non-monetary liability (i.e. £1 = KRW1,500). Entity G also recognises the remaining revenue of £600 for the sale of the goods using the exchange rate at the date of the sale (£1 = KRW1,800) as follows.

		KRW	KRW
Dr	Contract liability	600,000	
Dr	Receivable (£600 × 1,800)	1,080,000	
Cr	Revenue (KWR600,000 + KRW1,080,000)		1,680,000

The receivable is a monetary item which is retranslated up to the date that the receivable is settled in accordance with IAS 21:23(a) (see **3.4.2**) as follows.

		KRW	KRW
Dr	Receivable	120,000	
Cr	Foreign exchange gain (profit or loss) (£600 × (2,000 – 1,800))		120,000

On 15 March 20X7, the second payment is received by Entity G and the receivable is derecognised as follows.

		KRW	KRW
Dr	Cash (£600 × 2,000)	1,200,000	
Cr	Receivable (KRW1,080,000 + KRW120,000)		1,200,000

The exchange rate on 30 November 20X8 is US$1 = CHF1.9.

On 1 August 20X8, Entity J receives the first payment and recognises a non-monetary contract liability (deferred income) using the exchange rate on that date as follows.

		CHF	CHF
Dr	Cash (US$1,500 × 1.5)	2,250	
Cr	Contract liability (US$1,500 × 1.5)		2,250

The contract liability is a non-monetary liability and consequently, in accordance with IAS 21:23(b), it is not subsequently retranslated (see **3.5.1**).

On 31 August 20X8, when Product A is delivered to Entity L, Entity J derecognises the contract liability and, in accordance with IFRIC 22:8 (see **3.3.3.3**), recognises revenue in profit or loss using the exchange rate at the date of initial recognition of the non-monetary liability (i.e. the rate at 1 August 20X8 – US$1 = CHF1.5). Entity J recognises the remaining revenue of US$500 allocated to Product A using the exchange rate at 31 August 20X8 (US$1 = CHF1.7).

		CHF	CHF
Dr	Contract liability	2,250	
Dr	Receivable (US$500 × 1.7)	850	
Cr	Revenue (CHF2,250 + CHF850)		3,100

The receivable is a monetary item which is retranslated up to the date that the receivable is settled in accordance with IAS 21:23(a) (see **3.4.2**) as follows.

		CHF	CHF
Dr	Receivable	100	
Cr	Foreign exchange gain (profit or loss) (€500 × (1.9 – 1.7))		100

On 30 November 20X8, Product B is delivered to Entity L and the second payment is received by Entity J. Entity J recognises revenue of US$3,000 for the sale of Product B using the exchange rate at the date of the transaction (US$1 = 1.9) and derecognises the receivable as follows.

		CHF	CHF
Dr	Cash (US$3,500 × 1.9)	6,650	
Cr	Revenue (US$3,000 × 1.9)		5,700
Cr	Receivable (CHF850 + CHF100)		950

3.3.3.8 *Effective date and transition arrangements for IFRIC 22*

IFRIC 22 is effective for annual periods beginning on or after 1 January 2018, with earlier application permitted. If an entity applies IFRIC 22 for a period beginning before 1 January 2018, it is required to disclose that fact. [IFRIC 22:A1]

An entity can choose to apply IFRIC 22 either retrospectively, applying IAS 8, or prospectively. [IFRIC 22:A2] If it chooses to apply IFRIC 22 prospectively, it should apply IFRIC 22 to all assets, expenses and income in the scope of IFRIC 22 initially recognised on or after either: [IFRIC 22:A2(b)]

- the beginning of the reporting period in which the entity first applies IFRIC 22; or
- the beginning of a prior reporting period presented as comparative information in the financial statements of the reporting period in which the entity first applies IFRIC 22.

When IFRIC 22 is applied prospectively, assets, expenses and income initially recognised on or after the cut-off date selected under IFRIC 22:A2(b) should be accounted for in accordance with IFRIC 22 even when the non-monetary asset or non-monetary liability arises from advance consideration received or paid before that date. [IFRIC 22:A3]

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3.3.3.8-1

Prospective application of IFRIC 22 – example

Entity A, which has a functional currency of Australian dollars, adopts IFRIC 22 for the year beginning 1 January 2018 and chooses, in accordance with IFRIC 22:A2(b), to apply IFRIC 22 from the beginning of that reporting period (i.e. for all transactions on or after 1 January 2018). Entity A received a payment in euro on 30 November 2017 for a transaction for which the revenue will be recognised on 15 January 2018. Although the payment was received before 1 January 2018, because the revenue is recognised after 1 January 2018, the transaction is in the scope of IFRIC 22 and, therefore, for the purposes of calculating the revenue recognised on 15 January 2018, the spot exchange rate on 30 November 2017 should be used.

3.4 Reporting foreign currency items at the end of subsequent reporting periods – monetary items

3.4.1 *Monetary items – definition*

Monetary items are defined as units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency. [IAS 21:8]

- meet the definition of an asset or a liability at the acquisition date; [IFRS 3:11] and
- be part of the business acquired (the acquiree) rather than the result of a separate transaction (see **8.3**). [IFRS 3:12]

Note that, when applying IFRS 3, acquirers are required to apply the definitions of an asset and a liability and supporting guidance in the IASC's *Framework for the Preparation and Presentation of Financial Statements* adopted by the Board in 2001 rather than the *Conceptual Framework for Financial Reporting* issued in March 2018 (see **1.2**).

7.1.1-1

Goodwill previously recognised by the acquiree – example

Entity A acquires 100 per cent of Entity B for CU100. The net assets recognised in Entity B's consolidated statement of financial position at the date of acquisition comprise goodwill of CU20 that arose when Entity B acquired one of its subsidiaries and identifiable net assets of CU70 (for simplicity, assume that the carrying amount of the identifiable net assets equals their fair value).

Assume that there are no assets or liabilities that are not recognised in Entity B's statement of financial position that should be recognised as part of the accounting for the business combination.

In Entity A's consolidated financial statements, the goodwill previously recognised by Entity B should not be recognised separately from the goodwill arising on Entity A's acquisition of Entity B. Any goodwill that is recognised in the statement of financial position of the acquiree is ignored when recognising the identifiable assets acquired and liabilities assumed by the parent. Therefore, in the circumstances described, the goodwill arising on the acquisition of Entity B is CU30.

However, any business combination entered into by Entity B after the date of acquisition by Entity A will be a business combination from the perspective of both Entity B and Entity A and will give rise to goodwill both in the consolidated financial statements of Entity B (if consolidated financial statements are presented by Entity B) and in the consolidated financial statements of Entity A.

The following are outcomes that result from applying the recognition condition in IFRS 3:11 (see above).

- **Post-acquisition reorganisation** Costs that the acquirer expects but is not obliged to incur in the future to effect its plan to exit an activity of an acquiree or to terminate the employment of or relocate an acquiree's employees are not liabilities at the acquisition date. [IFRS 3:11]

- **Unrecognised assets and liabilities** The acquirer may recognise some assets and liabilities that the acquiree had not previously recognised in its financial statements. For example, the acquirer recognises the acquired identifiable intangible assets (e.g. brand names, patents or customer relationships) that the acquiree did not recognise as assets in its financial statements because it developed them internally and recognised the related costs as expenses. [IFRS 3:13]

7.1.2 *Classifying or designating identifiable assets acquired and liabilities assumed in a business combination*

7.1.2.1 *Classification or designation generally based on conditions at the acquisition date*

Subject to the exceptions set out at **7.1.2.2**, IFRS 3 requires that, *at the acquisition date*, the identifiable assets acquired and liabilities assumed should be classified or designated as necessary to apply other IFRS Standards subsequently. The acquirer makes those classifications or designations on the basis of contractual terms, economic conditions, its operating or accounting policies, and other pertinent conditions as they exist at the acquisition date. [IFRS 3:15]

Examples of classifications or designations made at the acquisition date include: [IFRS 3:16]

- for entities that have adopted IFRS 9:
  - classification of particular financial assets as measured at fair value through profit or loss or at amortised cost, or as a financial asset measured at fair value through other comprehensive income, in accordance with IFRS 9;
  - designation of a derivative as a hedging instrument in accordance with IFRS 9; and
  - assessment of whether an embedded derivative should be separated from a host contract in accordance with IFRS 9 (which is a classification matter); and
- for entities that have not yet adopted IFRS 9:
  - classification of particular financial assets and liabilities as a financial asset or liability at fair value through profit or loss, or as a financial asset available for sale or held-to-maturity in accordance with IAS 39;
  - designation of a derivative as a hedging instrument in accordance with IAS 39; and
  - assessment of whether an embedded derivative should be separated from a host contract in accordance with IAS 39 (which is a classification matter).

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7.1.2.2 Circumstances in which classification or designation is based on conditions not at the acquisition date

For entities that have not yet adopted IFRS 17, IFRS 3 specifies two exceptions to the principle (set out at **7.1.2.1**) that classifications or designations are based on the terms of the instruments and conditions at the acquisition date. The two exceptions relate to: [IFRS 3:17]

- the classification of a lease contract as either an operating lease or a finance lease. This exception applies for lessors under IFRS 16 (effective for annual periods beginning on or after 1 January 2019, with earlier application permitted – see **chapter A17**) and for both lessees and lessors under IFRS 16's predecessor Standard IAS 17 (see **appendix A4**); and
- the classification of a contract as an insurance contract in accordance with IFRS 4 (see **chapter A39**).

The acquirer classifies such leases and insurance contracts on the basis of the contractual terms and other factors *at the inception of the contract* (or, if the terms of the contract have been modified in a manner that would change its classification, at the date of that modification, which might be the acquisition date).

For entities that have adopted IFRS 17 (effective for annual periods beginning on or after 1 January 2021 – see **section 7** of **chapter A39** for a summary of its requirements), the exception regarding the classification of insurance contracts is deleted and specific measurement requirements are introduced (see **7.5.6**).

7.2 Measurement principle for assets and liabilities

7.2.1 Measurement principle – general

Identifiable assets acquired and liabilities assumed are measured at their acquisition-date fair values. [IFRS 3:18] Fair value is defined as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See IFRS 13*Fair Value Measurement*.)". [IFRS 3:Appendix A]

7.2.2 Assets with uncertain cash flows (valuation allowances)

An acquirer is not permitted to recognise a separate valuation allowance as at the acquisition date for assets acquired in a business combination that are measured at their acquisition-date fair values because the effects of uncertainty about future cash flows are included in the fair value measure. For example, because IFRS 3 requires the acquirer to measure acquired receivables, including loans, at their acquisition-date fair values, the acquirer does not recognise a separate valuation allowance for the contractual cash flows that are deemed to be uncollectible at that date nor, for entities that have adopted IFRS 9, a loss allowance for expected credit losses. [IFRS 3:B41]

The requirements of IFRS 3:B41 have been updated for consequential amendments arising from IFRS 9.

The principle of 'no valuation allowance' also extends to property, plant and equipment such that, following a business combination, such assets are stated at a single fair value amount, and not at a gross 'deemed cost' and accumulated depreciation.

7.2.3 Assets that the acquirer intends not to use or to use in a way that is different from the way other market participants would use them

To protect its competitive position, or for other reasons, the acquirer may intend not to use an acquired non-financial asset actively, or it may not intend to use the asset according to its highest and best use. For example, that might be the case for an acquired research and development intangible asset that the acquirer plans to use defensively by preventing others from using it. Nevertheless, the acquirer is required to measure the fair value of the non-financial asset assuming its highest and best use by market participants in accordance with the appropriate valuation premise, both initially and when measuring fair value less costs of disposal for subsequent impairment testing. [IFRS 3:B43]

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This requirement has been stated explicitly in IFRS 3 to avoid inconsistencies in practice. IFRS 13 describes the concept of highest and best use and provides examples of its application in a business combination (see **section 4** of **chapter A6**). [IFRS 3:BC262]

7.2.3-1

Acquisition of an intangible asset that will not be used – example

Company A acquires Company B. The identifiable net assets of Company B include a trademark, which is a logo previously used by Company B as a direct competitor to Company A. Company A does not intend to use this logo in the future.

The logo is considered to be separable because it could, for example, be licensed to a third party. It also arises from legal rights. Therefore, the intangible asset should be recognised, separately from goodwill, as part of the accounting for the business combination.

For the purposes of impairment testing, the question of whether the logo should be allocated to existing cash-generating units of

they will be accounted for as equity transactions. This is discussed further at **11.4.5** in **chapter A24**;

- this would suggest that the amount of goodwill that is subject to impairment testing under IAS 36 will differ. However, the requirements of IAS 36 mean that this effect is equalised (see **8.2.8.6** in **chapter A10**). When an entity measures NCIs at their proportionate interest in the net identifiable assets of a subsidiary at the acquisition date, rather than at fair value, for the purposes of impairment testing, the carrying amount of goodwill allocated to the cash-generating unit (CGU) is grossed up to include the goodwill attributable to the NCIs. This adjusted carrying amount is then compared with the recoverable amount of the CGU to determine whether the CGU is impaired (see IAS 36:C4).

7.3.3 Measuring the fair value of non-controlling interests

For the purpose of measuring NCIs at fair value, it may be possible to measure the acquisition-date fair value on the basis of a quoted price in an active market for the equity shares not held by the acquirer. When a quoted price in an active market for the equity shares is not available because the shares are not publicly traded, the acquirer should measure the fair value of the NCIs using another valuation technique. [IFRS 3:B44]

The fair values of the acquirer's interest in the acquiree and the NCIs on a per-share basis may differ. The main difference is likely to be the inclusion of a control premium in the per-share fair value of the acquirer's interest in the acquiree or, conversely, the inclusion of a discount for lack of control in the per-share fair value of the NCIs if market participants would take into account such a premium or discount when pricing the non-controlling interests. [IFRS 3:B45]

7.3.3-1

Potential to arrive at different fair values for non-controlling interests reflecting different circumstances – example

Entity A acquired Entity B in two separate transactions:

- a one-third equity interest for which Entity A paid CU10 per share, which resulted in Entity A having significant influence over Entity B; and
- a further one-third equity interest for which Entity A paid CU15 per share, which resulted in Entity A having a controlling interest.

Based on the market prices of the remaining shares, Entity A assesses the fair value of the non-controlling interests at CU9 per share.

In this case, it appears that three different fair values have been attributed to similar-sized equity interests. However, each fair value reflects a different fact pattern and, therefore, a different market:

- CU10 represents the fair value of an equity interest carrying significant influence in an entity where other holdings are dispersed and the holder has the potential to launch a bid for a controlling interest;
- CU15 represents the fair value of a controlling interest, including a control premium; and
- CU9 represents the fair value of an equity interest in an entity controlled by another party.

7.3.4 Statutory obligation to launch a takeover bid

7.3.4-1

Statutory obligation to launch a takeover bid – example

Entity A has an agreement with the shareholders of Entity B to acquire 60 per cent of the shares in Entity B, a listed entity. Under local law, an investor purchasing 30 per cent or more of a listed entity is obliged to launch a takeover bid for the remaining shares. All conditions for the acquisition of the 60 per cent interest have been satisfied.

The obligation to launch a takeover bid for the remaining interest in Entity B should be recognised as a liability by Entity A if the obligation results in either a financial liability or an onerous contract for Entity A. Paragraph AG12 of IAS 32 clarifies that "[l]iabilities or assets that are not contractual (such as income taxes that are created as a result of statutory requirements imposed by governments) are not financial liabilities or financial assets".

In the circumstances described, for the holders of the remaining 40 per cent of the shares in Entity B, the statutory obligation on Entity A to purchase their shares is not a contractual right to receive cash evidenced by a financial instrument and is not a financial asset. For Entity A, the statutory obligation to make the offer is not a contractual obligation evidenced by a financial instrument and no financial liability should be recognised.

Entity A should consider whether a liability for an onerous contract should be recognised in accordance with IAS 37 as a result of the statutory obligation to launch a takeover bid.

The acquisition of the remaining 40 per cent interest (or part of it) should be accounted for when it occurs as an equity transaction in accordance with paragraph 23 of IFRS 10 (see **11.4** in **chapter A24**).

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7.4 Guidance on the recognition and measurement of specific categories of assets and liabilities

7.4.1 Operating leases

IFRS 3 includes specific guidance on how operating leases should be recognised and measured when accounting for a business combination.

- **Classification as operating or finance** Classification of a lease contract as either an operating or a finance lease at the acquisition date is based on factors at the inception of the lease, which is generally before the acquisition date. If the terms of the contract have been changed subsequent to the inception of the lease such that the classification of the lease would change, then the classification at the acquisition date is based on the contractual terms and other factors at the date of that change. This means that an acquiree's lease classifications (if determined in accordance with IFRS Standards) are not changed when accounting for the business combination, unless a lease contract is modified at the date of acquisition. [IFRS 3:17]

  This guidance applies for lessors under IFRS 16 (effective for annual periods beginning on or after 1 January 2019, with earlier application permitted – see **chapter A17**) and for both lessees and lessors under IFRS 16's predecessor Standard IAS 17 (see **appendix A4**);

- **Measurement when acquiree is the lessee** In general, the acquirer should not recognise any asset or liability related to an operating lease in which the acquiree is the lessee. [IFRS 3:B28] It follows that any lease incentive that is being amortised by the acquiree will not be recognised by the acquirer. However, the acquiree may be party to operating lease arrangements that involve future lease payments at below or above market rates. The acquirer determines whether the terms of each operating lease in which the acquiree is the lessee are favourable or unfavourable. The acquirer recognises an intangible asset if the terms of an operating lease are favourable relative to market terms, and a liability if the terms are unfavourable relative to market terms. [IFRS 3:B29]

  IFRS 3:B28 and B29 are deleted as consequential amendments arising from IFRS 16. Under that Standard, right-of-use assets and lease liabilities are recognised by the acquirer for all leases in which the acquiree is the lessee, subject to specified exceptions (see **7.5.10**).

  The guidance in **7.4.1-1** and **7.4.1-2** below is therefore only relevant for entities applying IAS 17.

7.4.1-1

Acquiree has deferred rent relating to an operating lease – example

Entity A acquires Entity B. Before the acquisition date, Entity B recognised deferred rent relating to an operating lease as a liability in its statement of financial position (because Entity B has benefited from a rent-free period under the terms of the lease agreement but is required to recognise the lease payments on a straight-line basis over the lease term in accordance with IAS 17).

Entity A should not recognise Entity B's deferred rent as a liability at the acquisition date because it does not meet the definition of a liability. Instead, as required by IFRS 3:B29, Entity A will recognise an intangible asset if the terms of the operating lease are favourable relative to market terms and a liability if the terms are unfavourable relative to market terms.

Entity A should, however, recognise any additional deferred rent arising in the post-combination period based on the terms of the assumed lease.

Assume that Entity B's lease has a five-year term with a rent-free period in Year 1, payments in Years 2 and 3 of CU150, in Year 4 of CU200 and in Year 5 of CU250.

At the acquisition date, the lease had a remaining contractual life of three years and Entity B had recognised a liability of CU150 for deferred rent. This is calculated as the straight-line accumulated expense of CU300 [(CU150 + CU150 + CU200 + CU250) ÷ 5 × 2] less cash payments of CU150.

Entity A does not recognise any amounts related to Entity B's deferred rent liability on the acquisition date. However, the terms of the lease will give rise to deferred rent in the post-combination period. Entity A will recognise a deferred rent liability of CU50 at the end of the first year after acquisition. This is calculated as the straight-line expense of CU200 [(CU150 + CU200 + CU250) ÷ 3] less cash payments of CU150.

Entity A may also need to recognise an asset or a liability at the acquisition date to the extent that the future lease payments are favourable or unfavourable relative to market terms. For example, if market rates at the date of acquisition are CU220 per annum, Entity A will recognise an asset reflecting the fair value of the difference between this and the actual future payments, which will average CU200 per annum.

- **Separate identifiable intangible asset** An identifiable intangible asset may be associated with an operating lease, which may be evidenced by market participants' willingness to pay a price for the lease even if it is

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