Philippine Interpretations Committee

Guidance on Financial Reporting
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Introduction

When it comes to accounting for their transactions and disclosing the required information in their financial statements, companies in the Philippines have been consistently applying Philippine Financial Reporting Standards or PFRS since the adoption of these standards in 2005. However, preparers of financial statements oftentimes encounter instances where there is no explicit guidance in the PFRS applicable to specific transactions. Thus, there is a need to supplement PFRS through the issuance of PIC Q&As which are approved and adopted by the Financial Reporting Standards Council (FRSC).

To further provide guidance on recurring financial reporting issues, the PIC has decided to issue this Financial Reporting Guidance (FRG), which is, in large part, based on the final decisions and rejection notices of the IFRS Interpretations Committee (IFRIC), the interpretations body supporting the IASB. Through this FRG, the PIC aims to:

- Provide continuous and up-to-date guidance on emerging issues elevated to the IASB or the IFRIC and for which these two bodies have already expressed their views;
- Provide additional guidance to both the preparers and the users of the financial statements, including those in the academe, about complex financial reporting issues; and,
- Provide guidance, with a simplified discussion of the basis for the final decisions reached by the IASB and IFRIC, for ease of reference and understanding.

This FRG is meant to be ‘organic’ in the sense that it will change and adapt accordingly as our financial reporting landscape evolves. We anticipate that this document will be updated on an annual basis to keep readers up-to-date on any future changes in our financial reporting framework.
Date approved by PIC: July 29, 2015 (Original signed)

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Date approved by FRSC: January 13, 2016
**PFRS 2, Share-based Payment**

**PFRS 2 – Price difference between the institutional offer price and the retail offer price for shares in an initial public offering**

**Issue**

Should an entity account for a price difference between the institutional offer price and the retail offer price for shares issued in an initial public offering (IPO) within the scope of PFRS 2, *Share-based Payment*?

**Background**

In an IPO, the final retail price could be different from the institutional price because of:

a. an unintentional difference arising from the book-building process; or

b. an intentional difference arising from a discount given to retail investors by the issuer of the equity instruments as indicated in the prospectus.

There are situations in which the issuer needs to fulfil a minimum number of shareholders to qualify for a listing under the stock exchange’s regulations in its jurisdiction. In achieving this minimum number, the issuer may offer shares to retail investors at a discount from the price at which shares are sold to institutional investors.

**Consensus**

To consider whether the transaction is a share-based payment transaction within the scope of PFRS 2, it must involve the receipt of identifiable or unidentifiable goods or services from the retail shareholder group.

Paragraph 13A of PFRS 2 requires that if consideration received by the entity appears to be less than the fair value of the equity instruments granted or liability incurred, then this situation typically indicates that other consideration (i.e. unidentified goods or services) has been (or will be) received by the entity.

Applying this guidance requires judgment and consideration of the specific facts and circumstances of each transaction.

In the circumstances underlying the transaction, the entity issues shares at different prices to two different groups of investors (retail and institutional) for the purpose of raising funds, and that the difference, if any, between the retail price and the institutional price of the shares in the fact pattern appears to relate to the existence of different markets (one that is accessible to retail investors only and another one accessible to institutional investors only) instead of the receipt of additional goods or services, because the only relationship between the entity and the parties to whom the shares are issued is that of investee-investors.

Consequently, the guidance in PFRS 2 is not applicable because there is no share-based payment transaction.
In the fact pattern considered, the listing is not received from the institutional or retail shareholders. The fact that a regulatory requirement is met by virtue of issuing the retail shares does not indicate that unidentifiable goods or services were received from the purchasers.
PF 3, *Business Combinations*

PF 3 and PF 2 – Accounting for reverse acquisitions that do not constitute a business

**Issue**

How should transactions in which the former shareholders of a non-listed operating entity become the majority shareholders of the combined entity by exchanging their shares for new shares of a listed non-operating entity be accounted for?

The transaction is structured such that the listed non-operating entity acquires the entire share capital of the non-listed operating entity.

**Background**

The transaction has some features of a reverse acquisition under PF 3, *Business Combinations*, because the former shareholders of the legal subsidiary obtain control of the legal parent.

In the absence of a Standard that specifically applies to the transaction, it is appropriate to apply by analogy, in accordance with paragraphs 10-12 of PAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, the guidance in paragraphs B19–B27 of PF 3 for reverse acquisitions.

Application of the reverse acquisitions guidance by analogy would result in the non-listed operating entity being identified as the accounting acquirer, and the listed non-operating entity being identified as the accounting acquiree. In applying the reverse acquisition guidance in paragraph B20 of PF 3 by analogy, the accounting acquirer is deemed to have issued shares to obtain control of the acquiree.

If the listed non-operating entity qualifies as a business on the basis of the guidance in paragraph B7 of PF 3, PF 3 would be applicable to the transaction. However, if the listed non-operating entity is not a business, the transaction is not a business combination and is therefore not within the scope of PF 3.

**Consensus**

Based on the above discussion, the transaction is not within the scope of PF 3 and is therefore a share-based payment transaction which should be accounted for in accordance with PF 2, *Share-based Payment*.

On the basis of the guidance in paragraph 13A of PF 2, any difference in the fair value of the shares deemed to have been issued by the accounting acquirer and the fair value of the accounting acquiree’s identifiable net assets represents a service received by the accounting acquirer.

Regardless of the level of monetary or non-monetary assets owned by the non-listed operating entity, the entire difference should be considered to be payment for a service of a stock exchange listing for its shares, and that no amount should be considered a cost of
raising capital. The service received in the form of a stock exchange listing does not meet the definition of an intangible asset because it is not “identifiable” in accordance with paragraph 12 of PAS 38 (i.e. it is not separable). The service received also does not meet the definition of an asset that should be recognized in accordance with other Standards and the Conceptual Framework.

On the basis of the guidance in paragraph 8 of PFRS 2 which states that “when the goods or services received or acquired in a share-based payment transaction do not qualify for recognition as assets, they shall be recognized as expenses”, the cost of the service received is recognized as an expense.

**PFRS 3 – Continuing employment**

**Issue**

In accordance with PFRS 3, *Business Combinations*, what is the accounting for contingent payments to selling shareholders in circumstances in which those selling shareholders become, or continue as, employees?

**Background**

Paragraph B55(a) of PFRS 3 states that:

“The terms of continuing employment by the selling shareholders who become key employees may be an indicator of the substance of a contingent consideration arrangement. The relevant terms of continuing employment may be included in an employment agreement, acquisition agreement or some other document. A contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is remuneration for post-combination services. Arrangements in which the contingent payments are not affected by employment termination may indicate that the contingent payments are additional consideration rather than remuneration.”

Some asked for clarification whether paragraph B55(a) of PFRS 3 is conclusive in determining that payments to an employee that are forfeited upon termination of employment are remuneration for post-combination services and not part of the consideration for an acquisition. The question arose because they asserted that paragraph B55 introduces subparagraphs (a) - (h) as indicators, but paragraph B55(a) uses conclusive language stating that the arrangement described is remuneration for post-combination services.

**Consensus**

An arrangement in which contingent payments are automatically forfeited if employment terminates would lead to a conclusion that the arrangement is compensation for post-combination services rather than additional consideration for an acquisition, unless the service condition is not substantive. This conclusion is reached on the basis of the conclusive language used in paragraph B55(a) of PFRS 3.
PFRS 3 – Identification of the acquirer in accordance with PFRS 3 and the parent in accordance with PFRS 10 Consolidated Financial Statements in a stapling arrangement

Issue

Is an acquirer identified for the purpose of PFRS 3 (as revised 2008) considered a parent for the purpose of PFRS 10 in circumstances in which a business combination is achieved by contract alone, such as a stapling arrangement, with no combining entity obtaining control of the other combining entities?

Background

PFRS 3 (as revised 2008) defines a business combination as “a transaction or other event in which an acquirer obtains control of one or more businesses”. In addition, PFRS 3 (as revised 2008) refers to PFRS 10 for the meaning of the term ‘control’. PFRS 10 states that an investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. It is observed that an investment is not needed in order for an entity to control another entity.

The definition of a business combination in PFRS 3 (as revised 2008) includes transactions in which an acquirer obtains control of one or more businesses. It also includes transactions that are sometimes referred to as ‘true mergers’ or ‘mergers of equals’. In other words, it includes transactions in which none of the combining entities obtains control of the other combining entities. If the stapling arrangement combines separate entities and businesses by the unification of ownership and voting interests in the combining entities, then such a transaction is a business combination as defined by PFRS 3 (as revised 2008).

Consensus

Notwithstanding the fact that PFRS 3 (as revised 2008) includes business combinations in which none of the combining entities obtains control of the other combining entities, paragraph 6 of PFRS 3 (as revised 2008) requires that one of the combining entities in a business combination must be identified as the acquirer. Paragraphs B14–B18 of PFRS 3 (as revised 2008) provides additional guidance for identifying the acquirer if the guidance in PFRS 10 does not clearly indicate which combining entity is the acquirer.

Paragraph B15(a) of PFRS 3 (as revised 2008) provides guidance on identifying the acquirer by assessing the relative voting rights in the combined entity after the combination – this guidance explains that the acquirer is usually the combining entity whose owners, as a group, receive the largest portion of the voting rights in the combined entity. This guidance is consistent with the observation that the definition of a business combination includes transactions in which none of the combining entities or businesses is identified as having
control of the other combining entities. This guidance would be relevant to identifying which of the combining entities is the acquirer in the stapling transaction considered.

The intended interaction between PFRS 3 (issued in 2004) and PAS 27 Consolidated and Separate Financial Statements is that an entity that is identified as the ‘acquirer’ of another entity in accordance with PFRS 3 (issued in 2004) is a ‘parent’ for the purposes of PAS 27. The meaning of the term ‘acquirer’ has not changed since 2004 and that the term ‘control’ is used consistently between PFRS 3 (as revised in 2008) and PFRS 10. It also noted that the notion in PFRS 3 (as revised in 2008) that a business combination could occur even if none of the combining entities obtains control of the other combining entities has not changed from PFRS 3 (issued in 2004). Accordingly, the interaction between PFRS 3 (issued in 2004) and PAS 27 remains valid in respect of the interaction between PFRS 3 (as revised in 2008) and PFRS 10. Consequently, the combining entity in the stapling arrangement that is identified as the acquirer for the purpose of PFRS 3 (as revised in 2008) should prepare consolidated financial statements of the combined entity in accordance with PFRS 10.
PFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*

**PFRS 5 – Classification in conjunction with a planned IPO, but where the prospectus has not been approved by the securities regulator**

**Issue**

Would a disposal group qualify as held for sale before the prospectus is approved by the securities regulator, assuming that all of the other criteria in PFRS 5, *Non-current Assets Held for Sale and Discontinued Operations* have been fulfilled?

**Background**

This Q&A deals with the application of the guidance in PFRS 5 regarding the classification of a non-current asset (or disposal group) as held for sale, in the case of a disposal plan that is intended to be achieved by means of an initial public offering (IPO), but where the prospectus (i.e., the legal document with an initial offer) has not yet been approved by the securities regulator.

**Consensus**

Paragraph 7 of PFRS 5 requires that the asset (or disposal group) must be available for immediate sale in its present condition, subject only to terms that are usual and customary for sales of such assets (or disposal groups) and its sale must be highly probable.

An entity should apply the guidance in paragraphs 8-9 of PFRS 5 to assess whether the sale of a disposal group by means of an IPO is highly probable. Terms that are "usual and customary" is a matter of judgment based on the facts and circumstance of each sale.

The following criteria in paragraph 8 of PFRS 5 represent events that must have occurred:

a. the appropriate level of management must be committed to a plan to sell the asset (or disposal group);

b. an active programme to locate a buyer and complete the plan must have been initiated; and

c. the asset (or disposal group) must be actively marketed for sale at a price that is reasonable in relation to its current fair value.

The following criteria would be assessed based on expectations of the future, and their probability of occurrence would be included in the assessment of whether a sale is highly probable:

a. the sale should be expected to qualify for recognition as a completed sale within one year from the date of classification (except as permitted by paragraph 9);

b. actions required to complete the plan should indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn; and
c. the probability of shareholders’ approval (if required in the jurisdiction) should be considered as part of the assessment of whether the sale is highly probable.
PFRS 10, *Consolidated Financial Statements*

**PFRS 10: Investment Entities Amendment – The definition of investment-related services or activities**

**Issue**

Can ‘tax optimization’ be considered as investment-related services or activities?

**Background**

An investment entity provides investment-related services or activities, either directly or through a subsidiary. If an investment entity provides investment-related services or activities through a subsidiary, the investment entity shall consolidate that subsidiary.

Some investment entities establish wholly-owned intermediate subsidiaries in some jurisdictions, which own all or part of the portfolio of investments in the group structure. The sole purpose of the intermediate subsidiaries is to minimize the tax paid by investors in the ‘parent’ investment entity. There is no activity within the subsidiaries and the tax advantage comes about because of returns being channeled through the jurisdiction of the intermediate subsidiary. A question was raised on whether such ‘tax optimization’ should be considered investment-related services or activities.

According to paragraph BC272 of PFRS 10, *Consolidated Financial Statements*, the fair value measurement of all of an investment entity’s subsidiaries would provide the most useful information, except for subsidiaries providing investment-related services or activities. One of the characteristics of ‘tax optimization’ subsidiaries is “that there is no activity within the subsidiary”.

**Consensus**

Accordingly, the parent should not consolidate such subsidiaries, because they do not provide investment-related services or activities, and do not meet the requirements to be consolidated in accordance with paragraph 32 of PFRS 10. The parent should therefore account for such an intermediate subsidiary at fair value.
PFRS 10 – Classification of puttable instruments that are non-controlling interests

Issue

How should puttable instruments that are issued by a subsidiary but that are not held, directly or indirectly, by the parent be classified in the consolidated financial statements of a group?

Background

This Q&A deals with puttable instruments classified as equity instruments in the financial statements of the subsidiary in accordance with paragraphs 16A-16B of PAS 32 (‘puttable instruments’) that are not held, directly or indirectly, by the parent. This discusses whether these instruments should be classified as equity or liability in the parent’s consolidated financial statements.

Some claim that paragraph 22 of PFRS 10 is not consistent with paragraph AG29A of PAS 32, because:

a) PFRS 10 defines non-controlling interests (NCI) as equity in a subsidiary not attributable, directly or indirectly, to a parent;

b) according to paragraph 22 of PFRS 10 a parent shall present non-controlling interests (NCI) in the consolidated statement of financial position within equity; but

c) according to paragraph AG29A of PAS 32, instruments classified as equity instruments in accordance with paragraphs 16A-16D of PAS 32 in the separate or individual financial statements of the subsidiary that are NCI are classified as liabilities in the consolidated financial statements of the group.

Consensus

Paragraphs 16A-16D of PAS 32 state that puttable instruments and instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation meet the definition of a financial liability. These instruments are classified as equity in the financial statements of the subsidiary as an exception to the definition of a financial liability if all relevant requirements are met. Paragraph AG29A clarifies that this exception applies only to the financial statements of the subsidiary and does not extend to the parent’s consolidated financial statements. Consequently, these financial instruments should be classified as financial liabilities in the parent’s consolidated financial statements.
PFRS 10 – Effect of protective rights on an assessment of control

Issue

Should the assessment of control be reassessed when facts and circumstances change in such a way that rights, previously determined to be protective, change (for example upon the breach of a covenant in a borrowing arrangement that causes the borrower to be in default) or whether, instead, such rights are never included in the reassessment of control upon a change in facts and circumstances?

Background

This Q&A deals with the guidance relating to protective rights and the effect of those rights on the power over the investee.

Consensus

Paragraph 8 of PFRS 10, *Consolidated Financial Statements*, requires an investor to reassess whether it controls an investee if facts and circumstances indicate that there are changes to one or more of the three elements of control.

A breach of a covenant that results in rights becoming exercisable constitutes such a change. It noted that PFRS 10 does not include an exemption for any rights from this need for reassessment.

The intention of PFRS 10 was that rights initially determined to be protective should be included in a reassessment of control whenever facts and circumstances indicate that there are changes to one or more of the three elements of control.

Accordingly, the conclusion about which party controlled the investee would need to be reassessed after the breach occurred. It also noted that the reassessment may or may not result in a change to the outcome of the assessment of control, depending on the individual facts and circumstances.
PFRS 10 – Non-cash acquisition of a non-controlling interest by a controlling shareholder in the consolidated financial statements

Issue

What is the accounting for the purchase of a non-controlling interest (NCI) by the controlling shareholder when the consideration includes non-cash items? Should the difference between the fair value of the consideration given and the carrying amount of such consideration be recognized in equity or in profit or loss?

Background

According to paragraph B96 of PFRS 10 Consolidated Financial Statements, the difference described should be recognized in equity, whereas applying IFRIC 17 Distributions of Non-cash Assets to Owners, by analogy the difference should be recognized in profit or loss.

Consensus

Paragraph B96 of PFRS 10 deals solely with the difference between the carrying amount of NCI and the fair value of the consideration given; this difference is required to be recognized in equity. This paragraph does not deal with the difference between the fair value of the consideration given and the carrying amount of such consideration.

The difference between the fair value of the assets transferred and their carrying amount arises from the derecognition of those assets. PFRSs generally require an entity to recognize, in profit or loss, any gain or loss arising from the derecognition of an asset.
PFRS 10 and PFRS 11 – Transition provisions in respect of impairment, foreign exchange and borrowing costs

Issue

What are the transition provisions in PFRS 10 and 11 in respect of impairment, foreign exchange and borrowing costs?

Background

The transition provisions of IFRS 10 and IFRS 11 include exemptions from retrospective application in specific circumstances. However, IFRS 10 and IFRS 11 do not provide specific exemptions from retrospective application in respect of the application of PAS 21 The Effects of Changes in Foreign Exchange Rates, PAS 23 Borrowing Costs or PAS 36 Impairment of Assets.

Consensus

When PFRS 10 is applied for the first time, it must be applied retrospectively, except for the specific circumstances for which exemptions from retrospective application are given. When PFRS 10 is applied retrospectively, there may be consequential accounting requirements arising from other Standards (such as PAS 21, PAS 23 and PAS 36). These requirements must also be applied retrospectively in order to measure the investee’s assets, liabilities and non-controlling interests, as described in paragraph C4 of PFRS 10, or the interest in the investee, as described in paragraph C5 of PFRS 10. If retrospective application of the requirements of IFRS 10 is impracticable because it is impracticable to apply retrospectively the requirements of other Standards, then PFRS 10 (paragraphs C4A and C5A) provides exemption from retrospective application.

Although the meaning of the term ‘joint control’ as defined in PFRS 11 is different from its meaning in PAS 31 Interests in Joint Ventures (2003) because of the new definition of ‘control’ in PFRS 10, nevertheless the outcome of assessing whether control is held ‘jointly’ would in most cases be the same in accordance with PFRS 11 as it was in accordance with PAS 31. As a result, typically, the changes resulting from the initial application of PFRS 11 would be to change from proportionate consolidation to equity accounting or from equity accounting to recognizing a share of assets and a share of liabilities. In those situations, PFRS 11 already provides exemption from retrospective application.
PFRS 10 – Single-asset, single lessee lease vehicles

Issue

Should the lessee (or lender in the case of a finance lease) consolidate a Structured Entity that was created to lease a single asset to the said lessee (or lender)?

Background

A Structured Entity (SE) is created on behalf of a manufacturer. The SE holds a single asset manufactured by the manufacturer, which is subsequently leased to a single customer.

If the lease is considered an operating lease, the question was whether the lessee should consolidate the SE. If the lease is considered a finance lease, the question was whether the lender should consolidate the SE.

Consensus

Paragraph 10 of PFRS 10 states that an investor has power over an investee when the investor has existing rights that give the investor the current ability to direct the relevant activities, or those activities that significantly affect the investee’s returns.

Upon entering into a lease, regardless of whether such a lease is a finance or an operating lease, the SE or the lessor would have the following rights:

1. A right to receive lease payments; and,
2. A right to the residual value of the leased asset at the end of the lease

Consequently, the SE’s relevant activities would be those that relate to managing the returns derived from these rights (e.g., managing the credit risk associated with the lease payments or managing the leased asset at the end of the lease term). How the decision-making relating to those activities would significantly affect the SE’s returns would depend on the specific facts and circumstances.

By itself, the lessee’s right to use the leased asset over a period of time would not typically give the lessee (or the lender) decision-making rights over the relevant activities of the SE. However, this does not mean that a lessee (or lender) can never control the lessor. The lessee (or lender) would need to consider all of the rights that it has in relation to the SE to determine whether it has power over the SE. This would include rights in contractual arrangements other than the lease contract (i.e., contractual arrangements for loans made to the SE), as well as rights included within the lease contract. These rights include those that go beyond simply providing the lessee (or lender) with the right to use the land.
PFRS 11, *Joint Arrangements*

**PFRS 11 – Classification of joint arrangements**

**Issue**

How should the assessment of ‘other facts and circumstances’ described in PFRS 11, *Joint Arrangements* affect the classification of a joint arrangement as a joint operation or a joint venture?

**Background**

It was considered whether the assessment of ‘other facts and circumstances’ should be undertaken with a view only towards whether those facts and circumstances create enforceable rights to the assets and obligations for the liabilities or whether that assessment should also consider the design and purpose of the joint arrangement, the entity’s business needs and the entity’s past practices.

Paragraph 14 of PFRS 11 requires the classification of a joint arrangement as a joint operation or a joint venture to depend on rights to the assets and obligations for the liabilities of the parties to the arrangement, and that rights and obligations, by nature, are enforceable.

Paragraph B30 of PFRS 11 describes that when ‘other facts and circumstances’ give the parties rights to the assets, and obligations for the liabilities, relating to the arrangement, the assessment of ‘other facts and circumstances’ would lead to the joint arrangement being classified as a joint operation.

**Consensus**

The assessment of ‘other facts and circumstances’ should focus on whether those facts and circumstances create rights to the assets and obligations for the liabilities.

**PFRS 11 – Classification of joint arrangements: the assessment of ‘other facts and circumstances’**

**Issue**

How should the assessment of ‘other facts and circumstances’ as noted in paragraph 17 of PFRS 11 be performed? Should the assessment of ‘other facts and circumstances’ be undertaken with a view only towards whether those facts and circumstances create enforceable rights to the assets and obligations for the liabilities, or whether that assessment should also consider the design and purpose of the joint arrangement, the entity’s business needs and the entity’s past practices?
Background
Paragraph 14 of IFRS 11 requires the classification of a joint arrangement as a joint operation or a joint venture to depend on each party's rights to the assets and obligations for the liabilities of the joint arrangement, and that the rights and obligations are enforceable.

Paragraph B30 of IFRS 11 explains that the assessment of other facts and circumstances would lead to the joint arrangement being classified as a joint operation when those other facts and circumstances give each party both rights to the assets, and obligations for the liabilities, relating to the arrangement.

Consensus
Consequently, the assessment of other facts and circumstances should focus on whether those facts and circumstances create enforceable rights to the assets and obligations for the liabilities.

The following paragraphs describe how and why particular facts and circumstances create rights to the assets and obligations for the liabilities.

How and why particular facts and circumstances create rights and obligations that result in the joint arrangement being classified as a joint operation, when the joint arrangement is structured through a separate vehicle whose legal form causes the separate vehicle to be considered in its own right.

The assessment of other facts and circumstances is performed when there is no contractual arrangement to reverse or modify the rights and obligations conferred by the legal form of the separate vehicle through which the arrangement has been structured. The assessment of other facts and circumstances thus focuses on whether the other facts and circumstances establish, for each party to the joint arrangement, rights to the assets and obligations for the liabilities relating to the joint arrangement.

Paragraphs B31–B32 of IFRS 11 state that parties to the joint arrangement have rights to the assets of the joint arrangement through other facts and circumstances when they:

a. have rights to substantially all of the economic benefits (for example, ‘output’) of assets of the arrangement; and
b. have obligations to acquire those economic benefits and thus assume the risks relating to those economic benefits (for example, the risks relating to the output).

Paragraphs B14 and B32–B33 of PFRS 11 state that parties to the joint arrangement have obligations for liabilities of the joint arrangement through other facts and circumstances when:
(a) as a consequence of their rights to, and obligations for, the assets of the joint arrangement, they provide cash flows that are used to settle liabilities of the joint arrangement; and
(b) settlement of the liabilities of the joint arrangement occurs on a continuous basis.

On the basis of these paragraphs, when each party to a joint arrangement meets the criteria and therefore has both rights to the assets of the joint arrangement and obligations for the liabilities of the joint arrangement through other facts and circumstances, a joint arrangement structured through a separate vehicle is a joint operation.

Consequently, in order to classify the joint arrangement as a joint operation as a result of assessing other facts and circumstances, it is necessary to demonstrate that:
(a) each party to the joint arrangement has rights and obligations relating to economic benefits of the assets of the arrangement; and
(b) each party is obliged to provide cash to the arrangement through enforceable obligations, which is used to settle the liabilities of the joint arrangement on a continuous basis.

*Implication of ‘economic substance’*

Some observed that the concept of ‘economic substance’ may not be consistently understood or applied in practice with regard to the assessment of other facts and circumstances.

As discussed above, the assessment of other facts and circumstances should focus on whether each party to the joint arrangement has rights to the assets, and obligations for the liabilities, relating to the joint arrangement. Consequently, in reference to paragraph BC43 of IFRS 11, it is noted that the consideration of other facts and circumstances is not a test of whether each party to the joint arrangement is closely or fully involved with the operation of the separate vehicle, but is instead a test of whether other facts and circumstances override the rights and obligations conferred upon the party by the legal form of the separate vehicle.

On the basis of this analysis, the assessment of other facts and circumstances should be undertaken with a view towards whether those facts and circumstances create enforceable rights to assets and obligations for liabilities.
Philippine Interpretations Committee

PFRS 11 – Classification of joint arrangements: application of ‘other facts and circumstances’ to specific fact patterns

Issue

How should ‘other facts and circumstances’ be applied to some specific fact patterns?

Background

This Q&A identified four different cases and considered how particular features of those fact patterns would affect the classification of the joint arrangement when assessing other facts and circumstances.

Consensus

1. **Output sold at a market price**

   This case discusses whether the fact that the output from the joint arrangement is sold to the parties of the joint arrangement at a market price prevents the joint arrangement from being classified as a joint operation, when assessing other facts and circumstances.

   It is concluded that the sale of output from the joint arrangement to the parties at market price, on its own, is not a determinative factor for the classification of the joint arrangement. The parties would need to consider, among other things, whether the cash flows provided to the joint arrangement through the parties’ purchase of the output from the joint arrangement at market price, along with any other funding that the parties are obliged to provide, would be sufficient to enable the joint arrangement to settle its liabilities on a continuous basis.

   Exercising judgment is needed in this situation in order to determine whether the arrangement is a joint operation based on other facts and circumstances.

2. **Financing from a third party**

   This case discusses whether financing from a third party prevents a joint arrangement from being classified as a joint operation.

   If the cash flows to the joint arrangement from the sale of output to the parties, along with any other funding that the parties are obliged to provide, satisfy the joint arrangement’s liabilities, then third-party financing alone would not affect the classification of the joint arrangement, irrespective of whether the financing occurs at inception or during the course of the joint arrangement’s operations. In this situation, the joint arrangement will, or may, settle some of its liabilities using cash flows from third-
party financing, but the resulting obligation to the third-party finance provider will, in due course, be settled using cash flows that the parties are obliged to provide.

3. **Nature of output (i.e. fungible or bespoke output)**

This case discusses whether the nature of the output (i.e. fungible or bespoke output) produced by the joint arrangement determines the classification of a joint arrangement when assessing other facts and circumstances.

It is concluded whether the output that is produced by the joint arrangement and purchased by the parties is fungible or bespoke is not a determinative factor for the classification of the joint arrangement. The focus of ‘obligation for the liabilities’ in PFRS 11 is on the existence of cash flows flowing from the parties to satisfy the joint arrangement’s liabilities as a consequence of the parties’ rights to, and obligations for, the assets of the joint arrangement, regardless of the nature of the product (i.e. fungible or bespoke output).

4. **Determining the basis for ‘substantially all of the output’**

This case discusses whether volumes or monetary values of output should be the basis for determining whether the parties to the joint arrangement are taking ‘substantially all of the output’ from the joint arrangement when assessing other facts and circumstances.

Referring to paragraphs B31–B32 of IFRS 11, parties to the joint arrangement have rights to the assets of the joint arrangement through other facts and circumstances when they:

(a) have rights to substantially all of the economic benefits (for example, ‘output’) of the assets of the arrangement; and

(b) have obligations to acquire those economic benefits and thus assume the risks relating to those economic benefits (for example, the risks relating to the output).

It is also noted from paragraphs B31–B32 of IFRS 11 that in order to meet the criteria for classifying the joint arrangement as a joint operation through the assessment of other facts and circumstances:

(a) the parties to the joint arrangement should have rights to substantially all the economic benefits of the assets of the joint arrangement; and

(b) the joint arrangement should be able to settle its liabilities from the ‘cash flows’ received as a consequence of the parties’ rights to and obligations for the assets of the joint arrangement, along with any other funding that the parties are obliged to provide.
Therefore, the economic benefits of the assets of the joint arrangement would relate to the cash flows arising from the parties' rights to, and obligations for, the assets. Consequently, it noted that the assessment is based on the monetary value of the output, instead of physical quantities.

**PFRS 11 – Classification of joint arrangements: consideration of two joint arrangements with similar features that are classified differently**

**Issue**

Can two joint arrangements with similar features, apart from the fact that one is structured through a separate vehicle and the other is not (in circumstances in which the legal form confers separation between the parties and the separate vehicle) be classified differently?

**Background**

Two such joint arrangements could be classified differently because:

(a) the legal form of a joint arrangement structured through a separate vehicle must be overridden by other contractual arrangements or specific other facts and circumstances for the joint arrangement to be classified as a joint operation; but

(b) a joint arrangement that is not structured through a separate vehicle is classified as a joint operation.

**Consensus**

PFRS 11 could lead to two joint arrangements being classified differently if one is structured through a separate vehicle and the other is not, but in other respects they have apparently similar features. This is because the legal form of the separate vehicle could affect the rights and obligations of the parties to the joint arrangement. The legal form of the separate vehicle is relevant in assessing the type of joint arrangement, as noted, for example, in paragraphs B22 and BC43 of PFRS 11.

Such different accounting would not conflict with the concept of economic substance. This is because, according to the approach adopted in PFRS 11, the concept of economic substance means that the classification of the joint arrangement should reflect the rights and obligations of the parties to the joint arrangement and the presence of a separate vehicle plays a significant role in determining the nature of those rights and obligations.

The requirements of PFRS 11 provide the principles necessary for determining the classification of joint arrangements, including assessing the impact of a separate vehicle.
The assessment of the classification would depend on specific contractual terms and conditions and requires a full analysis of features involving the joint arrangement.

**PFRS 11 – Accounting by the joint operator: recognition of revenue by a joint operator**

**Issue**

Should a joint operator recognize revenue in relation to the output purchased from the joint operation by the parties?

**Background**

This issue relates to the application of paragraph 20(d) of PFRS 11, which requires a joint operator to recognize its share of the revenue from the sale of the output by the joint operation.

**Consensus**

Examining paragraph 20(d) of PFRS 11, it is noted that if the joint arrangement is structured through a separate vehicle and the assessment of other facts and circumstances results in the joint arrangement being classified as a joint operation, in circumstances in which the parties take all the output of the joint arrangement in proportion to their rights to the output, the application of paragraph 20(d) of PFRS 11 would not result in the recognition of revenue by the parties. This is because, if the joint operators purchase all the output from the joint operation in proportion to their rights to the output, they would recognize ‘their revenue’ only when they sell the output to third parties.

In other words, the joint operators would not recognize any amount in relation to the ‘share of the revenue from the sale of the output by the joint operation’. This is because a joint operator that has an obligation to purchase the output from the joint operation has rights to the assets of the joint operation. Accordingly, the sale of the output by the joint operation to the joint operator would mean selling output to itself and, therefore, the joint operator would not recognize a share of the revenue from the sale of that output by the joint operation.

Consequently, paragraph 20(d) of PFRS 11 would result in the recognition of revenue by a joint operator only when the joint operation sells its output to third parties. For this purpose, third parties do not include other parties who have rights to the assets and obligations for the liabilities relating to the joint operation.
PFRS 11 – Accounting by the joint operator: the accounting treatment when the joint operator’s share of output purchased differs from its share of ownership interest in the joint operation

Issue

What is the accounting treatment in the circumstance in which the joint operator’s share of the output purchased differs from its share of ownership interest in the joint operation?

Background

This Q&A considered a fact pattern in which the joint arrangement is structured through a separate vehicle and for which the parties to the joint arrangement have committed themselves to purchase substantially all of the output produced at a price designed to achieve a break-even result. In this fact pattern, the parties to the joint arrangement would be considered to have rights to the assets and obligations for the liabilities. Such a joint arrangement is presented in Example 5 of the application guidance to PFRS 11 and is classified as a joint operation. A variation of such a fact pattern could (and does) arise in circumstances in which the parties’ percentage ownership interest in the separate vehicle differs from the percentage share of the output produced, which each party is obliged to purchase.

Consensus

Referring to paragraph 20 of IFRS 11, it can be noted that the joint operators of such a joint operation would account for their assets, liabilities, revenues and expenses in accordance with the shares specified in the contractual arrangement. However, when an assessment of other facts and circumstances has concluded that the joint arrangement is a joint operation, and the joint arrangement agreement does not specify the allocation of assets, liabilities, revenues or expenses, the question arises about what share of assets, liabilities, revenue and expenses each joint operator should recognize. Specifically, should the share of assets, liabilities, revenue and expenses recognized reflect the percentage of ownership of the legal entity, or should it reflect the percentage of output purchased by each joint operator?

There could be many different scenarios in which the joint operator’s share of the output purchased differs from its share of ownership interest in the joint operation: for example, when the share of output purchased by each party varies over the life of the joint arrangement. A key issue that arises in this situation is over what time horizon should the share of output be considered.

If the joint operators made a substantial investment in the joint operation that differed from their ownership interest, there may be other elements of the arrangements that could explain why there is a difference between the percentage of ownership interest and the percentage share of the output produced, which each party is obliged to purchase. The identification of
the other elements may provide relevant information to determine how to account for the difference between the two.

Consequently, it is important to understand why the share of the output purchased differs from the ownership interests in the joint operation. Judgment will therefore be needed to determine the appropriate accounting.

**PFRS 11 – Accounting in separate financial statements: accounting by the joint operator in its separate financial statements**

**Issue**

How should a joint operator account for in its separate financial statements its share of assets and liabilities of a joint operation when that joint operation is structured through a separate vehicle?

**Consensus**

PFRS 11 requires the joint operator to account for its rights and obligations in relation to the joint operation. It also noted that those rights and obligations, in respect of that interest, are the same regardless of whether separate or consolidated financial statements are prepared, by referring to paragraph 26 of PFRS 11. Consequently, the same accounting is required in the consolidated financial statements and in the separate financial statements of the joint operator.

PFRS 11 requires the joint operator to account for its rights and obligations, which are its share of the assets held by the entity and its share of the liabilities incurred by it. Accordingly, the joint operator would not additionally account in its separate or consolidated financial statements its shareholding in the separate vehicle, whether at cost in accordance with PAS 27 *Separate Financial Statements* or at fair value in accordance with PFRS 9 *Financial Instruments.*
PFRS 11 – Accounting by the joint operation: accounting by the joint operation that is a separate vehicle in its financial statements

Background and Issue

A joint operator recognizes in both its consolidated and separate financial statements its share in the assets and liabilities of a joint operation that is a separate vehicle. Should the joint operation recognize the same assets and liabilities in its own financial statements?

Consensus

PFRS 11 applies only to the accounting by the joint operators and not to the accounting by the separate vehicle that is a joint operation. The financial statements of the separate vehicle would therefore be prepared in accordance with the applicable PFRS.

Company law often requires a legal entity/separate vehicle to prepare financial statements. Consequently, the reporting entity for the financial statements would include the assets, liabilities, revenues and expenses of that legal entity/separate vehicle. However, when identifying the assets and liabilities of the separate vehicle, it is necessary to understand the joint operators’ rights and obligations relating to those assets and liabilities and how those rights and obligations affect those assets and liabilities.

PFRS 10 and PFRS 11 – Transition provisions in respect of impairment, foreign exchange and borrowing costs

Issue

What are the transition provisions in PFRS 10 and 11 in respect of impairment, foreign exchange and borrowing costs?

Background

The transition provisions of IFRS 10 and IFRS 11 include exemptions from retrospective application in specific circumstances. However, IFRS 10 and IFRS 11 do not provide specific exemptions from retrospective application in respect of the application of PAS 21 The Effects of Changes in Foreign Exchange Rates, PAS 23 Borrowing Costs or PAS 36 Impairment of Assets.

Consensus

When PFRS 10 is applied for the first time, it must be applied retrospectively, except for the specific circumstances for which exemptions from retrospective application are given. When PFRS 10 is applied retrospectively, there may be consequential accounting requirements arising from other Standards (such as PAS 21, PAS 23 and PAS 36). These requirements must also be applied retrospectively in order to measure the investee’s assets, liabilities and
non-controlling interests, as described in paragraph C4 of PFRS 10, or the interest in the investee, as described in paragraph C5 of PFRS 10. If retrospective application of the requirements of IFRS 10 is impracticable because it is impracticable to apply retrospectively the requirements of other Standards, then PFRS 10 (paragraphs C4A and C5A) provides exemption from retrospective application.

Although the meaning of the term ‘joint control’ as defined in PFRS 11 is different from its meaning in PAS 31 Interests in Joint Ventures (2003) because of the new definition of ‘control’ in PFRS 10, nevertheless the outcome of assessing whether control is held ‘jointly’ would in most cases be the same in accordance with PFRS 11 as it was in accordance with PAS 31. As a result, typically, the changes resulting from the initial application of PFRS 11 would be to change from proportionate consolidation to equity accounting or from equity accounting to recognizing a share of assets and a share of liabilities. In those situations, PFRS 11 already provides exemption from retrospective application.
PFRS 12, Disclosure of Interests in Other Entities

PFRS 12 – Disclosure of summarized financial information about material joint ventures and associates

Issues

1. How should an entity apply the disclosure requirements in paragraph 21(b)(ii) of PFRS 12 on summarized financial information on material joint ventures and associates? How do the disclosure requirements interact with the aggregation principle in paragraphs 4 and B2-B6 of PFRS 12?

2. Would an investor be excused from disclosing summarized financial information when the information relates to a listed joint venture or associate, and local regulatory requirements prevent the investor from disclosing such information until the joint venture or associate has released its own financial statements?

Background

Paragraph 21(b)(ii) of PFRS 12 requires an entity to disclose summarized financial information about the joint venture or associate as specified in paragraphs B12 and B13.

Paragraph 4 of PFRS 12 requires an entity to consider the level of detail necessary to satisfy the disclosure objective and how much emphasis to place on each of the requirements in PFRS 12. It shall aggregate or disaggregate disclosures so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or the aggregation of items that have different characteristics (see paragraph B2-B6 of PFRS 12).

Some assert that there are two ways to interpret the application of those paragraphs. Either the information required in paragraph 21(b)(ii) of PFRS 12 can be disclosed in aggregate for all material joint ventures or such information should be disclosed individually for each material joint venture or associate.

Paragraph BC50 of PFRS 12's Basis for Conclusions states that:

“The Board observed that the requirement to present the amounts on a '100 per cent' basis would be appropriate only when the information is disclosed for individual joint ventures and associates. This is because presenting the financial information on a '100 per cent' basis when aggregating that information for all joint ventures or associates would not result in useful information when the entity holds different percentage ownership interests in its joint ventures or associates. In addition, some users and respondents to ED 9 recommended that the disclosures for associates should be aligned with those for joint ventures because investments in associates can be material and are often strategic to an investor with significant influence. Accordingly, the Board decided that summarized financial information should also be provided for each material associate.”
Consensus

1. **How should an entity apply the disclosure requirements in paragraph 21(b)(ii) of PFRS 12 on summarized financial information on material joint ventures and associates? How do the disclosure requirements interact with the aggregation principle in paragraphs 4 and B2-B6 of PFRS 12?**

   It is expected that the requirement in paragraph 21(b)(ii) of PFRS 12 shall lead to the disclosure of summarized information on an individual basis for each joint venture or associate that is material to the reporting entity.

   This also reflects the intentions of the International Accounting Standards Board (IASB or the Board) as described in paragraph BC50 of PFRS 12's Basis for Conclusions.

2. **Would an investor be excused from disclosing summarized financial information when the information relates to a listed joint venture or associate, and local regulatory requirements would prevent the investor from disclosing such information until the joint venture or associate has released its own financial statements?**

   There is no provision in PFRS 12 that permits non-disclosure of the information required in paragraph 21(b)(ii) of PFRS 12.

**PFRS 12 – Disclosures for a subsidiary with a material non-controlling interest**

**Issue**

Should the information required by paragraphs 12(e) - (g) of PFRS 12 should be provided:

i. at the subsidiary level (i.e. the ‘legal’ entity) and be based on the separate financial statements of the individual subsidiary; or

ii. at a subgroup level for the subgroup of the subsidiary together with its investees and be based either on

(a) the amounts of the subgroup included in the consolidated financial statements of the reporting entity; or

(b) the amounts included in consolidated financial statements of the subgroup; noting that transactions and balances between the subgroup and other entities outside the subgroup would not be eliminated.

**Background**

Paragraph 12 (e) – (g) of PFRS 12 state that:

An entity shall disclose for each of its subsidiaries that have non-controlling interests that are material to the reporting entity:

... 

(e) the profit or loss allocated to non-controlling interests of the subsidiary during the reporting period.
(f) accumulated non-controlling interests of the subsidiary at the end of the reporting period.
(g) summarized financial information about the subsidiary.

Consensus

Within the context of the disclosure objective in paragraph 10 of PFRS 12, materiality should be assessed by the reporting entity on the basis of the consolidated financial statements of the reporting entity. In this assessment, a reporting entity would consider both quantitative considerations (i.e. the size of the subsidiary) and qualitative considerations (i.e. the nature of the subsidiary).

The decision on which approach is used to present the disclosures required by paragraphs 12(e)–(g) should reflect the one that best meets the disclosure objective of paragraph 10 of PFRS 12 in the circumstances. According to this objective, ‘An entity shall disclose information that enables users of its consolidated financial statements to understand (i) the composition of the group; and (ii) the interest that non-controlling interests have in the group’s activities and cash flows’.

This judgment would be made separately for each subsidiary or subgroup that has a material non-controlling interest.

Disclosures required by paragraphs 12(e) and (f) of IFRS 12

A reporting entity would meet the requirements in paragraphs 12(e) and (f) by disclosing disaggregated information from the amounts included in the consolidated financial statements of the reporting entity in respect of subsidiaries that have non-controlling interests that are material to the reporting entity. A reporting entity should apply judgment in determining the level of disaggregation of this information; that is, whether:

(a) the entity presents this information about the subgroup of the subsidiary that has a material non-controlling interest (present the required information on the basis of the subsidiary together with its investees); or

(b) it is necessary in achieving the disclosure objective in paragraph 10 of IFRS 12 to disaggregate the information further to present information about individual subsidiaries that have material non-controlling interests within that subgroup.

Disclosures required by paragraph 12(g) of IFRS 12

It is observed that:

(a) paragraph 12(g) requires summarized information about the subsidiaries that have non-controlling interests that are material to the reporting entity;
(b) paragraph B10(b) states that an entity shall disclose ‘summarized financial information about the assets, liabilities, profit or loss and cash flows of the subsidiary that enables users to understand the interest that non-controlling interests have in the group’s activities and cash flows. That information might include but is not limited to, for example, current assets, non-current assets, current liabilities, non-current liabilities, revenue, profit or loss and total comprehensive income’; and

(c) paragraph B11 states that the ‘summarized financial information required by paragraph B10(b) shall be the amounts before inter-company eliminations’.

In order to meet the disclosure objective in paragraph B10(b), that information would need to be prepared on a basis that was consistent with the information included in the consolidated financial statements of the reporting entity. This is understood to mean that the information would be prepared from the perspective of the reporting entity. For example, if the subsidiary was acquired in a business combination, the amounts disclosed should reflect the effects of the acquisition accounting.

It is further observed that in providing the information required by paragraph 12(g) the entity would apply judgment in determining whether:

(a) the entity presents this information about the subgroup of the subsidiary that has a material non-controlling interest (i.e., it presents the required information on the basis of the subsidiary together with its investees); or

(b) it is necessary in achieving the disclosure objective in paragraph 10 of IFRS 12 to disaggregate the information further to present information about individual subsidiaries that have material non-controlling interests within that subgroup.

However, the information provided in respect of paragraph 12(g) would include transactions between the subgroup/subsidiary and other members of the reporting entity’s group without elimination in order to meet the requirements in paragraph B11 of IFRS 12. The transactions within the subgroup would be eliminated.
PFRS 13, *Fair Value Measurement*

PFRS 13 – Fair value hierarchy when third-party consensus prices are used

**Issue**

Under what circumstances prices that are provided by third parties would qualify as Level 1 in the fair value hierarchy in accordance with IFRS 13 *Fair Value Measurement*?

**Consensus**

When assets or liabilities are measured on the basis of prices provided by third parties, the classification of those measurements within the fair value hierarchy will depend on the evaluation of the inputs used by the third party to derive those prices, instead of on the pricing methodology used. In other words, the fair value hierarchy prioritizes the inputs to valuation techniques, not the valuation techniques used to measure fair value. In accordance with PFRS 13, only unadjusted quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date qualify as Level 1 inputs.

Consequently, a fair value measurement that is based on prices provided by third parties may only be categorized within Level 1 of the fair value hierarchy if the measurement relies solely on unadjusted quoted prices in an active market for an identical instrument that the entity can access at the measurement date.
PAS 1, *Presentation of Financial Statements*

**PAS 1 – Disclosure requirements relating to assessment of going concern**

**Issue**

Are disclosures required for judgments made in relation to material uncertainties related to events or conditions that may cast significant doubt upon the entity’s ability to continue as a going concern?

**Background**

This Q&A deals in a situation in which management of an entity has considered events or conditions that may cast significant doubt upon the entity’s ability to continue as a going concern.

Having considered all relevant information, including the feasibility and effectiveness of any planned mitigation, management concluded that there are no material uncertainties that require disclosure in accordance with paragraph 25 of PAS 1, *Presentation of Financial Statements*. However, reaching the conclusion that there was no material uncertainty involved significant judgment.

Paragraph 25 of PAS 1 requires that when preparing financial statements, management shall make an assessment of an entity’s ability to continue as a going concern. An entity shall prepare financial statements on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. When management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity’s ability to continue as a going concern, the entity shall disclose those uncertainties. When an entity does not prepare financial statements on a going concern basis, it shall disclose that fact, together with the basis on which it prepared the financial statements and the reason why the entity is not regarded as a going concern.

**Consensus**

Paragraph 122 of PAS 1 requires that an entity shall disclose, in the summary of significant accounting policies or other notes, the judgments, apart from those involving estimations, that management has made in the process of applying the entity’s accounting policies and that have the most significant effect on the amounts recognized in the financial statements.

The disclosure requirements of paragraph 122 of PAS 1 shall apply to the judgments made in concluding that there remain no material uncertainties related to events or conditions that may cast significant doubt upon the entity’s ability to continue as a going concern.
PAS 1 and PAS 12 – Presentation of payments on non-income taxes

Issue

Should production based royalty payments payable to one taxation authority that are claimed as an allowance against taxable profit for the computation of income tax payable to another taxation authority be presented as an operating expense or a tax expense in the statement of comprehensive income?

Background

On the basis of the assumption that the production-based royalty payments are, in themselves, outside the scope of PAS 12, *Income Taxes* while the income tax payable to the other taxation authority is within the scope of PAS 12, this Q&A clarifies whether the production-based royalty payments can be viewed as prepayment of the income tax payable.

Consensus

The line item of ‘tax expense’ that is required by paragraph 82(d) of PAS 1, *Presentation of Financial Statements*, is intended to require an entity to present taxes that meet the definition of income taxes under PAS 12.

It is the basis of calculation determined by the relevant tax rules that determines whether a tax meets the definition of an income tax. Neither the manner of settlement of a tax liability nor the factors relating to recipients of the tax is a determinant of whether an item meets that definition.

Production-based royalty payments should not be treated differently from other expenses that are outside the scope of PAS 12, all of which may reduce income tax payable. Accordingly, it is inappropriate to consider the royalty payments to be prepayment of the income tax payables. Because the production-based royalties are not income taxes, the royalty payments should not be presented as an income tax expense in the statement of comprehensive income.
PAS 7, *Cash Flow Statements*

**PAS 7 – Identification of cash equivalents**

**Issue**

What is the basis of classification of investments as cash equivalents?

**Background**

This Q&A deals with the basis of classification of financial assets as cash equivalents in accordance with PAS 7.

Some argue that the classification of investments as cash equivalents on the basis of the remaining period to maturity as at the balance sheet date would lead to a more consistent classification rather than the current focus on the investment’s maturity from its acquisition date.

**Consensus**

On the basis of paragraph 7 of PAS 7, financial assets held as cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. This paragraph further states that an investment is classified as a cash equivalent, only when it has a short maturity from the date of acquisition.

Paragraph 7 of PAS 7 promotes consistency between entities in the classification of cash equivalents.
PAS 10, *Events after the Reporting Period*

PAS 10 – Reissuing previously issued financial statements

**Issue**

Does PAS 10, *Events after the Reporting Period*, permit only one date of authorization for issue (i.e. ‘dual dating’ is not permitted) when considered within the context of reissuing previously issued financial statements in connection with an offering document?

**Background**

This Q&A deals with the accounting implications of applying PAS 10, *Events after the Reporting Period*, when previously issued financial statements are reissued in connection with an offering document.

The issue arose in jurisdictions in which securities laws and regulatory practices require an entity to reissue its previously issued annual financial statements in connection with an offering document, when the most recently filed interim financial statements reflect matters that are accounted for retrospectively under the applicable accounting standards. In these jurisdictions, securities law and regulatory practices do not require or permit the entity, in its reissued financial statements, to recognize events or transactions that occur between the time the financial statements were first authorized for issuance and the time the financial statements are reissued, unless the adjustment is required by national regulation; instead security and regulatory practices require the entity to recognize in its reissued financial statements only those adjustments that would ordinarily be made to the comparatives in the following year’s financial statements. These adjustments would include, for example, adjustments for changes in accounting policy that are applied retrospectively, but would not include changes in accounting estimates. This approach is called ‘dual dating’.

**Consensus**

The scope of PAS 10 is the accounting for, and disclosure of, events after the reporting period and that its objective is to prescribe:

a) when an entity should adjust its financial statements for events after the reporting period; and

b) the disclosures that an entity should give about the date when the financial statements were authorized for issue and about events after the reporting period.

Financial statements prepared in accordance with PAS 10 should reflect all adjusting and non-adjusting events up to the date that the financial statements were authorized for issue.

PAS 10 does not address the presentation of re-issued financial statements in an offering document when the originally issued financial statements have not been withdrawn, but the re-issued financial statements are provided either as supplementary information or a representation of the original financial statements in an offering document in accordance with regulatory requirements.
PAS 12, *Income Taxes*

**PAS 12 – Recognition of current income tax on uncertain tax position**

**Issue**

Should PAS 12, *Income Taxes*, or PAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, be applied to determine whether to recognize an asset for the payment in relation to uncertain tax position?

**Background**

There are situations in which tax laws require an entity to make an immediate payment when a tax examination results in an additional charge, even if the entity intends to appeal against the additional charge. The entity expects, but is not certain, to recover some or all of the amount paid.

This Q&A deals with the guidance to be applied in the recognition of an asset for the payment.

**Consensus**

Paragraph 12 of PAS 12 provides guidance on the recognition of current tax assets and current tax liabilities. In particular, it states that:

a) current tax for current and prior periods shall, to the extent unpaid, be recognized as a liability; and

b) if the amount already paid in respect of current and prior periods exceeds the amount due for those periods, the excess shall be recognized as an asset.

In the specific fact pattern described above, an asset is recognized if the amount of cash paid (which is a certain amount) exceeds the amount of tax expected to be due (which is an uncertain amount). The timing of payment should not affect the amount of current tax expense recognized.

The reference to PAS 37 in paragraph 88 of PAS 12 in respect of tax-related contingent liabilities and contingent assets may have been understood by some to mean that PAS 37 applies to the recognition of such items.

However, it should be noted that paragraph 88 of PAS 12 provides guidance only on disclosures required for such items, and that PAS 12, not PAS 37, provides the relevant guidance on recognition.
PAS 12 – Recognition of deferred tax for a single asset in a corporate wrapper

Issue

How should deferred tax be accounted for in the consolidated financial statements of the parent, when a subsidiary has only one asset within it (the asset inside) and the parent expects to recover the carrying amount of the asset inside by selling the shares in the subsidiary (the shares)?

Background

Paragraph 11 of PAS 12 requires the entity to determine temporary differences in the consolidated financial statements by comparing the carrying amounts of assets and liabilities in the consolidated financial statements with the appropriate tax base. In the case of an asset or a liability of a subsidiary that files separate tax returns, this is the amount that will be taxable or deductible on the recovery (settlement) of the asset (liability) in the tax returns of the subsidiary.

The requirement in paragraph 11 of PAS 12 is complemented by the requirement in paragraph 38 of PAS 12 to determine the temporary difference related to the shares held by the parent in the subsidiary by comparing the parent’s share of the net assets of the subsidiary in the consolidated financial statements, including the carrying amount of goodwill, with the tax base of the shares for purposes of the parent’s tax returns.

Consensus

Paragraphs 11 and 28 of PAS 12 require a parent to recognize both the deferred tax related to the asset inside and the deferred tax related to the shares, if:

a) tax law attributes separate tax bases to the asset inside and to the shares;

b) in the case of deferred tax assets, the related deductible temporary differences can be utilized as specified in paragraphs 24-31 of PAS 12; and

c) no specific exceptions in PAS 12 apply.
PAS 12 – Impact of an internal reorganization on deferred tax amounts related to goodwill

Issue

In accordance with PAS 12, *Income Taxes*, how should an entity calculate deferred tax following an internal reorganization transaction in its consolidated financial statements?

Background

An entity (Entity H) recognized goodwill that had resulted from the acquisition of a group of assets (Business C) that meets the definition of a business in PFRS 3, *Business Combinations*. Entity H subsequently recorded a deferred tax liability relating to goodwill deducted for tax purposes.

Against this background, Entity H effects an internal reorganization in which:

a) Entity H sets up a new wholly-owned subsidiary (Subsidiary A);

b) Entity H transfers Business C, including the related (accounting) goodwill to Subsidiary A; however,

c) for tax purposes, the (tax) goodwill is retained by Entity H and not transferred to Subsidiary A.

Consensus

When entities in the same consolidated group file separate tax returns, separate temporary differences will arise in those entities in accordance with paragraph 11 of PAS 12. When an entity prepares its consolidated financial statements, deferred tax balances would be determined separately for those temporary differences, using the applicable tax rates for each entity’s tax jurisdiction.

When calculating the deferred tax amount for the consolidated financial statements:

a) the amount used as the carrying amount by the ‘receiving’ entity (in this case, Subsidiary A that receives the (accounting) goodwill) for an asset or a liability is the amount recognized in the consolidated financial statements; and

b) the assessment of whether an asset or a liability is being recognized for the first time for the purpose of applying the initial recognition exception described in paragraphs 15 and 24 of PAS 12 is made from the perspective of the consolidated financial statements.

Transferring the goodwill to Subsidiary A would not meet the initial recognition exception described in paragraphs 15 and 24 of PAS 12 in the consolidated financial statements.

Consequently, deferred tax would be recognized in the consolidated financial statements for any temporary differences arising in each separate entity by using the applicable tax rates for each entity’s tax jurisdiction (subject to meeting the recoverability criteria for recognizing deferred tax assets described in PAS 12).
If there is a so-called ‘outside basis difference’ (i.e. a temporary difference between the carrying amount of the investment in Subsidiary A and the tax base of the investment) in the consolidated financial statements, deferred tax for such a temporary difference would also be recognized subject to the limitations and exceptions applying to the recognition of a deferred tax asset (in accordance with paragraph 44 of PAS 12) and a deferred tax liability (in accordance with paragraph 39 of PAS 12).

Transferring assets between the entities in the consolidated group would affect the consolidated financial statements in terms of recognition, measurement and presentation of deferred tax, if the transfer affects the tax base of assets or liabilities, or the tax rate applicable to the recovery or settlement of those assets or liabilities. Such a transfer could also affect:

a) the recoverability of any related deductible temporary differences and thereby affect the recognition of deferred tax assets; and

b) the extent to which deferred tax assets and liabilities of different entities in the group are offset in the consolidated financial statements.

**PAS 12 – Recognition and measurement of deferred tax assets when an entity is loss-making**

**Issues**

1. Does PAS 12, *Income Taxes*, require that a deferred tax asset be recognized for the carryforward of unused tax losses when there are suitable reversing taxable temporary differences, regardless of an entity’s expectations of future tax losses?

2. How should the guidance in PAS 12 be applied when tax laws limit the extent to which tax losses brought forward can be recovered against future taxable profits?

In the tax systems considered for the second issue, the amount of tax losses brought forward that can be recovered in each tax year is limited to a specified percentage of the taxable profits of that year.

**Consensus**

According to paragraphs 28 and 35 of PAS 12:

a) A deferred tax asset is recognized for the carryforward of unused tax losses to the extent of the existing taxable temporary differences, of an appropriate type, that reverse in an appropriate period. The reversal of those taxable temporary differences enables the utilization of the unused tax losses and justifies the recognition of deferred tax assets. Consequently, future tax losses are not considered.

b) When tax laws limit the extent to which unused tax losses can be recovered against future taxable profits in each year, the amount of deferred tax assets recognized from unused tax losses as a result of suitable existing taxable temporary differences is
restricted as specified by the tax law. This is because when the suitable taxable temporary differences reverse, the amount of tax losses that can be utilized by that reversal is reduced as specified by the tax law. Also, in this case future tax losses are not considered.

c) In both cases, if the unused tax losses exceed the amount of suitable existing taxable temporary differences (after taking into account any restrictions), an additional deferred tax asset is recognized only if the requirements in paragraphs 29 and 36 of PAS 12 are met (i.e. to the extent that it is probable that the entity will have appropriate future taxable profit, or to the extent that tax planning opportunities are available to the entity that will create appropriate taxable profit).

PAS 12 – Accounting for market value uplifts on assets that are to be introduced by a new income tax regime

Issue

What is the accounting for market value uplifts introduced in a new income tax regime in a jurisdiction?

Background

In calculating taxable profit under the tax regime, entities are permitted to calculate tax depreciation for certain mining assets using the market value of the assets as of a particular date as the ‘starting base allowance’, rather than the cost or carrying amount of the assets. If there is insufficient profit against which the annual tax depreciation can be used, it is carried forward and can be used as a deduction against taxable profit in future years.

Consensus

The starting base allowance, including the part that is attributable to the market value uplift, is attributed to the related assets under the tax regime and will become the basis for depreciation expense for tax purposes.

Consequently, the market value uplift forms part of the related asset’s ‘tax base’, as defined in paragraph 5 of PAS 12, Income Taxes. PAS 12 requires an entity to reflect an adjustment to the tax base of an asset that is due to an increase in the deductions available as a deductible temporary difference. Accordingly, a deferred tax asset should be recognized to the extent that it meets the recognition criteria in paragraph 24 of PAS 12.
PAS 12 – Selection of applicable tax rate for the measurement deferred tax relating to an investment in an associate

Issue

What is the applicable tax rate for the measurement of deferred tax relating to an investment in an associate in a multi-tax rate jurisdiction?

Background

This Q&A discusses how the tax rate should be selected when local tax legislation prescribes different tax rates for different manners of recovery (for example, dividends, sale, liquidation, etc). This Q&A describes a situation in which the carrying amount of an investment in an associate could be recovered by:

(a) receiving dividends (or other distribution of profit);
(b) sale to a third party; or
(c) receiving residual assets upon liquidation of the associate.

Consensus

Paragraph 51A of PAS 12 states that an entity measures deferred tax liabilities and deferred tax assets using the tax rate and the tax base that are consistent with the expected manner of recovery or settlement.

Accordingly, the tax rate should reflect the expected manner of recovery or settlement. If one part of the temporary difference is expected to be received as dividends, and another part is expected to be recovered upon sale or liquidation (for example, an investor has a plan to sell the investment later and expects to receive dividends until the sale of the investment), different tax rates would be applied to the parts of the temporary difference in order to be consistent with the expected manner of recovery.
PAS 16, *Property, Plant and Equipment*

**PAS 16 – Disclosure of carrying amounts under the cost model**

**Issue**

Is an entity required to reflect the capitalization of borrowing costs to meet the disclosure requirement in paragraph 77(e) of PAS 16 *Property, Plant and Equipment*, for assets stated at revalued amounts for which borrowing costs are not capitalized in accordance with paragraph 4(a) of PAS 23, *Borrowing Costs*?

**Background**

Paragraph 77(e) of PAS 16 requires that if items of property, plant and equipment are stated at revalued amounts, the carrying amount that would have been recognized had the assets been carried under the cost model shall be disclosed for each revalued class of property, plant and equipment.

Paragraph 4(a) of PAS 23 states that an entity is not required to apply PAS 23 to borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset measured at fair value.

Some assert that the capitalization of borrowing costs for these assets to meet disclosure requirements is burdensome and suggested that it should not be a requirement of PAS 16 to capitalize these costs.

**Consensus**

The requirements in paragraph 77(e) of PAS 16 are clear. This paragraph requires an entity to disclose the amount at which assets stated at revalued amounts would have been stated at had those assets been carried under the cost model. The amount to be disclosed includes borrowing costs capitalized in accordance with PAS 23.
PAS 17, *Leases*

**PAS 17 – Meaning of ‘incremental costs’**

**Issue**

Can salary costs of permanent staff involved in negotiating and arranging new leases qualify as ‘incremental costs’ within the context of PAS 17, *Leases*?

**Background**

PAS 17 defines initial direct costs as incremental costs that are directly attributable to negotiating and arranging a lease, except for such costs incurred by a manufacturer or dealer lessors.

Initial direct costs incurred by lessors in negotiating an operating lease are added to the carrying amount of the leased asset and recognized over the lease term on the same basis as the lease income.

**Consensus**

Internal fixed costs, including costs of permanent staff involved in negotiating and arranging new leases, do not qualify as ‘incremental costs’. Only those costs that would not have been incurred if the entity had not negotiated and arranged a lease should be included in the initial measurement of the finance lease receivable.

**PAS 17, PAS 38 and PAS 16 – Purchase of right to use land**

**Issue**

Should a purchase of a right to use land be accounted for as a:

a) purchase of property, plant and equipment;

b) purchase of an intangible asset; or

c) lease of land?

**Fact Pattern**

In some jurisdictions, the laws and regulations stipulate that only individual citizens are allowed to have freehold title of land. They do not permit entities to own freehold title to land. Instead, entities can purchase the right to cultivate or build on land, for which agreement is approved by the government. The government determines the legal relationship between the land and the right holder, where the government acts as the administrator and the regulator for the State.

The payment, which is generally based on the fair value of the land, is made directly to the individual owner to purchase the right. Once the entity purchases the right, the owner will not retain any rights over the land. Only the government can revoke the entity’s right. There are two grounds for revocation: based on public interest or if the entity fails to meet the administrative requirements.
The right can be extended and renewed indefinitely at only an insignificant cost (administrative fees and related taxes) to be paid to the government. An entity has a legally protected right to obtain the extension / renewal, provided that all the legal and administrative requirements are met and that the land is not claimed by the government to be used for public interest purposes.

Adequate compensation will be provided for the assets (i.e., building) on the surface of the land in any circumstances. However, compensation for the land based on the fair value will be provided only if the government revokes the entity’s right during the period of the contract. No compensation will be provided for the land if the government revokes the entity’s right when the period of the right has ended or expired or if the application to extend or renew the right is declined by the government.

The right can be used as collateral for debts and can be transferred to another party through sale, exchange, in-kind capital contribution, grant or inheritance.

In these jurisdictions, there is diversity in practice on how to account for a land right.

**Consensus**

In the fact pattern considered, characteristics of a lease can be identified, in accordance with the definition of a lease as defined in PAS 17. A lease could be indefinite via extensions or renewals and, therefore, the existence of an indefinite period does not prevent the ‘right to use’ from qualifying as a lease in accordance with PAS 17.

The lessee has the option to renew the right and that the useful life for depreciation purposes might include renewal periods. Judgment will need to be applied in making the assessment of the appropriate length of the depreciation period.
PAS 17 – Refundable security deposit related to lease

Background

Philippine Accounting Standards (PAS) 17, Leases, requires a lease to be classified as either a finance lease or an operating lease, depending on the substance of the transaction, and accounted for in accordance with this classification. Paragraph 10 of PAS 17 enumerates examples of situations that “individually or in combination would normally lead to a lease being classified as a finance lease”. One such example under Paragraph 10(d) is that “at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset” (Emphasis added).

In most lease contracts, a lessee is required to pay a deposit to the lessor at the inception of the lease. The deposit is refundable at the termination of the contract, to the extent that it has not been applied by the lessor to remedy the breach of any provisions in the contract or to indemnify any consequential costs or losses related to the leased property that are properly chargeable to the lessee. During the term of the lease contract, the lessee will not receive any interest for its deposit or, if there is any interest, the interest rate is lower than the market interest rate.

Issue

Should a refundable security deposit be considered a component of minimum lease payments (MLP)?

Consensus

The refundable security deposit meets the definition of a financial asset (for the lessee) and a financial liability (for the lessor) under Paragraph 11 of PAS 32, Financial Instruments: Presentation, thus, it is within the scope of PAS 39, Financial Instruments: Recognition and Measurement, and must initially be accounted for at fair value in accordance with Paragraph 43 of that standard. The fair value of the deposit is determined based on the prevailing market rate of interest for a similar loan, considering the credit worthiness of the lessor and, depending on facts and circumstances, any additional security available to the lessee.

The excess between the amount of the deposit over its fair value is within the scope of PAS 17, Leases. Paragraph 4 of PAS 17 defines MLP as “the payments over the lease term that the lessee is or can be required to make”. The difference between the present value and the amount of the deposit paid at inception is therefore regarded as an additional amount payable by the lessee / receivable by the lessor. It is therefore taken into account for purposes of calculating the MLP and, consequently, in determining whether the lease is an operating lease or a finance lease.
PAS 19, *Employee Benefits*

**PAS 19 – Pre-tax or post-tax discount rate**

**Issue**

Is the discount rate used to calculate a defined benefit obligation a pre-tax or post-tax rate in accordance with PAS 19, *Employee Benefits* (Revised)?

**Background**

This Q&A deals with the guidance on the calculation of defined benefit obligations. In particular, this clarifies whether, in accordance with PAS 19, the discount rate used to calculate a defined benefit obligation should be a pre-tax or post-tax rate.

The tax regime considered in this Q&A can be summarized as follows:

a) the entity receives a tax deduction for contributions that are made to the plan;

b) the plan pays tax on the contributions received and on the investment income earned; but

c) the plan does not receive a tax deduction for the benefits paid.

**Consensus**

It should be noted that:

a) paragraph 76(b)(iv) of PAS 19 mentions only taxes on contributions and benefits payable within the context of measuring the defined benefit obligation;

b) paragraph 130 of PAS 19 states that: “in determining the return on plan assets, an entity deducts the costs of managing the plan assets and any tax payable by the plan itself, other than tax included in the actuarial assumptions used to measure the defined benefit obligation”; and

c) according to paragraph BC130 of PAS 19 the measurement of the obligation should be independent of the measurement of any plan assets actually held by a plan.

Consequently, the discount rate used to calculate a defined benefit obligation should be a pre-tax discount rate.
PAS 28, *Investment in Associates and Joint Ventures*

**PAS 28 – Impairment of investments in associates in separate financial statements**

**Issue**

Should an entity apply the provisions of PAS 36, *Impairment of Assets*, or PAS 39, *Financial Instruments: Recognition and Measurement*, to test its investments in subsidiaries, joint ventures, and associates carried at cost for impairment in its separate financial statements?

**Background**

According to paragraph 10 of PAS 27, *Consolidated and Separate Financial Statements* (2011) an entity, in its separate financial statements, shall account for investments in subsidiaries, joint ventures and associates either at cost or in accordance with PAS 39 or PFRS 9, *Financial Instruments*.

According to paragraphs 4 and 5 of PAS 36 and paragraph 2(a) of PAS 39, investments in subsidiaries, joint ventures, and associates that are not accounted for in accordance with PAS 39 are within the scope of PAS 36 for impairment purposes.

**Consensus**

In its separate financial statements, an entity should apply the provisions of PAS 36 to test for impairment its investments in subsidiaries, joint ventures, and associates that are carried at cost in accordance with paragraph 10(a) of PAS 27.
Philippine Interpretations Committee

PAS 32, *Financial Instruments: Presentation*

**PAS 32 – Accounting for a financial instrument that is mandatorily convertible into a variable number of shares subject to a cap and a floor**

**Issue**

How should an entity classify a financial instrument that is mandatorily convertible into a variable number of shares subject to a cap and a floor in accordance with PAS 32, *Financial Instruments: Presentation*, and PAS 39, *Financial Instruments: Recognition and Measurement*, or PFRS 9, *Financial Instruments*?

**Background**

The financial instrument has a stated maturity date and, at maturity, the issuer must deliver a variable number of its own equity instruments to equal a fixed cash amount – subject to a cap and a floor, which limit and guarantee, respectively, the number of equity instruments to be delivered.

**Consensus**

The issuer’s obligation to deliver a variable number of the entity’s own equity instruments is a non-derivative that meets the definition of a financial liability in paragraph 11(b)(i) of PAS 32 in its entirety.

Paragraph 11(b)(i) of the definition of a liability does not have any limits or thresholds regarding the degree of variability that is required. Therefore, the contractual substance of the instrument is a single obligation to deliver a variable number of equity instruments at maturity, with the variation based on the value of those equity instruments. Such a single obligation to deliver a variable number of own equity instruments cannot be subdivided into components for the purposes of evaluating whether the instrument contains a component that meets the definition of equity. Even though the number of equity instruments to be delivered is limited and guaranteed by the cap and the floor, the overall number of equity instruments that the issuer is obliged to deliver is not fixed and therefore the entire obligation meets the definition of a financial liability.

Furthermore, the cap and the floor are embedded derivative features whose values change in response to the price of the issuer’s equity share. Therefore, assuming that the issuer has not elected to designate the entire instrument under the fair value option, the issuer must separate those features and account for the embedded derivative features separately from the host liability contract at fair value through profit or loss in accordance with PAS 39 or PFRS 9.
PAS 32 – A financial instrument that is mandatorily convertible into a variable number of shares (subject to a cap and a floor) but gives the issuer the option to settle by delivering the maximum (fixed) number of shares

Issue

How should an issuer assess the substance of a particular early settlement option included in a financial instrument in accordance with PAS 32, *Financial Instruments: Presentation*?

Background

The instrument has a stated maturity date and at maturity, the issuer must deliver a variable number of its own equity instruments to equal a fixed cash amount, subject to a cap and a floor. The cap and the floor limit and guarantee, respectively, the number of equity instruments to be delivered. The issuer is required to pay interest at a fixed rate.

The issuer has the contractual right to settle the instrument at any time before maturity. If the issuer chooses to exercise that early settlement option, it must:

a) deliver the maximum number of equity instruments specified in the contract; and

b) pay in cash all of the interest that would have been payable if the instrument had remained outstanding until its maturity date.

Consensus

The definitions of financial asset, financial liability and equity instrument in PAS 32 are based on the financial instrument’s contractual rights and contractual obligations. However, paragraph 15 of PAS 32 requires the issuer of a financial instrument to classify the instrument in accordance with the substance of the contractual arrangement. Consequently, if a contractual term of a financial instrument lacks substance, that contractual term would be excluded from the classification assessment of the instrument.

The issuer cannot assume that a financial instrument (or its components) meets the definition of an equity instrument simply because the issuer has the contractual right to settle the financial instrument by delivering a fixed number of its own equity instruments.

Judgment will be required to determine whether the issuer’s early settlement option is substantive and thus should be considered in determining how to classify the instrument. If the early settlement option is not substantive, that term would not be considered in determining the classification of the financial instrument.

The guidance in paragraph 20(b) of PAS 32 is relevant because it provides an example of a situation in which one of an instrument’s settlement alternatives is excluded from the classification assessment. Specifically, the example in that paragraph describes an instrument that the issuer will settle by delivering either cash or its own shares and states that one of the settlement alternatives should be excluded from the classification assessment in some circumstances.
To determine whether the early settlement option is substantive, the issuer will need to understand whether there are actual economic or other business reasons that the issuer would exercise the option. In making that assessment, the issuer could consider, along with other factors, whether the instrument would have been priced differently if the issuer’s early settlement option had not been included in the contractual terms.

Factors such as the term of the instrument, the width of the range between the cap and the floor, the issuer’s share price and the volatility of the share price could be relevant to the assessment of whether the issuer’s early settlement option is substantive. For example, the early settlement option may be less likely to have substance – especially if the instrument is short-lived – if the range between the cap and the floor is wide and the current share price would equate to the delivery of a number of shares that is close to the floor (i.e., the minimum). That is because the issuer may have to deliver significantly more shares to settle early than it may otherwise be obliged to deliver at maturity.

PAS 32 – Classification of financial instruments that give the issuer the contractual right to choose the form of settlement

Issue

How should financial instruments that give the issuer the contractual right to choose the form of settlement be classified in accordance with PAS 32, Financial Instruments: Presentation?

Background

This Q&A clarifies how an issuer would classify three financial instruments in accordance with PAS 32. None of the financial instruments had a maturity date but each gave the holder the contractual right to redeem at any time. The holder’s redemption right was described differently for each of the three financial instruments; however in each case the issuer had the contractual right to choose to settle the instrument in cash or a fixed number of its own equity instruments if the holder exercised its redemption right. The issuer was not required to pay dividends on the three instruments but could choose to do so at its discretion.

Paragraph 15 of PAS 32 requires the issuer of a financial instrument to classify the instrument in accordance with the substance of the contractual arrangement. Consequently, the issuer cannot achieve different classification results for financial instruments with the same contractual substance simply by describing the contractual arrangements differently.

Paragraph 11 of PAS 32 sets out the definitions of both a financial liability and an equity instrument. Paragraph 16 describes in more detail the circumstances in which a financial instrument meets the definition of an equity instrument.

Consensus

A non-derivative financial instrument that gives the issuer the contractual right to choose to settle in cash or a fixed number of its own equity instruments meets the definition of an equity instrument in PAS 32 as long as the instrument does not establish an obligation to deliver cash (or another financial asset) indirectly through its terms and conditions. Paragraph 20(b) of PAS 32 provides the example that an indirect contractual obligation
would be established if a financial instrument provides that on settlement the entity will deliver either cash or its own equity instruments whose value is determined to exceed substantially the value of the cash.

Financial instruments, in particular those that are more structured or complex, require careful analysis to determine whether they contain equity and non-equity components that must be accounted for separately in accordance with PAS 32.

If the issuer has a contractual obligation to deliver cash, that obligation meets the definition of a financial liability.
**Issue**

How should an entity apply the requirements of PAS 34, *Interim Financial Reporting*, regarding the presentation and content of the condensed statement of cash flows in the interim financial statements?

**Background**

There are divergent views on the presentation and content of the condensed statement of cash flows. One view is that an entity should present a detailed structure of the condensed statement of cash flows showing cash flows by nature. Another view is that an entity may present a three-line condensed statement of cash flows showing only a total for each of operating, investing and financing cash flow activities.

A condensed statement of cash flows is one of the primary statements that is included as part of an interim financial report as prescribed by paragraph 8 of PAS 34. Paragraph 10 of PAS 34 specifies that each of the condensed statements shall include, at a minimum, each of the headings and subtotals that were included in the most recent annual financial statements. Paragraph 10 of PAS 34 also requires additional line items to be included if their omission would make the interim financial statements misleading.

In an interim financial report:

a) an entity shall include an explanation of events and transactions that are significant to an understanding of the changes in financial position and performance of the entity since the end of the last annual reporting period. Information disclosed in relation to those events and transactions shall update the relevant information presented in the most recent annual financial report (see paragraph 15 of PAS 34).

b) the overriding goal is to ensure that an interim financial report includes all information that is relevant to understanding an entity’s financial position and performance during the interim period (see paragraph 25 of PAS 34). The Interpretations Committee further noted that in accordance with paragraph OB20 of the *Conceptual Framework*, information about cash flows helps users to understand a reporting entity’s operations, evaluate its financing and investing activities, assess its liquidity or solvency and interpret other information about financial performance.

**Consensus**

To meet the requirements in paragraphs 10, 15 and 25 of PAS 34, a condensed statement of cash flows should include all information that is relevant in understanding the entity’s ability to generate cash flows and the entity’s needs to utilize those cash flows. A three-line presentation alone would not meet the requirements in PAS 34.
PAS 39, Financial Instruments: Recognition and Measurement

PAS 39 – Income and expenses arising on financial instruments with a negative yield – presentation in the statement of comprehensive income

Issue
How should an expense arising on a financial asset because of a negative effective interest rate be presented in the statement of comprehensive income?

Background
This Q&A discusses the ramifications of the economic phenomenon of negative interest rates for the presentation of income and expenses in the statement of comprehensive income.

Consensus
Interest resulting from a negative effective interest rate on a financial asset does not meet the definition of interest revenue in PAS 18, Revenue, because it reflects a gross outflow, instead of a gross inflow, of economic benefits. Also, this amount is not an interest expense because it arises on a financial asset instead of on a financial liability of the entity.

Consequently, the expense arising on a financial asset because of a negative effective interest rate should not be presented as interest revenue or interest expense, but in some other appropriate expense classification. In accordance with paragraphs 85 and 112(c) of PAS 1, Presentation of Financial Statements, the entity is required to present additional information about such an amount if that is relevant to an understanding of the entity’s financial performance or to an understanding of this item.
IFRIC 21, Levies

IFRIC 21 – Identification of a present obligation to pay a levy that is subject to a pro rata activity threshold as well as an annual activity threshold

Issue

How should the requirements in paragraph 8 of IFRIC 21, Levies, be interpreted in identifying an obligating event for a levy?

Background

In May 2013, IFRIC 21, which is effective for annual periods beginning on or after 1 January 2014, with earlier application permitted, was issued. IFRIC 21 provides an interpretation of the requirements in PAS 37, Provisions, Contingent Liabilities and Contingent Assets, for the recognition of liabilities for obligations to pay levies that are within the scope of IFRIC 21.

There are tax regimes in which an obligation to pay a levy arises as a result of activity during a period but is not payable until a minimum activity threshold, as identified by the legislation, is reached. The threshold is set as an annual threshold, but this threshold is reduced, pro rata to the number of days in the year that the entity participated in the relevant activity, if its participation in the activity started or stopped during the course of the year.

Paragraph 8 of IFRIC 21 provides that the obligating event that gives rise to a liability to pay a levy is the activity that triggers the payment of the levy, as identified by the legislation. For example, if the activity that triggers the payment of the levy is the generation of revenue in the current period and the calculation of that levy is based on the revenue that was generated in a previous period, the obligating event for that levy is the generation of revenue in the current period. The generation of revenue in the previous period is necessary, but not sufficient, to create a present obligation.

This Q&A deals with how the thresholds stated in the legislation should be taken into consideration when deciding “the activity that triggers the payment of the levy” in paragraph 8 of IFRIC 21.

Consensus

In the circumstance described above, the payment of the levy is triggered by the reaching of the annual threshold as identified by the legislation.

The entity would be subject to a threshold that is lower than the threshold that applies at the end of the annual assessment period if, and only if, the entity stops the relevant activity before the end of the annual assessment period.

Accordingly, in the light of the guidance in paragraph 12 of IFRIC 21, the obligating event for the levy is the reaching of the threshold that applies at the end of the annual assessment period.

It should be noted that there is a distinction between a levy with an annual threshold that is reduced pro rata when a specified condition is met and a levy for which an obligating event
occurs progressively over a period of time as described in paragraph 11 of IFRIC 21; until the specified condition is met, the pro rata reduction in the threshold does not apply.