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# **EXPOSURE DRAFT**

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## **Proposed Financial Reporting Framework for Small- and Medium-Sized Entities**

**Released November 1, 2012**

**Comments are requested by January 30, 2013**

**Prepared by the AICPA FRF for SMEs Task Force for comment from persons  
interested  
in financial reporting of privately owned small- and medium-sized entities**

**Comments should be addressed to Robert Durak at [rdurak@aicpa.org](mailto:rdurak@aicpa.org), or you can send  
them by mail to Robert Durak, AICPA, 1211 Avenue of the Americas, 19th Floor, New  
York, NY 10036.**

# Proposed Financial Reporting Framework for Small- and Medium-Sized Entities

## **AICPA FRF for SMEs Task Force (2012–2013)**

David Morgan, *Chair*  
Theresa Bible  
DeAnn Hill  
Karen Kerber  
Ken Odom

Marc Parkinson  
Pat Piteo  
Tom Ratcliffe  
Eric Wallace

### **AICPA Staff**

Charles E. Landes  
*Vice President*  
*Professional Standards and Services*

Robert Durak  
*Director, Private Company Financial Reporting*  
*Accounting Standards*

Daniel Noll  
*Director*  
*Accounting Standards*



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New York, NY 10036-8775

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# EXPLANATORY MEMORANDUM

## Introduction

This memorandum provides a description of the proposed *Financial Reporting Framework for Small- and Medium-Sized Entities (FRF for SMEs)*, and a discussion of the circumstances leading to its release. The AICPA *FRF for SMEs* task force (task force) seeks comments from stakeholders about the proposed *FRF for SMEs*. Undergoing professional scrutiny will contribute to the appropriateness, comprehensiveness, distinction, and reliability of the *FRF for SMEs*.

## Description of the *FRF for SMEs*

The *FRF for SMEs* is a self-contained, special purpose framework<sup>1</sup> intended for use by privately-held small- to medium-sized entities (SMEs) in preparing their financial statements. The *FRF for SMEs* draws upon a blend of traditional methods of accounting and accrual income tax accounting. The *FRF for SMEs* is a less complicated and less costly framework of accounting for SMEs that do not require financial statements based on accounting principles generally accepted in the United States of America (GAAP). The *FRF for SMEs* is a cost-beneficial solution for management, owners, and others who require financial statements that are prepared in a consistent and reliable manner in accordance with a framework that has undergone public comment and professional scrutiny. The accounting principles comprising the *FRF for SMEs* are intended to be the most appropriate for the preparation of SME financial statements based on the needs of the financial statement users and cost-benefit considerations. Accounting principles in the *FRF for SMEs* are responsive to the well-documented issues and concerns stakeholders currently encounter when preparing financial statements for SMEs.

## Features of the *FRF for SMEs*

The *FRF for SMEs* is not proposed as an authoritative document, and the AICPA would have no authority to require the use of the *FRF for SMEs* for any entity. Use of the *FRF for SMEs* is a choice made by the management of an entity. Therefore, the *FRF for SMEs* will have no effective date, and management can decide to use the *FRF for SMEs* once it is released.

Key features of the *FRF for SMEs* that make it especially suited and relevant to SMEs and highly useful and responsive to the financial reporting needs of lenders and other financial statement users include the following:

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<sup>1</sup> Special purpose frameworks, with the exception of the contractual basis of accounting, are commonly referred to as other comprehensive bases of accounting (OCBOA). Special purpose frameworks include cash basis, modified cash basis, tax basis, regulatory basis, contractual basis, and other bases of accounting that utilize a definite set of logical, reasonable criteria that is applied to all material items appearing in the financial statements.

- The framework is built upon a foundation of reliable and comprehensive accounting principles.
- Historical cost is the primary measurement basis.
- Disclosures are reduced, while still providing users with the relevant information they need.
- Familiar and traditional accounting methods are employed.
- Adjustments needed to reconcile tax return income with book income are reduced.
- The framework is a principles-based framework, usable across industries by incorporated and unincorporated entities.
- The framework contains less complicated, leaner, relevant financial reporting principles for SMEs.
- Only financial statement matters that are typically encountered by SMEs are addressed in the framework.

The *FRF for SMEs* is intended as a stable framework that will not undergo frequent changes.

Implementation guidance, in the form of application examples, illustrative financial statements, a disclosure checklist, and similar tools will be offered in a companion volume to complement the *FRF for SMEs*. This companion implementation guidance volume will also include accounting principles related to defined benefit pension plans (see chapter 28 of the *FRF for SMEs*.) The companion volume is not included with this exposure draft and will be issued concurrently with the final issuance of the *FRF for SMEs*.

## **Background**

The AICPA believes that a new financial reporting framework for privately-owned small- and medium-sized businesses is needed. The framework must be attuned to and responsive to the financial reporting needs of SMEs and their financial statement users. This framework must produce reliable financial statements that are based upon comprehensive and consistently applied accounting principles. The AICPA's recognition of this need strengthened and became well-defined recently, as the private company financial reporting community and CPA profession embarked upon efforts to improve GAAP for private companies.

Many small- and medium-sized entities may not need to prepare their financial statements in accordance with GAAP because GAAP is not required or is not the best solution for their financial reporting needs. Similarly, existing non-GAAP accounting frameworks are sometimes insufficient or lack adequate standardization to meet the financial reporting needs of many businesses. A financial reporting framework more reliable, comprehensive, and consistent than existing non-GAAP accounting frameworks

and less complicated, less voluminous, and more tailored to the SME environment than GAAP, is required. This financial reporting need has been expressed by stakeholders and is growing greater as SMEs are increasingly challenged to find more cost-beneficial solutions to their financial reporting needs and their financial statement users demand relevant and decision-useful information. The *FRF for SMEs* has been developed to answer this growing financial reporting need of SME stakeholders.

## **Guide for Respondents**

The task force is seeking comments about the *FRF for SMEs* from those who are stakeholders in the financial reporting of privately-owned small- and medium-sized entities, including financial statement preparers, CPA practitioners, and financial statement users. Comments about the specific content of each chapter of the *FRF for SMEs*, including technical sufficiency, comprehensiveness, relevance, suitability, and operability are sought.

Comments are most helpful when they refer to specific paragraphs, include the reasons for the comments, and, when appropriate, make specific suggestions for any proposed changes to wording.

Written comments on the exposure draft will become part of the public record of the AICPA and will be available for public inspection at the offices of the AICPA after January 31, 2013, for one year.

Responses should be sent to Robert Durak at [rdurak@aicpa.org](mailto:rdurak@aicpa.org) or mailed to Robert Durak, AICPA, 1211 Avenue of the Americas, 19th Floor, New York, NY 10036

## **Comment Period**

The comment period for this exposure draft ends on January 30, 2013.

## Notice to Readers

The proposed *Financial Reporting Framework for Small- and Medium-Sized Entities (FRF for SMEs)* was developed by a task force of CPA practitioners and professionals serving and working at small- and medium-sized entities and the staff of the AICPA. The *FRF for SMEs* has not been approved, disapproved, or otherwise acted upon by any senior technical committee of the AICPA or the Financial Accounting Standards Board and has no official or authoritative status.

The AICPA does not accept responsibility for loss caused to any person who acts or refrains from acting in reliance on the material in this publication, whether such loss is caused by negligence or otherwise.

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## FOREWORD

### **About the *Financial Reporting Framework for Small- and Medium-Sized Entities (FRF for SMEs)***

This *FRF for SMEs* has been developed by the AICPA *FRF for SMEs* Task Force (task force) and the staff of the AICPA as a special purpose framework<sup>1</sup> for smaller- and medium-sized entities. It is intended to be a self-contained financial reporting framework. A separate volume containing examples, implementation guidance, illustrative financial statements, and other tools have been developed by the task force to supplement the *FRF for SMEs*. This companion Implementation Guidance volume also includes accounting principles related to defined benefit pension plans (see chapter 28 of the *FRF for SMEs*.)

The *FRF for SMEs* draws upon a blend of traditional accounting principles and accrual income tax methods of accounting. As a result, the *FRF for SMEs* departs from some measures of accounting principles generally accepted in the United States of America (GAAP), such as the increased use of fair values, the detailed standards for complex transactions, and the large volume of disclosure requirements. The *FRF for SMEs* is far less restrictive than GAAP. Although users will find that the *FRF for SMEs* lacks a sizeable amount of guidance that exists in GAAP, the *FRF for SMEs* does lay out principles that encourage the use of professional judgment in the particular circumstances of a transaction or event.

The *FRF for SMEs* is a cost-beneficial solution for management, owners, and others who require financial statements that are prepared in a consistent and reliable manner in accordance with a framework that has undergone public comment and professional scrutiny. The accounting principles comprising the *FRF for SMEs* are intended to be the most appropriate for the preparation of small- and medium-sized entity financial statements based on the needs of the financial statement users and cost and benefit considerations.

The task force that developed the *FRF for SMEs* consisted of professionals and staff who have an abundance of experience serving smaller- to medium-sized entities or who have worked directly for such organizations.

The task force believes that the *FRF for SMEs* is suitable criteria for general use financial statements or external uses when external users have direct access to management. As such, the *FRF for SMEs* has the following attributes:

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<sup>1</sup> Special purpose frameworks, with the exception of the contractual basis of accounting, are commonly referred to as other comprehensive bases of accounting (OCBOA). Special purpose frameworks include cash basis, modified cash basis, tax basis, regulatory basis, contractual basis, and other bases of accounting that utilize a definite set of logical, reasonable criteria that is applied to all material items appearing in the financial statements.

- Objectivity. The *FRF for SMEs* is free from bias.
- Measurability. The *FRF for SMEs* permits reasonably consistent measurements.
- Completeness. The *FRF for SMEs* is sufficiently complete so that those relevant factors that would alter a conclusion about the financial statements are not omitted.
- Relevance. The *FRF for SMEs* is relevant to financial statement users.

The use of this *FRF for SMEs* requires the exercise of individual professional judgment.

## **Scope**

The *FRF for SMEs* was developed for smaller- to medium-sized entities that require reliable financial statements for internal use and for external uses when external users have direct access to management. The task force believes that this framework can be used by entities in many industry groups and may be used by unincorporated entities, as well as those incorporated.

Typically, this framework would be used by management and owners who rely on a set of financial statements to confirm their assessments of performance and of what they own and what they owe. Often, their financial statements support applications for bank financing when the banker does not base a lending decision solely on the financial statements but also on available collateral or other evaluation mechanisms not related to the financial statements.

The use of the *FRF for SMEs* by entities is premised on the view that a majority of owners and management have no intention of going public. Owners and management that do have such an intention should consider using GAAP in the preparation of their financial statements. The *FRF for SMEs* is not intended to be a substitute for GAAP when GAAP-based financial statements are necessary or appropriate.

## **Authority and Effective Date of the *FRF for SMEs***

The AICPA has no authority to require the use of the *FRF for SMEs* for any entity. Therefore, use of the *FRF for SMEs* is purely optional. Management, who prepares an entity's financial statements in accordance with the *FRF for SMEs*, may represent or assert that such financial statements have been prepared in accordance with the *FRF for SMEs*, a special purpose framework established by the task force.

Because use of the *FRF for SMEs* is optional, there is no effective date for its implementation. Subsequent amendments to the *FRF for SMEs* may be adopted early unless otherwise specified in the amendment.

## **Background**

In the years prior to the development of the *FRF for SMEs*, concern has escalated among private companies, and the CPA practitioners who serve them, about the cost to prepare financial statements. Concern has also escalated over an increasing lack of relevance of a number of accounting standards for many users of private company financial statements. These concerns are especially prevalent among small- and medium-sized entities.

In response to these concerns and to the appeals for a solution by many stakeholders, the AICPA formed the task force to develop a financial reporting framework other than GAAP for small- to medium-sized entities. Accounting principles in the *FRF for SMEs* are responsive to the well-documented issues and concerns stakeholders have encountered when preparing financial statements.

## **Maintenance of the *FRF for SMEs***

The task force intends to review and propose amendments to the *FRF for SMEs* approximately every three or four years. Amendments will be primarily based on input from stakeholders and developments in accounting and financial reporting.

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# Chapter 1—*Financial Statement Concepts*

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## Purpose and Scope

**1.01** This chapter describes the concepts underlying the development and use of accounting principles in general purpose financial statements (hereafter referred to as financial statements). Such financial statements are designed to meet the common information needs of owners and management that need reliable financial statements for internal use and the needs of external users of financial information about an entity.

**1.02** This chapter may be used by preparers of financial statements and accounting practitioners in exercising their professional judgment about the application of the *Financial Reporting Framework for Small- and Medium-Sized Entities (FRF for SMEs)*.

**1.03** This chapter does not establish principles for particular measurement or disclosure issues. Nothing in the chapter overrides any specific principles elsewhere in the *FRF for SMEs*.

## Financial Statements

**1.04** *Financial statements* normally include a balance sheet, a statement of income, a statement of changes in equity (changes in equity may be disclosed in the notes to the financial statements or as part of another financial statement), and a statement of cash flows. Notes to financial statements and supporting schedules to which the financial statements are cross-referenced are an integral part of such statements. However, nothing precludes the use of this framework when only a single financial statement (for example, a balance sheet) is prepared.

**1.05** Financial statements are based on representations of past, rather than future, transactions and events, although they often require estimates to be made in anticipation of future transactions and events and include measurements that may, by their nature, be approximations.

**1.06** Material presentation items should not be netted in the financial statements, unless specifically allowed by the *FRF for SMEs*.

## Objective of Financial Statements

**1.07** The objective of financial statements is to communicate information that is useful to management, creditors, and other users (users) in making their resource allocation decisions or assessing management stewardship, or both. Consequently, financial statements provide information about

- a. an entity's economic resources, obligations, and equity;
- b. changes in an entity's economic resources, obligations, and equity; and
- c. the economic performance of the entity.

## **Benefit Versus Cost Constraint**

**1.08** The benefits expected to arise from providing information in financial statements should exceed the cost of doing so. In developing this framework, the AICPA *FRF for SMEs* Task Force (task force) weighed the anticipated costs and benefits of its proposals in general terms to assess whether they are justified on cost and benefit grounds. The task force recognizes that the evaluation of the nature and amount of benefits and costs is substantially a judgmental process.

## **Materiality**

**1.09** Users are interested in information that may affect their decision making. *Materiality* is the term used to describe the significance of financial statement information to decision makers. An item of information, or an aggregate of items, is material if it is probable that its omission or misstatement would influence or change a decision. Materiality is a matter of professional judgment in the particular circumstances.

## **Qualitative Characteristics**

**1.10** *Qualitative characteristics* define and describe the attributes of information provided in financial statements that make that information useful to users. The four principal qualitative characteristics are understandability, relevance, reliability, and comparability.

## **Understandability**

**1.11** For the information provided in financial statements to be useful, users must be able to understand it. Users are assumed to have a reasonable understanding of business and economic activities and accounting, together with a willingness to study the information with reasonable diligence.

## **Relevance**

**1.12** For the information provided in financial statements to be useful, it must be relevant to the decisions made by users. Information is relevant by its nature when it can influence the users' decisions by helping them evaluate the financial impact of past, present, or future transactions and events or confirm or correct previous evaluations. Relevance is achieved through information that has predictive value or feedback value and by its timeliness:

- a. *Predictive value and feedback value.* Information that helps users to predict an entity's future income and cash flows has predictive value. Although information provided in financial statements will not normally be a prediction in itself, it may be useful in making predictions. For example, the predictive value of the statement of income is enhanced if abnormal items are separately disclosed. Information that confirms or corrects previous predictions has feedback value. Information often has both predictive value and feedback value.

- b. *Timeliness.* For information to be useful for decision making, it must be received by the decision maker before it loses its capacity to influence decisions. The usefulness of information for decision making declines as time elapses.

## Reliability

**1.13** For the information provided in financial statements to be useful, it must be reliable. Information is reliable when it is in agreement with the actual underlying transactions and events, the agreement is capable of independent verification, and the information is reasonably free from error and bias. Reliability is achieved through representational faithfulness, verifiability, and neutrality. Neutrality is affected by the use of conservatism in making judgments under conditions of uncertainty.

- a. *Representational faithfulness.* Representational faithfulness is achieved when transactions and events affecting the entity are presented in financial statements in a manner that is in agreement with the actual underlying transactions and events. Thus, transactions and events are accounted for and presented in a manner that conveys their substance rather than necessarily their legal or other form.

The substance of transactions and events may not always be consistent with the substance apparent from their legal or other form. To determine the substance of a transaction or event, it may be necessary to consider a group of related transactions and events as a whole. The determination of the substance of a transaction or event will be a matter of professional judgment in the circumstances.

- b. *Verifiability.* The financial statement representation of a transaction or event is verifiable if knowledgeable and independent observers would concur that it is in agreement with the actual underlying transaction or event with a reasonable degree of precision. Verifiability focuses on the correct application of a basis of measurement rather than its appropriateness.
- c. *Neutrality.* Information is *neutral* when it is free from bias that would lead users toward making decisions that are influenced by the way the information is measured or presented. Bias in measurement occurs when a measure tends to consistently overstate or understate the items being measured. In the selection of accounting principles, bias may occur when the selection is made with the interests of particular users or with particular economic or political objectives in mind.

Financial statements that do not include everything necessary for faithful representation of transactions and events affecting the entity would be incomplete and, therefore, potentially biased.

- d. *Conservatism.* Use of conservatism in making judgments under conditions of uncertainty affects the neutrality of financial statements in an acceptable manner. When uncertainty exists, estimates of a conservative nature attempt to ensure that assets, revenues, and gains are not overstated and, conversely, that

liabilities, expenses, and losses are not understated. However, conservatism does not encompass the deliberate understatement of assets, revenues, and gains or the deliberate overstatement of liabilities, expenses, and losses.

## **Comparability**

**1.14** *Comparability* is a characteristic of the relationship between two pieces of information rather than of a particular piece of information by itself. It enables users to identify similarities in, and differences between, the information provided by two sets of financial statements. Comparability is important when comparing the financial statements of two different entities and when comparing the financial statements of the same entity over two periods or at two different points in time.

**1.15** Comparability in the financial statements of an entity is enhanced when the same accounting policies are used consistently from period to period. Consistency helps prevent misconceptions that might result from the application of different accounting policies in different periods. When a change in accounting policy is deemed to be appropriate, disclosure of the effects of the change may be necessary to maintain comparability.

## **Qualitative Characteristics Trade-off**

**1.16** In practice, a trade-off between qualitative characteristics is often necessary, particularly between relevance and reliability. For example, there is often a trade-off between the timeliness of producing financial statements and the reliability of the information reported in the statements. Generally, the aim is to achieve an appropriate balance among the characteristics in order to meet the objective of financial statements. The relative importance of the characteristics in different cases is a matter of professional judgment.

## **Elements of Financial Statements**

**1.17** Elements of financial statements are the basic categories of items portrayed therein in order to meet the objective of financial statements. There are two types of elements: those that describe the economic resources, obligations, and equity of an entity at a point in time and those that describe changes in economic resources, obligations, and equity over a period of time. Notes to financial statements, which are useful for the purpose of clarification or further explanation of the items in financial statements, although an integral part of financial statements, are not considered to be an element.

**1.18** *Net income* is the residual amount after expenses and losses are deducted from revenues and gains. Net income generally includes all transactions and events increasing or decreasing the equity of the entity, except those that result from equity contributions and distributions.

## **Assets**

**1.19** *Assets* are economic resources controlled by an entity as a result of past

transactions or events and from which future economic benefits may be obtained.

**1.20** Assets have three essential characteristics:

- a. They embody a future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash flows.
- b. The entity can control access to the benefit.
- c. The transaction or event giving rise to the entity's right to, or control of, the benefit has already occurred.

**1.21** It is not essential for control of access to the benefit to be legally enforceable for a resource to be an asset, provided the entity can control its use by other means.

**1.22** A close association exists between incurring expenditures and generating assets, but the two do not necessarily coincide. Therefore, when an entity incurs an expenditure, this may provide evidence that future economic benefits were sought but is not conclusive proof that an item satisfying the definition of an *asset* has been obtained. Similarly, the absence of a related expenditure does not preclude an item from satisfying the definition of an *asset* and, thus, becoming a candidate for recognition in the balance sheet. For example, items that have been donated to the entity may satisfy the definition of an *asset*.

## **Liabilities**

**1.23** *Liabilities* are obligations of an entity arising from past transactions or events, the settlement of which may result in the transfer or use of assets, provision of services, or other yielding of economic benefits in the future.

**1.24** Liabilities have three essential characteristics:

- a. They embody a duty or responsibility to others that entails settlement by future transfer or use of assets, provision of services, or other yielding of economic benefits, at a specified or determinable date, on occurrence of a specified event, or on demand.
- b. The duty or responsibility obligates the entity, leaving it little or no discretion to avoid it.
- c. The transaction or event obligating the entity has already occurred.

**1.25** Liabilities do not have to be legally enforceable provided that they otherwise meet the definition of *liabilities*; they can be based on equitable or constructive obligations. An equitable obligation is a duty based on ethical or moral considerations. A constructive obligation is one that can be inferred from the facts in a particular situation, as opposed to a contractually-based obligation.

## **Equity**

**1.26** *Equity* is the ownership interest in the assets of an entity after deducting its

liabilities. Although equity of an entity in total is a residual, it includes specific categories of items (for example, types of capital stock, additional paid-in-capital, and retained earnings). As used in the *FRF for SMEs*, the term *retained earnings* also refers to owners' capital accounts, depending upon the nature of the entity.

## **Revenues**

**1.27** *Revenues* are increases in economic resources, either by way of inflows or enhancements of assets or reductions of liabilities, resulting from the ordinary activities of an entity. Revenues of entities normally arise from the sale of goods, the rendering of services, or the use by others of entity resources yielding rent, interest, royalties, or dividends.

## **Expenses**

**1.28** *Expenses* are decreases in economic resources, either by way of outflows or reductions of assets or incurrence of liabilities, resulting from an entity's ordinary revenue generating or service delivery activities.

## **Gains**

**1.29** *Gains* are increases in equity from peripheral or incidental transactions and events affecting an entity and from all other transactions, events, and circumstances affecting the entity, except those that result from revenues or equity contributions.

## **Losses**

**1.30** *Losses* are decreases in equity from peripheral or incidental transactions and events affecting an entity and from all other transactions, events, and circumstances affecting the entity except those that result from expenses or distributions of equity.

## **Recognition Criteria**

**1.31** *Recognition* is the process of including an item in the financial statements of an entity. Recognition consists of the addition of the amount involved into statement totals together with a narrative description of the item (for example, "inventory" or "sales") in a statement. Similar items may be grouped together in the financial statements for the purpose of presentation.

**1.32** Recognition does not mean disclosure in the notes to the financial statements. Notes either provide further details about items recognized in the financial statements or provide information about items that do not meet the criteria for recognition and, thus, are not recognized in the financial statements.

**1.33** Whether any particular item is recognized will require the application of professional judgment in considering whether the specific circumstances meet the recognition criteria.

**1.34** The recognition criteria are as follows:

- a. The item has an appropriate basis of measurement, and a reasonable estimate can be made of the amount involved.
- b. For items involving obtaining or giving up future economic benefits, it is probable that such benefits will be obtained or given up.

**1.35** It is possible that an item will meet the definition of an *element* but still not be recognized in the financial statements because it is not probable that future economic benefits will be obtained or given up or because a reasonable estimate cannot be made of the amount involved. It may be appropriate to provide information about items that do not meet the recognition criteria in notes to the financial statements. Not recognizing an expenditure as an asset does not imply either that the intention of management in incurring the expenditure was other than to generate future economic benefits for the entity or that management was misguided. The only implication is that the degree of certainty that economic benefits will flow to the entity beyond the current accounting period is insufficient to warrant the recognition of an asset.

**1.36** Items recognized in financial statements are accounted for in accordance with the accrual basis of accounting. The accrual basis of accounting recognizes the effect of transactions and events in the period in which the transactions and events occur, regardless of whether there has been a receipt or payment of cash or its equivalent.

**1.37** Revenues are generally recognized when performance is achieved, or partially achieved in the context of contracts in process, and reasonable assurance regarding measurement and collectability of the consideration exists.

**1.38** Gains are generally recognized when realized.

**1.39** Expenses and losses are generally recognized when an expenditure or previously recognized asset does not have future economic benefit. Expenses are related to a period on the basis of transactions or events occurring in that period or by allocation.

**1.40** Expenses are recognized in the statement of income on the basis of a direct association between the costs incurred and the earning of specific items of income. This process, commonly referred to as the *matching of costs with revenues*, involves the simultaneous or combined recognition of revenues and expenses that result directly and jointly from the same transactions or other events. For example, the various components of expense making up the cost of goods sold are recognized at the same time as the income derived from the sale of the goods.

**1.41** When economic benefits are expected to arise over several accounting periods and the association with income can only be broadly or indirectly determined, expenses are recognized in the statement of income on the basis of systematic and rational allocation procedures. This is often necessary in recognizing the expenses associated with the using up of assets such as property, plant, equipment, patents, and trademarks. In such cases, the expense is referred to as *depreciation* or *amortization*. These allocation procedures are intended to recognize expenses in the accounting periods in which the economic benefits associated with these items are consumed or expire.

**1.42** An expense is recognized immediately in the statement of income when an

expenditure produces no future economic benefits or when, and to the extent that, future economic benefits do not qualify or cease to qualify, for recognition in the balance sheet as an asset.

## Measurement

**1.43** *Measurement* is the process of determining the amount at which an item is recognized in the financial statements. An amount can be measured on a number of bases. However, financial statements are prepared primarily using the historical cost basis of measurement whereby transactions and events are recognized in financial statements at the amount of cash or cash equivalents paid or received or the fair value ascribed to them when they took place.

**1.44** Other bases of measurement are also used but only in limited circumstances. They include the following:

- a. *Replacement cost*. The amount that would be needed currently to acquire an equivalent asset. This may be used, for example, when inventories are valued at the lower of historical cost and replacement cost.
- b. *Realizable value*. The amount that would be received by selling an asset. This may be used, for example, to value temporary and portfolio investments. Market value may be used to estimate realizable value when a market for an asset exists.
- c. *Present value*. The discounted amount of future cash flows expected to be received from an asset or required to settle a liability. This may be used, for example, to estimate the cost of pension benefits.

**1.45** Financial statements are prepared with no adjustment being made for the effect on capital of a change in the general purchasing power of the currency during the period (in other words, inflation or deflation.)

**1.46** Financial statements are prepared on the assumption that the entity is a going concern, meaning it will continue in operation for the foreseeable future and will be able to realize assets and discharge liabilities in the normal course of operations. Different bases of measurement may be appropriate when the entity is not expected to continue in operation for the foreseeable future.

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## **Chapter 2—General Principles of Financial Statement Presentation and Accounting Policies**

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### **Purpose and Scope**

**2.01** Financial reporting is, essentially, a process of communication of information. Although the success of this communication depends upon the appropriateness of the accounting principles followed and, ultimately, upon the degree of understanding by the readers of the financial statements, it also depends upon the extent and clarity of presentation and disclosure in the financial statements. This chapter establishes general principles of financial statement presentation.

**2.02** Decisions about presentation and disclosure in specific situations require the exercise of professional judgment, consideration of the *Financial Reporting Framework for Small- and Medium-Sized Entities (FRF for SMEs)*, and recognition of specific provisions in governing statutes or regulations. Effective reporting also gives recognition to new problems as they arise and changes in the requirements of investors, creditors, governments, and other applicable stakeholders.

### **Fair Presentation in Accordance With the *FRF for SMEs***

**2.03** Financial statements should present fairly in accordance with the *FRF for SMEs*, the financial position, results of operations, and cash flows of an entity (that is, represent faithfully the substance of transactions and other events in accordance with the elements of financial statements and the recognition and measurement criteria set out in chapter 1, “Financial Statement Concepts”).

**2.04** A fair presentation in accordance with the *FRF for SMEs* is achieved by

- a. applying the *FRF for SMEs*;
- b. providing sufficient information about transactions or events having an effect on the entity's financial position, results of operations, and cash flows for the periods presented that are of such size, nature, and incidence that their disclosure is necessary to understand that effect; and
- c. providing information in a manner that is clear and understandable.

**2.05** Management exercises professional judgment to provide sufficient information about the extent and nature of transactions or events having an effect on the entity's financial position, results of operations, and cash flows for the periods presented that are of such size, nature, and incidence that their disclosure is necessary to understand that effect. This information would include the significant terms and conditions of such transactions, as well as the nature of such events and their financial effects on the periods presented.

**2.06** Management provides information in a manner that clearly conveys the nature and extent, and significant terms and conditions, of the related transactions. Financial

statements are prepared in such form and use such terminology and classification of items that significant information is readily understandable. Items not significant in themselves are grouped with such other items as most closely approximate to their nature.

## Going Concern

**2.07** When preparing financial statements, management should make an assessment of whether the going concern basis of accounting is appropriate. The going concern basis of accounting presumes that an entity will be able to realize its assets and discharge its liabilities in the ordinary course of business. The going concern basis of accounting is appropriate unless management either intends to liquidate the entity or has no realistic alternative but to do so. The *FRF for SMEs* should not be used by an entity that is not a going concern and prepares its financial statements on the liquidation basis of accounting.

**2.08** In making its assessment as to whether the going concern basis is appropriate, management should take into account all known and available information about the future, which is limited to twelve months from the balance sheet date. When management becomes aware of material uncertainties relating to events or conditions that cast substantial doubt about the going concern basis,<sup>2</sup> the entity should disclose those uncertainties along with its plans for dealing with the adverse effects of the conditions and events.

**2.09** The degree of consideration and management's assessment depends on the facts in each case. When an entity has a history of profitable operations and ready access to financial resources, a conclusion that the going concern basis of accounting is appropriate may be reached without detailed analysis. In other cases, management may need to consider a wide range of factors relating to current and expected profitability, debt repayment schedules, and potential sources of replacement financing before it can satisfy itself that the going concern basis is appropriate.

## Financial Statements

**2.10** Financial statements, including notes to such statements and supporting schedules, should include all information required for a fair presentation in accordance with the *FRF for SMEs*.

**2.11** Financial statements include the balance sheet, statement of income, statement of changes in equity (changes in equity may be disclosed in the notes to the financial statements or as part of another financial statement) and statement of cash flows. The selection of specific financial statement titles is a matter of judgment, and the preceding titles are not the only acceptable titles (for example, the statement of income may be titled the statement of operations.) Notes to financial statements, and supporting schedules to which the financial statements are cross-referenced, are an integral part of

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<sup>2</sup> Substantial doubt about the going concern basis exists when management concludes that a known event or condition is probable of having a severe impact on the entity's ability to realize its assets and discharge its liabilities in the ordinary course of business.

such statements.

**2.12** Supplementary information set out in other material attached to, or submitted with, financial statements are not an integral part of the financial statements.

**2.13** Nothing in the *FRF for SMEs* precludes management from using the *FRF for SMEs* to prepare a single financial statement, rather than a complete set of financial statements.

**2.14** Notes to financial statements, and supporting schedules to which the financial statements are cross-referenced, are often essential to clarify or further explain the items in the financial statements. They have the same significance as if the information or explanations were set out in the body of the statements themselves. However, they are not to be used as a substitute for proper accounting treatment. Accounting treatments that are not in accordance with the *FRF for SMEs* are not rectified either by disclosure of the accounting policies used or by information provided in notes or supporting schedules. The information conveyed by every note or supporting schedule is consistent with the accounting treatment given to the specific item to which it relates.

**2.15** Management should select only one set of accounting policies for purposes of preparing general purpose financial statements in accordance with the *FRF for SMEs*. See chapter 5, “Accounting Changes, Changes in Accounting Estimates, and Correction of Errors,” for criteria about changing accounting policies, together with the accounting treatment and disclosure of changes in accounting policies.

## **Comparative Information**

**2.16** Financial statements may be prepared on a comparative basis. Comparative information is normally meaningful. However, this may not be the case in some circumstances, such as when the financial structure of an entity has significantly changed or when a comprehensive revaluation of assets and liabilities has been made in accordance with chapter 15, “New Basis (Push-Down) Accounting.”

**2.17** The classification of an item in the financial statements of the current period may be different from that in the financial statements of prior periods as a result of a change in the allocation or grouping of items within or among relevant categories. Such a change in classification is a matter of presentation and is not, in itself, a change in an accounting policy. However, to enhance comparability with the financial statements of the current period, the item is reclassified in the financial statements of the prior period to conform with the new basis.

## **Disclosure of Accounting Policies**

**2.18** *Accounting policies* are the specific principles, bases, conventions, rules, and practices applied by an entity in preparing and presenting financial statements. The accounting policies adopted by an entity affect the financial position, results of operations, and cash flows, as shown by its financial statements. Accordingly, the usefulness of financial statements is enhanced by disclosure of the accounting policies

followed by an entity.

**2.19** In addition to this chapter, other chapters provide details of certain specific disclosure requirements relating to accounting policies. Disclosure of the accounting policies followed by an entity is not a substitute for proper accounting treatment.

## **Disclosure**

**2.20** An entity that prepares its financial statements in accordance with the *FRF for SMEs* should state this basis of presentation prominently in the notes to its financial statements, along with a brief description of how this basis of accounting differs from accounting principles generally accepted in the United States of America. An illustrative disclosure follows:

The accompanying financial statements have been prepared in accordance with the *Financial Reporting Framework for Small- and Medium-Sized Entities* issued by the American Institute of Certified Public Accountants. This framework, unlike accounting principles generally accepted in the United States of America, generally does not make use of fair value accounting and also provides more flexibility in the areas of accounting for income taxes and consolidations.

**2.21** If its operating cycle is less than or greater than one year, an entity should disclose that fact, along with the length of the operating cycle.

**2.22** Reclassifications of financial statement items to conform to the present year's presentation, as described in paragraph 2.17, should be disclosed.

**2.23** An entity should identify and describe those accounting policies that are significant to its operations. At a minimum, disclosure should include information on areas in which judgment has been exercised (that is, when there is a choice between alternatives). Accounting principles, and the methods used in their application, may differ from one industry to another, and it cannot be assumed that a user of the financial statements is familiar with these differences.

**2.24** At a minimum, disclosure of information on accounting policies should be provided in the following situations:

- a. When a selection has been made from alternative acceptable accounting principles and methods
- b. When accounting principles and methods used are specific to an industry in which an entity operates, even if such accounting principles and methods are predominantly followed in that industry (Examples of items requiring disclosure of accounting policies include the recognition of revenue from long-term contracts and from franchising and leasing operations.)

**2.25** In order to provide an overview of the accounting policies of an entity, it is particularly useful that these be disclosed together in the form of a summary rather than in individual notes to the financial statements. Therefore, the disclosure of a summary

accounting policies should generally be the first note to the financial statements. Suitable titles would be "Summary of Significant Accounting Policies" or "Accounting Policies."

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## Chapter 3—Transition

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### Purpose and Scope

**3.01** The purpose of this chapter is to ensure that when an entity transitions to the *Financial Reporting Framework for Small- and Medium-Sized Entities (FRF for SMEs)* its financial statements provide a suitable starting point for accounting under the *FRF for SMEs* and contains high-quality, transparent and comparable information over all periods presented.

**3.02** An entity should apply this chapter to its financial statements upon transitioning to the *FRF for SMEs*. If an entity using the *FRF for SMEs* stops using it for one or more reporting periods and then decides to again prepare its financial statements under the *FRF for SMEs*, the exemptions from certain principles allowed by this chapter do not apply.

### Definitions

**3.03** The following terms are used in this chapter with the meanings specified:

*Date of transition to the FRF for SMEs.* The beginning of the earliest period for which an entity presents financial statements under the *FRF for SMEs*.

*Deemed cost.* An amount used as a surrogate for cost or depreciated cost at a given date. Subsequent depreciation or amortization assumes that the entity had initially recognized the asset or liability at the given date and that its cost was equal to the deemed cost.

*Fair value.* The amount of the consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties, who are under no compulsion to act.

### Opening Balance Sheet

**3.04** An entity should prepare and present an opening balance sheet at the date of transition to the *FRF for SMEs*. This opening balance sheet is the starting point for the entity's accounting under the *FRF for SMEs*.

**3.05** Except as noted in paragraphs 3.09 and 3.17, an entity, in its opening balance sheet prepared using the *FRF for SMEs*

- a. recognizes all assets and liabilities whose recognition is required by the *FRF for SMEs*;
- b. does not recognize items as assets or liabilities if the *FRF for SMEs* does not permit such recognition;
- c. reclassifies items that it recognized previously as one type of asset, liability, or component of equity but are now recognized as a different type of asset, liability, or component of equity under the *FRF for SMEs*; and

- d. applies the *FRF for SMEs* in measuring all recognized assets and liabilities.

### **Accounting Policies**

**3.06** Management should use the same accounting policies in its opening balance sheet and throughout all periods presented in its first financial statements prepared using the *FRF for SMEs*. Those accounting policies should comply with the accounting policies effective at the end of the year the entity adopts the *FRF for SMEs*, except as otherwise specified in this chapter.

**3.07** The accounting policies that management uses in its opening balance sheet prepared in accordance with the *FRF for SMEs* may differ from those that it used for the same date under its previous accounting policies. For example, an entity may have previously reported other comprehensive income, whereas there is no such concept in the *FRF for SMEs*. Any resulting adjustments arise from events and transactions before the date of transition to the *FRF for SMEs*. An entity should recognize such adjustments directly in equity at the date of transition to the *FRF for SMEs*.

**3.08** In some cases, management may elect to use certain exemptions to the principle that an entity's opening balance sheet should comply with the *FRF for SMEs*. Those exemptions relate to the application of certain chapters within the *FRF for SMEs*, as set out in paragraph 3.09. In addition, principles in certain chapters of the *FRF for SMEs* are prohibited from being applied retrospectively to the opening balance sheet. See paragraph 3.17.

### **Election of Exemptions From Certain Principles in the *FRF for SMEs* Upon Transition**

- 3.09** Management may elect to use exemptions related to one or more of the following:
- a. Business combinations (see paragraphs 3.10–.11)
  - b. Defined benefit plans (see paragraph 3.12)
  - c. Financial instruments (see paragraphs 3.13–.14)
  - d. Asset retirement obligations (see paragraph 3.15)
  - e. Related party transactions (see paragraph 3.16)

#### ***Business Combinations***

**3.10** When transitioning to the *FRF for SMEs*, management may elect not to apply chapter 11, “Business Combinations,” retrospectively to past business combinations (business combinations that occurred before the date of transition to the *FRF for SMEs*). However, if management, when transitioning to the *FRF for SMEs*, restates any business combination to comply with chapter 11, it restates all subsequent business combinations and also should apply chapter 13, “Consolidated Financial Statements and Noncontrolling Interests,” from that same date.

**3.11** When transitioning to the *FRF for SMEs*, if management does not apply chapter

11 retrospectively to a past business combination, it has the following consequences for that business combination:

- a. The entity retains the same classification (for example, as an acquisition) as in its previous financial statements.
- b. At the date of transition to the *FRF for SMEs*, the entity recognizes all its assets and liabilities that were acquired or assumed in a past business combination, except for financial assets and liabilities derecognized in prior periods (see paragraph 3.18). Any resulting change is accounted for by adjusting retained earnings, unless the change results from the recognition of an intangible asset that was previously subsumed within goodwill.
- c. The entity excludes from its opening balance sheet any item recognized under previous financial reporting principles that does not qualify for recognition as an asset or liability under the *FRF for SMEs*. Any resulting change is accounted for by adjusting retained earnings, unless the change results from an intangible asset that is reclassified as part of goodwill.
- d. If an asset acquired, or liability assumed, in a past business combination was not recognized previously but should be under the *FRF for SMEs*, it does not have a deemed cost of zero in the opening balance sheet. Instead, the acquirer recognizes and measures the item in its consolidated balance sheet on the basis that the principles would require in the balance sheet of the acquiree.

#### ***Defined Benefit Plans***

**3.12** Entities accounting and reporting on defined benefit plans should refer to the *FRF for SMEs Implementation Guidance* publication for transitional guidance.

#### ***Financial Instruments***

**3.13** An entity should apply chapter 32, “Financial Instruments and Long-Term Debt,” to its opening balance sheet for the first period presented in the financial statements for the year of adoption of the *FRF for SMEs*. Any difference between the recognition and measurement of financial instruments at that date, in accordance with chapter 32, and the prior year's closing balance sheet, is recorded as an adjustment to opening equity at the date of transition to the *FRF for SMEs*.

**3.14** Chapter 32 requires an entity to classify separately the component parts of a financial instrument that contains both a liability and an equity component. However, under this chapter, an entity transitioning to the *FRF for SMEs* need not separate the components if the liability component is no longer outstanding at the date of transition to the *FRF for SMEs*.

#### ***Asset Retirement Obligations***

**3.15** An entity that has not previously recognized asset retirement obligations on a basis consistent with the section, “Asset Retirement Obligations,” in chapter 26, “Contingencies,” may measure the obligation at the date of transition to the *FRF for*

*SMEs* and estimate the amount that should be included in the carrying amount of the related asset based on the original and remaining life of the asset. The difference between the change in the obligation and the change to the carrying amount of the asset is charged to opening equity at the date of transition to the *FRF for SMEs*.

### ***Related Party Transactions***

**3.16** Chapter 31, “Related Party Transactions,” specifies that certain related party transactions should be measured at the carrying amount and some at the exchange amount. An entity is not required to restate assets or liabilities related to transactions with related parties when the related party transaction occurred prior to the date of transition to the *FRF for SMEs*.

### **Exceptions to Retrospective Application of Certain Principles Within the *FRF for SMEs***

**3.17** This chapter prohibits retrospective application of some aspects of other principles relating to

- a. derecognition of financial assets and financial liabilities (see paragraph 3.18);
- b. estimates (see paragraphs 3.20–.22); and
- c. noncontrolling interests (see paragraph 3.23).

### ***Derecognition of Financial Assets and Financial Liabilities***

**3.18** Except as permitted by paragraph 3.19, an entity transitioning to the *FRF for SMEs* should apply the derecognition requirements in chapter 32 prospectively for transactions occurring on or after the date of transition to the *FRF for SMEs*.

**3.19** Management may apply the derecognition requirements in chapter 32 retrospectively from a date of the entity's choosing, provided that the information needed to apply chapter 32 to financial assets and financial liabilities derecognized as a result of past transactions was obtained at the time of initially accounting for those transactions.

### ***Estimates***

**3.20** Management’s estimates in its opening balance sheet prepared using the *FRF for SMEs* should be consistent with estimates in its balance sheet for the same date prepared using its previous accounting policies (after adjustments to reflect any difference in accounting policies), unless objective evidence exists that those estimates were in error.

**3.21** Management may receive information after the date of transition to the *FRF for SMEs* about estimates that it had made previously. Management should treat the receipt of that information in the same way as nonadjusting events after the balance sheet date under chapter 24, “Subsequent Events.”

**3.22** Management may need to make estimates for purposes of its opening balance sheet prepared using the *FRF for SMEs* that were not required for the balance sheet for

that date using its previous accounting policies. Those estimates should reflect conditions that existed at the date of the opening balance sheet prepared using the *FRF for SMEs*.

### **Noncontrolling Interests**

**3.23** An entity transitioning to the *FRF for SMEs* should apply the following requirements of chapter 13 prospectively from the date of transition to the *FRF for SMEs*:

- a. The requirements in paragraphs 13.29–.30 for accounting for changes in the parent's ownership interest in a subsidiary that do not result in a loss of control
- b. The requirements in paragraphs 13.31–.34 for accounting for a loss of control over a subsidiary
- c. The requirement in paragraph 13.39 that income is attributed to the owners of the parent and to the noncontrolling interests, even if this results in the noncontrolling interests having a deficit balance

However, if an entity transitioning to the *FRF for SMEs* elects to apply chapter 11 retrospectively to past business combinations, it also should apply chapter 13, in accordance with paragraphs 3.10–.11.

### **Disclosure**

**3.24** In the year of adoption of the *FRF for SMEs*, an entity should disclose

- a. the amount of each charge to equity at the date of transition to the *FRF for SMEs* resulting from the adoption of these principles and the reason therefor and
- b. a reconciliation of the net income reported in the entity's most recent previously issued financial statements to its net income under the *FRF for SMEs* for the same period.

**3.25** The disclosures required by paragraph 3.24 should give sufficient detail to enable users to understand the material adjustments to the balance sheet and statement of income. If an entity presented a statement of cash flows under its previous accounting policies, it should explain the material adjustments to the statement of cash flows.

**3.26** When an entity elects to use one or more of the exemptions in paragraphs 3.09–.16, it should disclose the exemptions used.

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## Chapter 4—*Risks and Uncertainties*

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### Purpose and Scope

**4.01** Volatility and uncertainty in the business and economic environment result in the need to disclose information about the risks and uncertainties confronted by reporting entities. This chapter establishes disclosure principles for certain risks and uncertainties in the financial statements. The risks and uncertainties addressed can stem from any of the following:

- Nature of operations
- Use of estimates in the preparation of financial statements
- Certain significant estimates
- Current vulnerability due to certain concentrations

**4.02** Financial statements are available to be issued when

- a. a complete set of financial statements, including all required note disclosures, has been prepared (see paragraphs 2.10–.12);
- b. all final adjusting journal entries have been reflected in the financial statements (for example, adjustments for income taxes and bonuses);
- c. no changes to the financial statements are planned or expected; and
- d. the financial statements meeting the preceding requirements have been approved in accordance with the entity's process to finalize its financial statements.

### Nature of Operations

**4.03** A reporting entity should include in the financial statements a description of the major products or services the reporting entity sells or provides and its principal markets, including the locations of those markets. Disclosures concerning the nature of operations do not have to be quantified, and relative importance may be described by terms such as *predominantly*, *about equally*, and *major*.

### Use of Estimates

**4.04** A reporting entity should include in the financial statements an explanation that the preparation of financial statements in conformity with the *Financial Reporting Framework for Small- and Medium-Sized Entities* requires the use of management's estimates.

### Significant Estimates

**4.05** A reporting entity should include a discussion of significant estimates when,

based on known information available before the financial statements are available to be issued, it is reasonably possible that (a) the estimate will change in the near term (a period of time not to exceed one year from the date of the financial statements), and (b) the effect of the change will be material. The estimate of the effect of a change in a condition, situation, or set of circumstances that existed at the date of the financial statements should be disclosed, and the evaluation should be based on known information available before the financial statements are available to be issued.

**4.06** The following are examples of assets and liabilities and gain and loss contingencies that may be based on estimates that are particularly sensitive to change in the near term and, therefore, require disclosure:

- a. Inventory subject to rapid technological obsolescence
- b. Specialized equipment subject to technological obsolescence
- c. Valuation allowances for deferred tax assets based on future taxable income
- d. Capitalized computer software costs
- e. Valuation allowances for commercial and real estate loans
- f. Environmental remediation-related obligations
- g. Litigation-related obligations
- h. Contingent liabilities for obligations of other entities
- i. Amounts reported for long-term obligations, such as amounts reported for pensions and postemployment benefits
- j. Estimated net proceeds recoverable, the provisions for expected loss to be incurred, or both, on disposition of a business or assets
- k. Amounts reported for long-term contracts

## **Concentrations**

**4.07** Vulnerability from concentrations arises because an entity is exposed to risk of loss greater than it would have had it mitigated its risk through diversification. An entity should disclose in the financial statements certain concentrations if, based on information known to management before the financial statements are available to be issued, all the following criteria are met:

- a. The concentration exists at the date of the financial statements.
- b. The concentration makes the entity vulnerable to the risk of a near-term severe impact.
- c. It is at least reasonably possible that the events that could cause the severe impact will occur in the near term.

**4.08** The following concentrations require disclosure if they meet the preceding criteria:

- a.* Concentrations in the volume of business transacted with a particular customer, supplier, or lender
- b.* Concentrations in revenue from particular products or services
- c.* Concentrations in the available sources of supply of materials, labor, or services or of licenses or other rights used in the entity's operations
- d.* Concentrations in the market or geographic area in which an entity conducts its operations

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## Chapter 5—Accounting Changes, Changes in Accounting Estimates, and Correction of Errors

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### Purpose and Scope

**5.01** The purpose of this chapter is to prescribe the criteria for changing accounting policies, together with the accounting treatment and disclosure of changes in accounting policies, changes in accounting estimates, and corrections of errors. This chapter is intended to enhance the relevance and reliability of an entity's financial statements and the comparability of those financial statements over time and with the financial statements of other entities.

**5.02** Disclosure requirements for accounting policies, except those for changes in accounting policies, are set out in chapter 2, “General Principles of Financial Statement Presentation and Accounting Policies.”

**5.03** This chapter should be applied in accounting for changes in accounting policies, changes in accounting estimates, and corrections of prior period errors.

**5.04** The tax effects of corrections of prior period errors and of retrospective adjustments made to apply changes in accounting policies are accounted for and disclosed in accordance with chapter 29, “Income Taxes.”

### Definitions

**5.05** The following terms are used in this chapter with the meanings specified:

*Change in accounting estimate.* An adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of errors.

*Impracticable.* Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so. For a particular prior period, it is impracticable to apply a change in an accounting policy retrospectively if

- the effects of the retrospective application are not determinable;
- the retrospective application requires assumptions about what management's intent would have been in that period; or
- the retrospective application requires significant estimates of amounts, and it is impossible to distinguish objectively information about those estimates that

- provides evidence of circumstances that existed on the date(s) at which those amounts are to be recognized, measured, or disclosed and
- would have been available when the financial statements for that prior period were completed.

*Prior period errors.* Omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that

- was available when financial statements for those periods were completed and
- could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.

*Retrospective application.* A type of application that applies a new accounting policy to transactions, other events, and conditions as if that policy had always been applied.

*Retrospective restatement.* Correcting the recognition, measurement, and disclosure of amounts of elements of financial statements as if a prior period error had never occurred.

*Prospective application.* A change in accounting policy, and of recognizing the effect of a change in an accounting estimate, that consists of

- applying the new accounting policy to transactions, other events, and conditions occurring after the date the policy is changed and
- recognizing the effect of the change in the accounting estimate in the current and future periods affected by the change.

## **Changes in Accounting Policies**

**5.06** Management should change an accounting policy only if the change

- a. is required by the Financial Reporting Framework for Small- and Medium-Sized Entities (FRF for SMEs);
- b. results in the financial statements providing reliable and more relevant information about the effects of transactions, other events, or conditions on the entity's financial position, financial performance, or cash flows; or
- c. is specified in paragraph 5.09.

**5.07** Users of financial statements need to be able to compare the financial statements of an entity over time to identify trends in its financial position, financial performance, and cash flows. Therefore, the same accounting policies are applied within each period, and from one period to the next, unless a change in accounting policy meets one of the criteria in paragraph 5.06.

**5.08** The following are not changes in accounting policies:

- a. The application of an accounting policy for transactions, other events, or conditions that differ in substance from those previously occurring
- b. The application of a new accounting policy for transactions, other events, or conditions that did not occur previously or were immaterial

**5.09** Management may change the following accounting policies without meeting the criterion in paragraph 5.06(b):

- a. To consolidate subsidiaries, to account for them using the equity method, or in accordance with chapter 32, “Financial Instruments and Long-Term Debt”(see chapter 12, “Subsidiaries”)
- b. To account for investments subject to significant influence using the equity method or in accordance with chapter 32 (see chapter 19, “Investments”)
- c. To capitalize or expense expenditures on internally-generated intangible assets during the development phase (see chapter 21, “Intangible Assets”)
- d. To account for defined benefit plans in accordance with the current contribution payable method, immediate recognition approach, or in accordance with the deferral and amortization approach (see chapter 28, “Retirement and Other Postemployment Benefits” and the *FRF for SMEs Implementation Guidance* publication)
- e. To account for income taxes using the taxes-payable method or the deferred income taxes method (see chapter 29)
- f. To initially measure the equity component of a financial instrument that contains both a liability and an equity component at zero (see chapter 32).

## **Applying Changes in Accounting Policies**

**5.10** Subject to paragraph 5.12

- a. an entity should account for a change in accounting policy resulting from the initial application of the *FRF for SMEs* in accordance with the specific transitional provisions, if any, described in chapter 3, “Transition,” and
- b. when management changes an accounting policy upon initial application of the *FRF for SMEs* that does not include specific transitional provisions applying to that change (see chapter 3), or changes an accounting policy voluntarily, it should apply the change retrospectively.

## **Retrospective Application**

**5.11** Subject to paragraph 5.12, when a change in accounting policy is applied retrospectively in accordance with paragraph 5.10(a) or (b), management should adjust the opening balance of each affected component of equity for the earliest prior period presented and the other comparative amounts disclosed for each prior period presented as if the new accounting policy had always been applied.

## **Limitations on Retrospective Application**

**5.12** When retrospective application is required by paragraph 5.10(a) or (b), a change in accounting policy should be applied retrospectively, except to the extent that it is impracticable to determine either the period-specific effects or the cumulative effect of the change.

**5.13** When it is impracticable to determine the period-specific effects of changing an accounting policy on comparative information for one or more prior periods presented, management should apply the new accounting policy to the carrying amounts of assets and liabilities at the beginning of the earliest period for which retrospective application is practicable, which may be the current period, and should make a corresponding adjustment to the opening balance of each affected component of equity for that period.

**5.14** When it is impracticable to determine the cumulative effect, at the beginning of the current period, of applying a new accounting policy to all prior periods, management should apply the new accounting policy prospectively from the earliest date practicable.

**5.15** When an entity applies a new accounting policy retrospectively, it applies the new accounting policy to comparative information for prior periods as far back as is practicable. Retrospective application to a prior period is not practicable unless the entity can determine the cumulative effect on the amounts in both the opening and closing balance sheet for that period. The amount of the resulting adjustment relating to periods before those presented in the financial statements is made to the opening balance of each affected component of equity of the earliest prior period presented. Any other information presented about prior periods, such as historical summaries of financial data, is also adjusted as far back as is practicable.

**5.16** When it is impracticable for an entity to apply a new accounting policy retrospectively because it cannot determine the cumulative effect of applying the policy to all prior periods, the entity, in accordance with paragraph 5.14, applies the new policy prospectively from the start of the earliest period practicable. Therefore, it disregards the portion of the cumulative adjustment to assets, liabilities, and equity arising before that date. Changing an accounting policy is permitted, even if it is impracticable to apply the policy prospectively for any prior period. Paragraphs 5.28–.31 provide guidance on when it is impracticable to apply a new accounting policy to one or more prior periods.

## **Changes in Accounting Estimates**

**5.17** As a result of the uncertainties inherent in business activities, many items in financial statements cannot be measured with precision but can only be estimated. Estimation involves judgments based on the latest available, reliable information. For example, estimates may be required of

- a.* bad debts;
- b.* inventory obsolescence;

- c. the useful lives of, or expected pattern of consumption of the future economic benefits embodied in, depreciable assets (see the example in paragraph 5.20);
- d. progress on uncompleted contracts; and
- e. warranty obligations.

**5.18** The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

**5.19** An estimate may need revision if changes occur in the circumstances on which the estimate was based or as a result of new information or more experience. By its nature, the revision of an estimate does not relate to prior periods and is not the correction of an error.

**5.20** Distinguishing between a change in an accounting principle and a change in an accounting estimate is sometimes difficult. In some cases, a change in accounting estimate is effected by a change in accounting principle. The effect of the change in accounting principle, or the method of applying it, may be inseparable from the effect of the change in accounting estimate. Changes of that type often are related to the continuing process of obtaining additional information and revising estimates and, therefore, should be considered changes in estimates for purposes of applying this guidance.

**5.21** The effect of a change in an accounting estimate, other than a change to which paragraph 5.20 applies, should be recognized prospectively by including it in net income in

- a. the period of the change, if the change affects that period only or
- b. the period of the change, and future periods, if the change affects both.

**5.22** To the extent that a change in an accounting estimate gives rise to changes in assets and liabilities or relates to an item of equity, it should be recognized by adjusting the carrying amount of the related asset, liability, or equity item in the period of the change.

**5.23** Prospective recognition of the effect of a change in an accounting estimate means that the change is applied to transactions, other events, and conditions from the date of the change in estimate. A change in an accounting estimate may affect only the current period's net income or the net income of both the current period and future periods. For example, a change in the estimate of the amount of bad debts affects only the current period's net income and, therefore, is recognized in the current period. However, a change in the estimated useful life of, or the expected pattern of consumption of the future economic benefits embodied in, a depreciable asset affects depreciation expense for the current period and for each future period during the asset's remaining useful life. In both cases, the effect of the change relating to the current period is recognized as income or expense in the current period. The effect, if any, on future periods is recognized as income or expense in those future periods.

## Errors

**5.24** Errors can arise in respect of the recognition, measurement, presentation, or disclosure of elements of financial statements. Financial statements do not comply with the *FRF for SMEs* if they contain either material errors or immaterial errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance, or cash flows. Potential current period errors discovered in that period are corrected before the financial statements are completed. However, material errors are sometimes not discovered until a subsequent period, and these prior period errors are corrected in the comparative information presented in the financial statements for that subsequent period (see paragraphs 5.25–.26).

**5.25** Management should correct material prior period errors retrospectively in the first set of financial statements completed after their discovery by

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

**5.26** The correction of a prior period error is excluded from net income for the period in which the error is discovered. Any information presented about prior periods, including any historical summaries of financial data, is restated.

**5.27** Corrections of errors are distinguished from changes in accounting estimates. Accounting estimates, by their nature, are approximations that may need revision as additional information becomes known. For example, the gain or loss recognized on the outcome of a contingency is not the correction of an error.

## Impracticability in Respect of Retrospective Application

**5.28** In some circumstances, it is impracticable to adjust comparative information for one or more prior periods to achieve comparability with the current period. For example, data may not have been collected in the prior period(s) in a way that allows retrospective application of a new accounting policy (including, for the purpose of paragraphs 5.29–.31, its prospective application to prior periods), and it may be impracticable to recreate the information. See paragraph 5.16 for additional guidance.

**5.29** It is frequently necessary to make estimates in applying an accounting policy to elements of financial statements recognized or disclosed in respect of transactions, other events, or conditions. Estimation is inherently subjective, and estimates may be developed after the balance sheet date. Developing estimates is potentially more difficult when retrospectively applying an accounting policy or making a retrospective restatement to correct a prior period error because of the longer period of time that might have passed since the affected transaction, other event, or condition occurred. However, the objective of estimates related to prior periods remains the same as for estimates made in the current period, namely, for the estimate to reflect the circumstances that existed when the

transaction, other event, or condition occurred.

**5.30** Therefore, retrospectively applying a new accounting policy requires distinguishing information that

- a. provides evidence of circumstances that existed on the date(s) the transaction, other event, or condition occurred and
- b. would have been available when the financial statements for that prior period were completed

from other information. For some types of estimates (for example, an estimate of fair value not based on an observable price or observable inputs), it is impracticable to distinguish these types of information. When retrospective application would require making a significant estimate for which it is impossible to distinguish these two types of information, it is impracticable to apply the new accounting policy retrospectively.

**5.31** Hindsight is not used when applying a new accounting policy to, or correcting amounts for, a prior period, either in making assumptions about what management's intentions would have been in a prior period or estimating the amounts recognized, measured, or disclosed in a prior period. The fact that significant estimates are frequently required when amending comparative information presented for prior periods does not prevent reliable adjustment or correction of the comparative information.

## Disclosure

### Changes in Accounting Policies

**5.32** When initial application of the *FRF for SMEs* has an effect on the current period or any prior period or would have such an effect, except that it is impracticable to determine the amount of the adjustment, an entity should disclose

- a. when applicable, that the change in accounting policy is made in accordance with its transitional provisions;
- b. the nature of the change in accounting policy;
- c. when applicable, a description of the transitional provisions;
- d. for the current period, to the extent practicable, the amount of the adjustment for each financial statement line item affected;
- e. the amount of the adjustment relating to periods before those presented to the extent practicable; and
- f. if retrospective application required by paragraph 5.10(a) or (b) is impracticable for a particular prior period or for periods before those presented, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy has been applied.

Financial statements of subsequent periods need not repeat these disclosures, unless

comparative financial statements are presented.

**5.33** When a voluntary change in accounting policy has an effect on the current period or any prior period or would have an effect on that period, except that it is impracticable to determine the amount of the adjustment, an entity should disclose

- a.* the nature of the change in accounting policy;
- b.* the reasons why applying the new accounting policy provides reliable and more relevant information (see paragraph 5.06), unless an accounting policy choice was allowed under the sections listed in paragraph 5.09, in which case, management should explain why it made the accounting policy choice;
- c.* for the current period, to the extent practicable, the amount of the adjustment for each financial statement line item affected;
- d.* the amount of the adjustment relating to periods before those presented to the extent practicable; and
- e.* if retrospective application is impracticable for a particular prior period or for periods before those presented, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy has been applied.

Financial statements of subsequent periods need not repeat these disclosures.

### **Changes in Accounting Estimates**

**5.34** Management should disclose the nature and amount of a change in an accounting estimate that has an effect in the current period. Disclosure of those effects is not necessary for estimates made each period in the ordinary course of accounting for items such as uncollectible accounts, progress on uncompleted contracts, or inventory obsolescence; however, disclosure is required if the effect of a change in the estimate is material.

### **Errors**

**5.35** In applying paragraph 5.25, management should disclose the following:

- a.* The nature of the prior period error
- b.* For each prior period presented, the amount of the correction for each financial statement line item affected
- c.* The amount of the correction at the beginning of the earliest prior period presented

Financial statements of subsequent periods need not repeat these disclosures.

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## Chapter 6—*Measurement Uncertainty*

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### Purpose and Scope

**6.01** This chapter establishes disclosure principles when there is measurement uncertainty arising from items recognized in financial statements. It does not deal with the disclosure of uncertainties relating to contingencies in financial statements (see chapter 26, “Contingencies”). The disclosures required by this chapter supplement the disclosure requirements in other chapters.

**6.02** *Measurement* is the process of determining the amount at which an item is recognized in the financial statements (see chapter 1, “Financial Statement Concepts”). Part of this process includes the review of the carrying amounts of financial statement items to assess the possibility of impairment and the need for a revision of a carrying amount. Measurement uncertainty may exist even if a carrying amount is not revised. Many items are measured using management's best estimates based on assumptions that reflect the most probable set of economic conditions and planned courses of action.

**6.03** The effect of using alternative accounting policies or methods that are disclosed in accordance with chapter 2, “General Principles of Financial Statement Presentation and Accounting Policies,” is not considered a measurement uncertainty. For example, the difference between straight-line and declining balance depreciation methods is not considered measurement uncertainty, whereas the uncertainty relating to the estimate of the useful life of an asset is considered a measurement uncertainty.

**6.04** A degree of uncertainty is associated with the measurement of many amounts recognized in financial statements. In many cases, however, such uncertainty is not material. A decision about whether a measurement uncertainty has a material effect on the financial statements is a matter of judgment. Management should consider

- a. information such as the range of reasonably possible amounts;
- b. whether the difference between the recognized amount and the outer limits of the range of reasonably possible amounts is material or whether the recognized amount could change by a material amount;
- c. the impact of other reasonably possible amounts on the entity's economic resources, obligations (for example, debt covenants), and equity and net assets; and
- d. the possible timing of the impact.

A judgment about the materiality of measurement uncertainty should be made considering the effect that a different reasonably possible amount would have on the financial statements.

### Definitions

**6.05** The following terms are used in this chapter with the meanings specified:

*Measurement uncertainty.* Uncertainty in the determination of the amount at which an item is recognized in financial statements. For the purpose of this chapter, such uncertainty exists when there is a variance between the recognized amount and another reasonably possible amount.

*Near term.* A period of time not to exceed one year from the date of the financial statements.

## Disclosure

**6.06** The nature of a measurement uncertainty about the amount at which an item is recognized in the financial statements should be disclosed when that uncertainty is material. The disclosure should include the following:

- a. A description of the circumstances giving rise to the uncertainty
- b. Relevant information about the anticipated resolution of the uncertainty

**6.07** The extent of a measurement uncertainty that is material for an item in the financial statements should be disclosed when it is reasonably possible that the recognized amount could change by a material amount in the near term.

**6.08** When disclosure has been made in accordance with paragraph 6.06 or 6.07, the recognized amount of the item subject to measurement uncertainty should be disclosed, except when disclosure of the amount would have a significant adverse effect on the entity. When the recognized amount is not disclosed, the financial statements should indicate the reasons for nondisclosure.

**6.09** The materiality of the effect of the measurement uncertainty on the financial statements is the sole criterion for determining whether disclosure of measurement uncertainty in accordance with paragraphs 6.06–.07 would be made. *Materiality* is the term used to describe the significance of financial statement information to decision makers. An item of information, or an aggregate of items, is material if it is probable that its omission or misstatement would influence or change a decision. Materiality is a matter of professional judgment in the particular circumstances (see paragraph 1.09).

**6.10** To assist users in understanding the significance of a material measurement uncertainty, the notes to the financial statements should provide information about its extent when a material change in the recognized amount of an item is reasonably possible in the near term. This could be accomplished, for example, by disclosing the extent to which a recognized amount could reasonably vary in the near term. Entities could disclose this variability by disclosing a range of reasonably possible amounts that relate to the estimate or by disclosing the effect of a change in the significant underlying assumptions used to estimate the amount. At a minimum, disclosure of extent should consist of a statement that it is reasonably possible, based on existing knowledge, that changes in future conditions in the near term could require a material change in the recognized amount.

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## **Chapter 7—Current Assets and Current Liabilities**

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### **Purpose and Scope**

**7.01** This chapter establishes presentation and disclosure principles for current assets and current liabilities. Other chapters provide additional presentation and disclosure requirements for specific current assets and liabilities.

**7.02** Assets and liabilities are normally segregated between current and noncurrent. However, the segregation of assets and liabilities between current and noncurrent may not be appropriate in financial statements of enterprises in certain industries.

### **Current Assets**

**7.03** As a balance sheet classification, current assets should include those assets ordinarily realizable within one year from the date of the balance sheet or within the normal operating cycle, when that is longer than a year. The current asset classification should also include the current portion of deferred income tax assets (see paragraphs 29.66–.70).

**7.04** Current assets should be segregated among the major classes, such as cash, investments, accounts and notes receivable, inventories, prepaid expenses, costs and estimated earnings in excess of billings on uncompleted contracts, and deferred income tax assets (see chapter 9, “Balance Sheet”).

**7.05** The cash surrender value of life insurance, unless converted to cash prior to the date the financial statements are available to be issued, should be excluded from current assets.

### **Current Liabilities**

**7.06** As a balance sheet classification, current liabilities should include amounts payable within one year from the date of the balance sheet or within the normal operating cycle, when that is longer than a year. The normal operating cycle should correspond with that used for current assets. The current liability classification should also include the current portion of deferred income tax liabilities (see paragraphs 29.66–.70).

**7.07** The current liability classification should also include amounts received or due from customers or clients with respect to goods to be delivered or services to be performed within one year from the date of the balance sheet.

**7.08** Obligations that would otherwise be classified as current liabilities should be excluded from the current liability classification to the extent that contractual arrangements have been made for settlement from other than current assets.

**7.09** Current liabilities should be segregated among the major classes, such as bank loans, trade creditors and accrued liabilities, loans payable, billings in excess of costs and

estimated earnings on uncompleted contracts, taxes payable, dividends payable, deferred revenues, current payments on long-term debt, and deferred income tax liabilities (see chapter 9). Amounts owing on loans from directors, officers, and shareholders and amounts owing to parent and other affiliated companies, whether on account of a loan or otherwise, should be shown separately.

## **Debt**

**7.10** The current liability classification should include only that portion of long-term debt obligations, including sinking-fund requirements, payable within one year from the date of the balance sheet.

**7.11** Noncurrent classification of debt is based on facts existing at the balance sheet date rather than on expectations regarding future refinancing or renegotiation. If the creditor has, at that date, or will have within one year (or operating cycle, if longer) from that date, the unilateral right to demand immediate repayment of any portion or all the debt under any provision of the debt agreement, the obligation is classified as a current liability unless

- a.* the creditor has waived, in writing, or subsequently lost, the right to demand payment for more than one year (or operating cycle, if longer) from the balance sheet date;
- b.* the obligation has been refinanced on a long-term basis before the balance sheet is completed; or
- c.* the debtor has entered into a noncancellable agreement to refinance the short-term obligation on a long-term basis before the balance sheet is completed, and there is no impediment to the completion of the refinancing.

**7.12** Long-term debt with a measurable covenant violation is classified as a current liability unless

- a.* as of the date the financial statements are available to be issued, the creditor has waived, in writing, or subsequently lost, the right, arising from violation of the covenant at the balance sheet date, to demand repayment for a period of more than one year from the balance sheet date; or
- b.* the debt agreement contains a grace period during which the debtor may cure the violation, and contractual arrangements have been made that ensure the violation will be cured within the grace period;

and a violation of the debt covenant giving the creditor the right to demand repayment at a future compliance date within one year of the balance sheet date is not likely.

## **Disclosure**

**7.13** Entities should disclose the amount payable at the end of the period in respect of government payments (other than income taxes), such as sales taxes and payroll taxes.

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## Chapter 8—*Statement of Income*

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### Purpose and Scope

**8.01** This chapter establishes the line items to be separately presented in the statement of income. In accordance with chapter 2, “General Principles of Financial Statement Presentation and Accounting Policies,” management also considers whether additional line items should be presented in order to provide a fair presentation in accordance with the *Financial Reporting Framework for Small- and Medium-Sized Entities (FRF for SMEs)*.

### Presentation

**8.02** The statement of income should present fairly, in accordance with the *FRF for SMEs*, the results of operations for the period.

**8.03** The statement of income should distinguish the following:

- a. Income or loss before discontinued operations
- b. Results of discontinued operations (see chapter 30, “Disposal of Long-Lived Assets and Discontinued Operations”)
- c. Net income or loss for the period

**8.04** In arriving at the income or loss before discontinued operations, the statement of income should present major elements, such as revenue, cost of goods sold, operating expenses, other revenues and gains, and other expenses and losses. Typical items that are distinguished in the statement of income are presented in the following text. Some of these items may be set out more readily in notes to the financial statements or in attached schedules. When this is done, the statement of income caption that contains these items is identified:

- a. Revenue recognized (see chapter 27, “Revenue”).
- b. Income from investments, disclosing income from
  - i. nonconsolidated subsidiaries and nonproportionately consolidated joint ventures (see chapter 12, “Subsidiaries” and chapter 14, “Interests in Joint Ventures”) showing separately
    1. investments measured using the equity method
    2. all other investments in nonconsolidated subsidiaries and nonproportionately consolidated joint ventures (see chapter 19, “Investments”).
  - ii. all other investments showing separately
    1. investments measured using the cost method (see chapter 19 and chapter 32, “Financial Instruments and Long-Term Debt”)

2. investments measured using the equity method (see chapter 19)
  3. investments measured at fair value (see chapter 32).
- c.* The amount charged for depreciation of property, plant, and equipment (see chapter 20, “Property, Plant, and Equipment”).
  - d.* The amount charged for amortization of intangible assets subject to amortization (see chapter 21, “Intangible Assets”).
  - e.* The amount of long-lived asset impairment losses, except for losses associated with discontinued operations that are included in the results of discontinued operations (see chapter 20).
  - f.* The amount of goodwill impairment losses, except for losses associated with discontinued operations that are included in the results of discontinued operations (see chapter 21).
  - g.* The amount of intangible asset impairment losses, except for losses associated with discontinued operations that are included in the results of discontinued operations (see chapter 21).
  - h.* The amount of exchange gain or loss included in net income (see chapter 16, “Foreign Currency Translation”). An entity may exclude from this amount those exchange gains or losses arising on financial instruments measured at fair value in accordance with chapter 32.
  - i.* Revenue, expenses, gains, or losses resulting from transactions or events that are not expected to occur frequently over several years or do not typify normal business activities of the entity (see chapter 2).
  - j.* Income taxes. Income tax expense included in the determination of income or loss before discontinued operations should be presented separately in the statement of income (see chapter 29, “Income Taxes”).

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## Chapter 9—*Balance Sheet*

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### Purpose and Scope

**9.01** This chapter establishes the line items to be separately presented in the balance sheet. In accordance with chapter 2, “General Principles of Financial Statement Presentation and Accounting Policies,” management also considers whether additional line items should be presented in order to provide a fair presentation in accordance with the *Financial Reporting Framework for Small- and Medium-Sized Entities (FRF for SMEs)*.

### Presentation

**9.02** The balance sheet should present fairly, in accordance with the *FRF for SMEs*, the financial position at the period end.

**9.03** If a classified balance sheet is presented, management should distinguish the following:

- a. Current assets (see chapter 7, “Current Assets and Current Liabilities”)
- b. Long-term assets
- c. Total assets
- d. Current liabilities (see chapter 7)
- e. Long-term liabilities
- f. Total liabilities
- g. Equity
- h. Total liabilities and equity

**9.04** The following assets should be separately presented. More detailed information about the following assets is presented in the chapters referenced. Some of these items may be set out more readily in notes to the financial statements or in attached schedules. When this approach is utilized, the balance sheet caption that contains these items is identified:

- a. Cash and cash equivalents (see chapter 7)
- b. Trade and other receivables (see chapter 7)
- c. Prepaid expenses (see chapter 7)
- d. Other financial assets (see chapter 32, “Financial Instruments and Long-Term Debt”)
- e. Inventories (see chapter 18, “Inventories”)

- f.* Investments in nonconsolidated subsidiaries and nonproportionately consolidated joint ventures (see chapter 12, “Subsidiaries” and chapter 14, “Interests in Joint Ventures”) showing separately
  - i. investments measured using the cost method
  - ii. investments measured using the equity method
  - iii. investments measured at fair value
- g.* All other investments showing separately
  - i. investments measured using the cost method (see chapter 19, “Investments,” and chapter 32)
  - ii. investments measured using the equity method (see chapter 19)
  - iii. investments measured at fair value (see chapter 32)
- h.* Property, plant, and equipment (see chapter 20, “Property, Plant, and Equipment”)
- i.* Intangible assets (see chapter 21, “Intangible Assets”)
- j.* Assets for current income taxes (see chapter 29, “Income Taxes”)
- k.* Assets for deferred income taxes (see chapter 29)
- l.* Long-lived assets and disposal groups classified as held for sale (see chapter 30, “Disposal of Long-Lived Assets and Discontinued Operations”)
- m.* Accrued benefit assets (see chapter 28, “Retirement and Other Postemployment Benefits”)

**9.05** The following liabilities should be separately presented:

- a.* Main classes of current liabilities in accordance with paragraph 7.11
- b.* Liabilities for deferred income taxes (see chapter 29)
- c.* Liabilities of disposal groups classified as held for sale (see chapter 30)
- d.* Obligations under capital leases (see chapter 22, “Leases”)
- e.* Accrued benefit liability (see chapter 28)
- f.* Long-term debt (see chapter 32)
- g.* Asset retirement obligations (see chapter 20)
- h.* Other financial liabilities

**9.06** Equity should be presented in accordance with the requirements of chapter 23, “Equity.”

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## Chapter 10—*Statement of Cash Flows*

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### Purpose and Scope

**10.01** Information about an entity's cash flows enables users of financial statements to assess the capacity of the entity to generate cash and cash equivalents and the needs of the entity for cash resources. The adequacy of expected cash inflows, taking into consideration their timing and certainty of generation, is evaluated against cash resources required to repay maturing financial obligations, finance the growth of productive assets, and make distributions to owners. Historical cash flow information is often used as an indicator of the amount, timing, and certainty of future cash flows. The purpose of this chapter is to require the provision of information about the historical changes in cash and cash equivalents of an entity by means of a statement of cash flows that classifies cash flows during the period arising from operating, investing, and financing activities.

**10.02** A statement of cash flows should be presented as an integral part of the financial statements for each period for which financial statements are presented.

**10.03** Users of an entity's financial statements are interested in how the entity generates and uses cash and cash equivalents. This is the case regardless of the nature of the entity's activities.

**10.04** An entity that presents consolidated financial statements includes a consolidated statement of cash flows in which cash flows within the consolidated entity, such as intercompany loans, repayments, and other cash transfers, are eliminated.

### Definitions

**10.05** The following terms are used in this chapter with the meanings specified:

*Cash.* Comprises cash on hand and demand deposits.

*Cash equivalents.* Short-term, highly liquid investments that are readily convertible to known amounts of cash and that are subject to an insignificant risk of changes in value.

*Cash flows.* Inflows and outflows of cash and cash equivalents.

*Financing activities.* Activities that result in changes in the size and composition of the equity capital and borrowings of the entity.

*Investing activities.* The acquisition and disposal of long-term assets and other investments not included in cash equivalents.

*Operating activities.* The principal revenue-producing activities of the entity and all other activities that are not investing or financing activities.

### Cash and Cash Equivalents

**10.06** Cash subject to restrictions that prevent its use for current purposes, such as

compensating balances required in accordance with lending arrangements, should not be included among cash and cash equivalents. Cash subject to restrictions should be classified on the balance sheet in accordance with chapter 7, “Current Assets and Current Liabilities,” and increases and decreases should be reflected in cash flows from investing activities.

**10.07** Cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investing or other purposes. For an investment to qualify as a cash equivalent, it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity of three months or less from the date of acquisition. Equity investments are excluded from cash equivalents.

**10.08** In certain circumstances, investments that qualify to be treated as cash equivalents may be classified as trading assets or investments. An entity should establish a policy concerning which short-term, highly liquid investments that satisfy the definition in paragraph 10.05 will be treated as cash equivalents. For example, an investment entity, whose portfolio consists largely of short-term, highly liquid investments may decide that all such items will be treated as investments rather than cash equivalents.

**10.09** Bank borrowings are generally considered to be financing activities. An increase (decrease) in bank overdrafts represents an increase (decrease) in bank borrowing and should be classified as a financing inflow (outflow). If an entity with multiple bank accounts has one account in an overdraft position at year-end, the entity should present as cash and cash equivalents on the statement of cash flows only the accounts with the positive balances. The total amounts of cash and cash equivalents at the beginning and end of the period should be the same amounts as similarly titled line items or subtotals shown in the statements of financial position. The net change in overdrafts during the period should be classified as a financing activity.

**10.10** Cash flows exclude movements between items that constitute cash or cash equivalents because these components are part of the cash management of an entity rather than part of its operating, investing, and financing activities.

## **Classification of Cash Flows**

**10.11** The statement of cash flows should report cash flows during the period classified by operating, investing, and financing activities.

**10.12** An entity presents its cash flows from operating, investing, and financing activities in a manner that is most appropriate to its business. Classification by activity provides information that allows users to assess the impact of those activities on the financial position of the entity and the amount of its cash and cash equivalents. This information may also be used to evaluate the relationships among those activities.

**10.13** A single transaction may include cash flows that are classified differently. For example, when the cash repayment of a liability includes both interest and principal, the interest component is classified as an operating activity and the principal component as a

financing activity.

### **Operating Activities**

**10.14** The amount of cash flows arising from operating activities is a key indicator of the extent to which the operations of the entity have generated sufficient cash flows to repay loans, maintain the operating capability of the entity, make new investments, and provide distributions to owners without recourse to external sources of financing. Information about the specific components of historical operating cash flows is useful in conjunction with other information in forecasting future operating cash flows.

**10.15** Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the entity. Therefore, they generally result from the transactions and other events that enter into the determination of net income or loss. Examples of cash flows from operating activities are

- a.* cash receipts from the sale of goods and the rendering of services;
- b.* cash receipts from royalties, fees, commissions, and other revenue;
- c.* cash payments to suppliers for goods and services;
- d.* cash payments to, and on behalf of, employees;
- e.* cash receipts and payments of interest and dividends included in the determination of net income;
- f.* cash payments and refunds of income and other taxes; and
- g.* cash receipts and payments from contracts held for trading purposes.

Some transactions, such as the sale of a capital asset, may give rise to a gain or loss that is included in the determination of net income or loss. However, the cash flows relating to such transactions are cash flows from investing activities.

**10.16** An entity may acquire securities and loans for trading purposes (that is, specifically for resale in the near term), in which case, they are similar to inventory acquired specifically for resale. Therefore, cash flows arising from the purchase and sale of trading assets are classified as operating activities.

### **Investing Activities**

**10.17** The separate presentation of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. Examples of cash flows arising from investing activities are

- a.* cash payments to acquire capital assets and other long-term assets (these payments include those relating to capitalized development costs and self-constructed capital assets, including interest paid and capitalized before the assets are substantially complete and ready for productive use);

- b. cash receipts from sales of capital assets and other long-term assets;
- c. cash payments to acquire equity or debt instruments of other enterprises and interests in joint ventures (other than payments for those instruments considered to be cash equivalents or those held for trading purposes);
- d. cash receipts from sales of equity or debt instruments of other enterprises and interests in joint ventures (other than receipts for those instruments considered to be cash equivalents and those held for trading purposes);
- e. cash advances and loans made to other parties;
- f. cash receipts from the repayment of advances and loans made to other parties;
- g. cash payments for futures contracts, forward contracts, option contracts, and swap contracts, except when the contracts are held for trading purposes or the payments are classified as financing activities; and
- h. cash receipts from futures contracts, forward contracts, option contracts, and swap contracts, except when the contracts are held for trading purposes or the receipts are classified as financing activities.

### **Financing Activities**

**10.18** The separate presentation of cash flows arising from financing activities is important because it is useful in predicting claims on future cash flows by providers of capital and debt financing to the entity. Examples of cash flows arising from financing activities are

- a. cash proceeds from issuing equity instruments;
- b. cash payments to owners to acquire or redeem the entity's shares;
- c. cash proceeds from issuing debentures, loans, notes, bonds, mortgages, and other short- or long-term borrowings;
- d. cash repayments of amounts borrowed;
- e. cash payments by a lessee for the reduction of the outstanding liability relating to a capital lease; and
- f. cash payments of dividends and interest charged to retained earnings.

### **Cash Flows From Operating Activities**

**10.19** An entity should report cash flows from operating activities using either the direct method or the indirect method. An entity should present separately major classes of gross cash receipts and gross cash payments arising from operating activities, if using the direct method.

**10.20** Examples of the major classes of cash flows from operating activities are contained in paragraph 10.15. This information may be obtained either

- a. from the accounting records of the entity or

- b. by adjusting sales, cost of sales, interest income and expense, and other items in the statement of income for
  - i. noncash items;
  - ii. changes during the period in inventories and operating receivables and payables;
  - iii. other deferrals or accruals of past or future operating cash receipts or payments; and
  - iv. items for which the cash effects are investing or financing cash flows.

**10.21** Under the indirect method, the net cash flow from operating activities is determined by adjusting net income or loss for the effects of

- a. noncash items, such as depreciation, provisions for losses, deferred taxes, unrealized foreign currency gains and losses, undistributed profits of equity-accounted investees, and noncontrolling interests;
- b. changes during the period in inventories and operating receivables and payables;
- c. other deferrals or accruals of past or future operating cash receipts or payments; and
- d. revenues, expenses, gains, or losses associated with investing or financing cash flows.

## **Cash Flows From Investing and Financing Activities**

**10.22** An entity should present separately major classes of gross cash receipts and gross cash payments arising from investing and financing activities.

**10.23** Examples of the major classes of investing activities are contained in paragraph 10.17. Examples of the major classes of financing activities are contained in paragraph 10.18.

## **Foreign Currency Cash Flows**

**10.24** Cash flows arising from transactions in a foreign currency should be recorded in an entity's reporting currency by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the cash flow.

**10.25** Cash flows denominated in a foreign currency are reported in a manner consistent with chapter 16, "Foreign Currency Translation." This permits use of an appropriately weighted average exchange rate for the period for the translation of revenues, expenses, gains, and losses. However, use of the exchange rate at the balance sheet date when translating the cash flows of a foreign subsidiary would not be appropriate unless that rate is a reasonable approximation of the actual rates at the dates of the cash flows.

**10.26** Unrealized gains and losses arising from changes in foreign currency exchange rates are not cash flows. However, the effect of exchange rate changes on cash and cash

equivalents denominated in a foreign currency is reported in the statement of cash flows in order to reconcile cash and cash equivalents at the beginning and the end of the period. This amount is presented separately from cash flows from operating, investing, and financing activities.

## **Interest and Dividends**

**10.27** Cash inflows from interest and dividends received should be classified as cash flows from operating activities. Cash outflows related to interest paid should be classified as an operating activity. Cash outflows related to dividends paid should be classified as cash flows used in financing activities. Cash outflows from dividends paid by subsidiaries to noncontrolling interests should be presented separately as cash flows used in financing activities.

**10.28** When an entity acquires a financial asset or issues a financial liability at a discount, the amortization of the discount over the term of the instrument does not reflect a cash flow.

**10.29** When an entity acquires a financial asset or issues a financial liability at a premium, the excess of the periodic interest payments, based on the stated rate, over the effective yield recognized in income is, in substance, a repayment of principal. Cash flows from operating activities should reflect interest income or expense recognized in income. The excess of actual cash flows over amounts recognized in income should be classified as cash flows from investing or financing activities.

## **Income Taxes**

**10.30** Cash flows arising from income taxes should be classified as cash flows from operating activities unless they can be specifically identified with financing and investing activities.

## **Investments in Equity-Accounted Subsidiaries, Investees, and Joint Ventures**

**10.31** When an investment in an entity is accounted for by use of the equity method, an investor restricts its reporting in the statement of cash flows to the cash flows between itself and the investee (for example, to dividends and advances).

## **Business Combinations and Disposals of Business Units**

**10.32** The aggregate cash flows arising from each of the business combinations accounted for using the purchase method and disposals of business units should be presented separately and classified as cash flows from investing activities.

**10.33** The separate presentation of the cash flow effects of business combinations accounted for as purchases and disposals of business units, together with the separate disclosure of the total amounts of assets and liabilities acquired or disposed of, helps to distinguish those cash flows from the cash flows arising from the other operating,

investing, and financing activities. The cash flow effects of disposals are not deducted from those of acquisitions.

**10.34** The aggregate amount of the cash paid or received as purchase or sale consideration is presented in the statement of cash flows net of cash and cash equivalents acquired or disposed of.

## **Noncash Transactions**

**10.35** Investing and financing transactions that do not require the use of cash or cash equivalents should be excluded from a statement of cash flows.

**10.36** Many investing and financing activities do not have a direct impact on current cash flows, although they do affect the capital and asset structure of an entity. The exclusion of noncash transactions from the statement of cash flows is consistent with the objective of a statement of cash flows because these items do not involve cash flows in the current period. Examples of noncash transactions are

- a.* the acquisition of assets by assuming directly related liabilities;
- b.* the acquisition of assets by means of a capital lease;
- c.* the acquisition of an entity in exchange for shares of the acquirer; and
- d.* the conversion of debt to equity.

An example of a transaction that would be considered a cash inflow followed by a cash outflow rather than a noncash transaction is the acquisition of a building financed by a third-party mortgage when the lender pays the vendor directly.

## **Disclosure**

### **Cash and Cash Equivalents**

**10.37** An entity should disclose the policy that it adopts in determining the composition of cash and cash equivalents and present a reconciliation of the amounts presented in its statement of cash flows with the equivalent items presented in the balance sheet.

**10.38** Any amounts of cash for which use is restricted should not be included in the composition of cash and cash equivalents. Material restrictions on cash should be disclosed.

**10.39** As discussed in paragraph 10.08, in certain circumstances, an entity may classify investments that qualify to be treated as cash equivalents as trading assets or investments. In such circumstances, the policy for determining components of cash and cash equivalents should be disclosed. Any change in the policy for determining the components of cash and cash equivalents (for example, a change in the classification of financial instruments previously considered to be part of an entity's investment portfolio) should be disclosed in accordance with chapter 5, "Accounting Changes, Changes in Accounting Estimates, and Correction of Errors."

## **Business Combinations and Disposals of Business Units**

**10.40** An entity should disclose, in aggregate, in respect of both business combinations and disposals of business units during the period

- a.* the total purchase or disposal consideration;
- b.* the portion of the purchase or disposal consideration composed of cash and cash equivalents;
- c.* the amount of cash and cash equivalents acquired or disposed of; and
- d.* the total assets, other than cash or cash equivalents, and total liabilities acquired or disposed of.

## **Noncash Transactions**

**10.41** Investing and financing transactions that do not require the use of cash or cash equivalents should either be presented on the face of the statement of cash flows as “noncash investing or financing activities” or disclosed in the notes to the financial statements in a way that provides all the relevant information about these investing and financing activities.

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## Chapter 11—*Business Combinations*

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### Purpose and Scope

- 11.01** This chapter establishes principles and requirements for how the acquirer
- a. recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree;
  - b. recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase; and
  - c. determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination.
- 11.02** This chapter applies to a transaction or other event that meets the definition of a *business combination*. This chapter does not apply to
- a. the formation of a joint venture.
  - b. the acquisition of an asset, or a group of assets, that does not constitute a business.

### Definitions

- 11.03** The following terms are used in this chapter with the meanings specified:

*Acquiree.* The business or businesses that the acquirer obtains control of in a business combination.

*Acquirer.* The entity that obtains control of the acquiree.

*Acquisition date.* The date on which the acquirer obtains control of the acquiree.

*Business.* An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants.

*Business combination.* A transaction or other event in which an acquirer obtains control of one or more businesses. Transactions sometimes referred to as *true mergers* or *mergers of equals* are also business combinations as that term is used in this chapter.

*Contingent consideration.* Usually an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. However, contingent consideration also may give the

acquirer the right to the return of previously transferred consideration if specified conditions are met.

*Control.* Control of an entity is the continuing power to determine its strategic operating, investing, and financing policies without the cooperation of others.

*Equity interests.* Used broadly to mean ownership interests of investor-owned entities and owner, member, or participant interests of mutual entities.

*Fair value.* The amount of the consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act.

*Goodwill.* An asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized.

*Identifiable.* An asset is identifiable if it either

- is separable (that is, capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability, regardless of whether the entity intends to do so) or
- arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

*Intangible asset.* An identifiable, nonmonetary asset without physical substance.

*Mutual entity.* An entity, other than an investor-owned entity, that provides dividends, lower costs, or other economic benefits directly to its owners, members, or participants. For example, a cooperative entity is a mutual entity.

*Noncontrolling interest.* The equity in a subsidiary not attributable, directly or indirectly, to a parent.

*Owners.* Used broadly to include holders of equity interests of investor-owned entities and owners or members of, or participants in, mutual entities.

## Identifying a Business Combination

**11.04** Management should determine whether a transaction or other event is a business combination by applying the definition in this chapter, which requires that the assets acquired and liabilities assumed constitute a business. If the assets acquired are not a business, the reporting entity should account for the transaction or other event as an asset acquisition. In such cases, the *acquirer* should identify and recognize the individual, identifiable assets acquired (including those assets that meet the definition of, and recognition criteria for, *intangible assets* in chapter 21, “Intangible Assets”) and liabilities assumed. The transaction cost should be allocated to the individual identifiable assets and liabilities on the basis of their relative fair values at the date of purchase. Such a transaction or event does not give rise to goodwill.

## The Acquisition Method

**11.05** Management should account for each business combination by applying the acquisition method.

**11.06** Applying the acquisition method requires

- a. identifying the acquirer;
- b. determining the acquisition date;
- c. recognizing and measuring the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree; and
- d. recognizing and measuring goodwill or a gain from a bargain purchase.

## Identifying the Acquirer

**11.07** For each business combination, one of the combining entities should be identified as the acquirer.

**11.08** The guidance in chapter 12, “Subsidiaries,” should be used to identify the acquirer—the entity that obtains control of the acquiree.

## Determining the Acquisition Date

**11.09** The acquirer should identify the acquisition date, which is the date it obtains control of the acquiree.

**11.10** The date the acquirer obtains control of the acquiree is generally the date the acquirer legally transfers the consideration, acquires the assets, and assumes the liabilities of the acquiree—the closing date. However, the acquirer might obtain control on a date that is either earlier or later than the closing date. For example, the acquisition date precedes the closing date if a written agreement provides that the acquirer obtains control of the acquiree on a date before the closing date. An acquirer should consider all pertinent facts and circumstances in identifying the acquisition date.

## **Recognizing and Measuring the Identifiable Assets Acquired, the Liabilities Assumed, and Any Noncontrolling Interest in the Acquiree**

### ***Recognition Principle***

**11.11** As of the acquisition date, the acquirer should recognize, separately from goodwill, the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. Recognition of identifiable assets acquired and liabilities assumed is subject to the conditions specified in paragraphs 11.12–.13.

### **Recognition Conditions**

**11.12** To qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must meet the definitions of *assets* and *liabilities* in chapter 1, “Financial Statement Concepts,” at the acquisition date. For example, costs the acquirer expects but is not obliged to incur in the future to effect its plan to exit an activity of an acquiree or to terminate the employment of or relocate an acquiree’s employees are not liabilities at the acquisition date. Therefore, the acquirer does not recognize those costs as part of applying the acquisition method. Instead, the acquirer recognizes those costs in its postcombination financial statements in accordance with other chapters.

**11.13** In addition, to qualify for recognition as part of applying the acquisition method, the identifiable assets acquired and liabilities assumed must be part of what the acquirer and the acquiree (or its former owners) exchanged in the business combination transaction rather than the result of separate transactions. The acquirer should apply the guidance in paragraphs 11.51–.52 to determine which assets acquired or liabilities assumed are part of the exchange for the acquiree and which, if any, are the result of separate transactions to be accounted for in accordance with their nature and the applicable chapters.

**11.14** The acquirer’s application of the recognition principle and conditions may result in recognizing some assets and liabilities that the acquiree had not previously recognized as assets and liabilities in its financial statements. For example, the acquirer recognizes the acquired identifiable intangible assets, such as a brand name, a patent, or a customer relationship, that the acquiree did not recognize as assets in its financial statements because it developed them internally and charged the related costs to expense.

**11.15** Paragraphs 11.23–.30 specify the types of identifiable assets and liabilities that include items for which this chapter provides limited exceptions to the recognition principle and conditions.

### **Classifying or Designating Identifiable Assets Acquired and Liabilities Assumed in a Business Combination**

**11.16** At the acquisition date, the acquirer should classify or designate the identifiable assets acquired and liabilities assumed as necessary to apply other chapters subsequently. The acquirer should make those classifications or designations on the basis of the

contractual terms, economic conditions, its operating or accounting policies, and other pertinent conditions as they exist at the acquisition date.

**11.17** In some situations, other chapters provide for different accounting depending on how an entity classifies or designates a particular asset or liability.

**11.18** This chapter provides an exception to the principle in paragraph 11.16 for the classification of a lease contract as either an operating lease, capital lease, sales-type lease, or a direct financing lease in accordance with chapter 22, “Leases.” The acquirer should classify those contracts on the basis of the contractual terms and other factors at the inception of the contract (or, if the terms of the contract have been modified in a manner that would change its classification, at the date of that modification, which might be the acquisition date).

### ***Measurement Principle***

**11.19** The acquirer should measure the identifiable assets acquired and the liabilities assumed at their acquisition-date fair values.

**11.20** For each business combination, the acquirer should measure any noncontrolling interest in the acquiree at the noncontrolling interest's proportionate share of the acquiree's identifiable net assets.

**11.21** Paragraphs 11.25–.31 specify the types of identifiable assets and liabilities that include items for which this chapter provides limited exceptions to the measurement principle.

### ***Exceptions to the Recognition or Measurement Principles***

**11.22** This chapter provides limited exceptions to its recognition and measurement principles. Paragraphs 11.23–.31 specify both the particular items for which exceptions are provided and the nature of those exceptions. The acquirer should account for those items by applying the requirements in paragraphs 11.23–.31, which will result in some items being

- a. recognized either by applying recognition conditions in addition to those in paragraphs 11.11–.12 or by applying the requirements of other chapters, with results that differ from applying the recognition principle and conditions and
- b. measured at an amount other than their acquisition-date fair values.

### **Exception to the Recognition Principle**

#### Contingent Liabilities

**11.23** Chapter 26, “Contingencies,” defines a *contingency* as an existing condition or situation involving uncertainty about possible gain or loss to an entity that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability.

**11.24** The requirements in chapter 26 do not apply in determining which contingent liabilities to recognize as of the acquisition date. Instead, the acquirer should recognize as of the acquisition date a contingent liability assumed in a business combination if it is a present obligation that arises from past events, and its fair value can be measured reliably. Therefore, contrary to chapter 26, the acquirer recognizes a contingent liability assumed in a business combination at the acquisition date, even if it is not probable that a future event will confirm that an asset had been impaired or a liability incurred at the date of the financial statements. Paragraph 11.57 provides guidance on the subsequent accounting for contingent liabilities.

## **Exceptions to Both the Recognition and Measurement Principles**

### **Asset Retirement Obligations**

**11.25** The acquirer should recognize and measure an asset retirement obligation associated with the assets acquired in a business combination in accordance with the section, “Asset Retirement Obligations,” in chapter 26.

### **Income Taxes**

**11.26** If the acquirer uses the deferred income taxes method of accounting for income taxes, then it should recognize and measure a deferred income tax asset or liability arising from the assets acquired and liabilities assumed in a business combination in accordance with chapter 29, “Income Taxes.”

**11.27** If the acquirer uses the deferred income taxes method of accounting for income taxes, then it should account for the potential tax effects of temporary differences and carryforwards of an acquiree that exist at the acquisition date or arise as a result of the acquisition in accordance with chapter 29.

### **Employee Benefits**

**11.28** The accrued benefit obligation is calculated using best estimate assumptions consistent with those that will be used on a going-forward basis in accordance with chapter 28, “Retirement and Other Postemployment Benefits.” Similarly, plan assets are valued at fair value in accordance with chapter 28. Any previously existing, unamortized net actuarial gain (loss), unamortized past prior service cost, unamortized transitional obligation, or unamortized transitional asset is eliminated with the result that the accrued benefit asset or accrued benefit liability is the difference between the accrued benefit obligation and the fair value of plan assets. The carrying amount of an accrued benefit asset in the acquired entity's financial statements may need to be reduced when the acquirer expects limitations on its ability to access a plan excess as a result of existing regulations of the relevant jurisdiction and the plan.

### **Indemnification Assets**

**11.29** The seller in a business combination may contractually indemnify the acquirer for the outcome of a contingency or uncertainty related to all or part of a specific asset or liability. For example, the seller may indemnify the acquirer against losses above a

specified amount on a liability arising from a particular contingency; in other words, the seller will guarantee that the acquirer's liability will not exceed a specified amount. As a result, the acquirer obtains an indemnification asset. The acquirer should recognize an indemnification asset at the same time that it recognizes the indemnified item measured on the same basis as the indemnified item. Therefore, if the indemnification relates to an asset or a liability that is recognized at the acquisition date and measured at its acquisition-date fair value, the acquirer should recognize the indemnification asset at the acquisition date measured at its acquisition-date fair value.

**11.30** In some circumstances, the indemnification may relate to an asset or a liability that is an exception to the recognition or measurement principles. For example, an indemnification may relate to a contingent liability that is not recognized at the acquisition date because its fair value is not reliably measurable at that date. Alternatively, an indemnification may relate to an asset or a liability (for example, one that results from an employee benefit that is measured on a basis other than acquisition-date fair value). In those circumstances, the indemnification asset should be recognized and measured using assumptions consistent with those used to measure the indemnified item, subject to management's assessment of the collectability of the indemnification asset and any contractual limitations on the indemnified amount. Paragraph 11.56 provides guidance on the subsequent accounting for an indemnification asset.

### **Exceptions to the Measurement Principle**

#### **Assets Held for Sale**

**11.31** The acquirer should measure an acquired noncurrent asset (or disposal group) that is classified as held for sale at the acquisition date in accordance with chapter 30, "Disposal of Long-Lived Assets and Discontinued Operations," at fair value less costs to sell.

### **Recognizing and Measuring Goodwill or a Gain From a Bargain Purchase**

**11.32** The acquirer should recognize goodwill as of the acquisition date measured as the excess of (a) over (b) below

- a. the aggregate of
  - i. the consideration transferred, measured in accordance with this chapter, which generally requires acquisition-date fair value (see paragraph 11.37);
  - ii. the amount of any noncontrolling interest in the acquiree measured in accordance with this chapter; and
  - iii. in a business combination, achieved in stages (see paragraphs 11.41–.42), the acquisition-date fair value of the acquirer's previously held equity interest in the acquiree; and

- b.* the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed measured in accordance with this chapter.

**11.33** In a business combination in which the acquirer and the acquiree (or its former owners) exchange only equity interests, the acquisition-date fair value of the acquiree's equity interests may be more reliably measurable than the acquisition-date fair value of the acquirer's equity interests. If so, the acquirer should determine the amount of goodwill by using the acquisition-date fair value of the acquiree's equity interests instead of the acquisition-date fair value of the equity interests transferred. To determine the amount of goodwill in a business combination in which no consideration is transferred, the acquirer should use the acquisition-date fair value of the acquirer's interest in the acquiree determined using a valuation technique in place of the acquisition-date fair value of the consideration transferred.

### **Bargain Purchases**

**11.34** Occasionally, an acquirer will make a bargain purchase, which is a business combination in which the amount in paragraph 11.32(b) exceeds the aggregate of the amounts specified in paragraph 11.32(a). If that excess remains after applying the requirements in paragraph 11.36, the acquirer should recognize the resulting gain in net income on the acquisition date. The gain should be attributed to the acquirer.

**11.35** A bargain purchase might happen, for example, in a business combination that is a forced sale in which the seller is acting under compulsion. However, the recognition or measurement exceptions for particular items discussed in paragraphs 11.22–.31 may also result in recognizing a gain (or change the amount of a recognized gain) on a bargain purchase.

**11.36** Before recognizing a gain on a bargain purchase, the acquirer should reassess whether it has correctly identified all the assets acquired and all the liabilities assumed and should recognize any additional assets or liabilities that are identified in that review. The acquirer should then review the procedures used to measure the amounts this chapter requires to be recognized at the acquisition date for all of the following:

- a.* The identifiable assets acquired and liabilities assumed
- b.* The noncontrolling interest in the acquiree, if any
- c.* For a business combination achieved in stages, the acquirer's previously held equity interest in the acquiree
- d.* The consideration transferred

The objective of the review is to ensure that the measurements appropriately reflect consideration of all available information as of the acquisition date.

### **Consideration Transferred**

**11.37** The consideration transferred in a business combination should be measured at fair value, which should be calculated as the sum of the acquisition-date fair values of the assets transferred by the acquirer, the liabilities incurred by the acquirer to former owners

of the acquiree, and the equity interests issued by the acquirer.

**11.38** The consideration transferred may include assets or liabilities of the acquirer that have carrying amounts that differ from their fair values at the acquisition date (for example, nonmonetary assets or an acquirer's business). If so, the acquirer should remeasure the transferred assets or liabilities to their fair values as of the acquisition date and recognize the resulting gains or losses, if any, in net income. However, sometimes the transferred assets or liabilities remain within the combined entity after the business combination (for example, because the assets or liabilities were transferred to the acquiree rather than to its former owners) and, therefore, the acquirer retains control of them. In that situation, the acquirer should measure those assets and liabilities at their carrying amounts immediately before the acquisition date and should not recognize a gain or loss in net income on assets or liabilities it controls both before and after the business combination.

### ***Contingent Consideration***

**11.39** The consideration the acquirer transfers in exchange for the acquiree includes any asset or liability resulting from a contingent consideration arrangement (see paragraph 11.38). The acquirer should recognize the acquisition-date fair value of contingent consideration as part of the consideration transferred in exchange for the acquiree.

**11.40** The acquirer should classify an obligation to pay contingent consideration as a liability or as equity on the basis of the definitions of an *equity instrument* and a *financial liability* in chapter 32, "Financial Instruments and Long-Term Debt." The acquirer should classify as an asset a right to the return of previously transferred consideration if specified conditions are met. Paragraph 11.57 provides guidance on the subsequent accounting for contingent consideration.

## **Additional Guidance for Applying the Acquisition Method to Particular Types of Business Combinations**

### **A Business Combination Achieved in Stages**

**11.41** An acquirer sometimes obtains control of an acquiree in which it held an equity interest immediately before the acquisition date. For example, on December 31, 20X1, entity A holds a 35 percent noncontrolling equity interest in entity B. On that date, entity A purchases an additional 40 percent interest in entity B, which gives it control of entity B. This chapter refers to such a transaction as a *business combination achieved in stages*, sometimes also referred to as a *step acquisition*.

**11.42** In a business combination achieved in stages, the acquirer should remeasure its previously held equity interest in the acquiree at its acquisition-date fair value and recognize the resulting gain or loss, if any, in net income.

### **A Business Combination Achieved Without the Transfer of Consideration**

**11.43** An acquirer sometimes obtains control of an acquiree without transferring

consideration. The acquisition method of accounting for a business combination applies to those combinations. Such circumstances include the following:

- a. The acquiree repurchases a sufficient number of its own shares for an existing investor (the acquirer) to obtain control.
- b. Minority veto rights lapse that previously kept the acquirer from controlling an acquiree in which the acquirer held the majority voting rights.
- c. The acquirer and acquiree agree to combine their businesses by contract alone. The acquirer transfers no consideration in exchange for control of an acquiree and holds no equity interests in the acquiree, either on the acquisition date or previously.

**11.44** In a business combination achieved by contract alone, the acquirer should attribute to the owners of the acquiree the amount of the acquiree's net assets recognized in accordance with this chapter. In other words, the equity interests in the acquiree held by parties other than the acquirer are a noncontrolling interest in the acquirer's postcombination financial statements, even if the result is that all the equity interests in the acquiree are attributed to the noncontrolling interest.

## Measurement Period

**11.45** If the initial accounting for a business combination is incomplete by the end of the reporting period in which the combination occurs, the acquirer should report in its financial statements provisional amounts for the items for which the accounting is incomplete. During the measurement period, the acquirer should retrospectively adjust the provisional amounts recognized at the acquisition date to reflect new information obtained about facts and circumstances that existed as of the acquisition date and, if known, would have affected the measurement of the amounts recognized as of that date. During the measurement period, the acquirer should also recognize additional assets or liabilities if new information is obtained about facts and circumstances that existed as of the acquisition date and, if known, would have resulted in the recognition of those assets and liabilities as of that date. The measurement period ends as soon as the acquirer receives the information it was seeking about facts and circumstances that existed as of the acquisition date or learns that more information is not obtainable. However, the measurement period should not exceed one year from the acquisition date.

**11.46** The measurement period is the period after the acquisition date during which the acquirer may adjust the provisional amounts recognized for a business combination. The measurement period provides the acquirer with a reasonable time to obtain the information necessary to identify and measure the following, as of the acquisition date, in accordance with the requirements of this chapter:

- a. The identifiable assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree
- b. The consideration transferred for the acquiree (or the other amount used in measuring goodwill)

- c. In a business combination achieved in stages, the equity interest in the acquiree previously held by the acquirer
- d. The resulting goodwill or gain on a bargain purchase

**11.47** The acquirer should consider all pertinent factors in determining whether information obtained after the acquisition date should result in an adjustment to the provisional amounts recognized or whether that information results from events that occurred after the acquisition date. Pertinent factors include the date when additional information is obtained and whether the acquirer can identify a reason for a change to provisional amounts. Information that is obtained shortly after the acquisition date is more likely to reflect circumstances that existed at the acquisition date than is information obtained several months later. For example, unless an intervening event that changed its fair value can be identified, the sale of an asset to a third party shortly after the acquisition date for an amount that differs significantly from its provisional fair value determined at that date is likely to indicate an error in the provisional amount.

**11.48** The acquirer recognizes an increase (decrease) in the provisional amount recognized for an identifiable asset (liability) by means of a decrease (increase) in goodwill. However, new information obtained during the measurement period may sometimes result in an adjustment to the provisional amount of more than one asset or liability. For example, the acquirer might have assumed a liability to pay damages related to an accident in one of the acquiree's facilities, part or all of which are covered by the acquiree's liability insurance policy. If the acquirer obtains new information during the measurement period about the acquisition-date fair value of that liability, the adjustment to goodwill resulting from a change to the provisional amount recognized for the liability should be offset (in whole or in part) by a corresponding adjustment to goodwill resulting from a change to the provisional amount recognized for the claim receivable from the insurer.

**11.49** During the measurement period, the acquirer should recognize adjustments to the provisional amounts as if the accounting for the business combination had been completed at the acquisition date. Thus, the acquirer should revise comparative information for prior periods presented in financial statements as needed, including making any change in depreciation, amortization, or other income effects recognized in completing the initial accounting.

**11.50** After the measurement period ends, the acquirer should revise the accounting for a business combination only to correct an error in accordance with chapter 5, "Accounting Changes, Changes in Accounting Estimates, and Correction of Errors."

## **Determining What Is Part of the Business Combination Transaction**

**11.51** The acquirer and the acquiree may have a preexisting relationship or other arrangement before negotiations for the business combination began, or they may enter into an arrangement during the negotiations that is separate from the business combination. In either situation, the acquirer should identify any amounts that are not part

of what the acquirer and the acquiree (or its former owners) exchanged in the business combination (that is, amounts that are not part of the exchange for the acquiree). The acquirer should recognize as part of applying the acquisition method only the consideration transferred for the acquiree and the assets acquired and liabilities assumed in the exchange for the acquiree. Separate transactions should be accounted for in accordance with the relevant chapters.

**11.52** A transaction entered into by, or on behalf of, the acquirer or primarily for the benefit of the acquirer or the combined entity, rather than primarily for the benefit of the acquiree (or its former owners) before the combination, is likely to be a separate transaction. The following are examples of separate transactions that are not to be included in applying the acquisition method:

- a. A transaction that, in effect, settles preexisting relationships between the acquirer and acquiree
- b. A transaction that remunerates employees or former owners of the acquiree for future services
- c. A transaction that reimburses the acquiree or its former owners for paying the acquirer's acquisition-related costs

### **Acquisition-Related Costs**

**11.53** Acquisition-related costs are costs the acquirer incurs to effect a business combination. Those costs include finder's fees; advisory, legal, accounting, valuation, and other professional or consulting fees; general administrative costs, including the costs of maintaining an internal acquisitions department; and costs of registering and issuing debt and equity securities. The acquirer should account for acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received, with one exception. The costs to issue equity securities should be recognized in accordance with chapter 23, "Equity."

### **Subsequent Measurement and Accounting**

**11.54** In general, an acquirer should subsequently measure and account for assets acquired, liabilities assumed or incurred, and equity instruments issued in a business combination in accordance with other applicable chapters for those items, depending on their nature. However, this chapter provides guidance on subsequently measuring and accounting for the following assets acquired, liabilities assumed or incurred, and equity instruments issued in a business combination:

- a. Contingent liabilities recognized as of the acquisition date
- b. Indemnification assets
- c. Contingent consideration

### **Contingent Liabilities**

**11.55** After initial recognition, and until the liability is settled, cancelled, or expires, the

acquirer should measure a contingent liability recognized in a business combination at the higher of

- a. the amount that would be recognized in accordance with chapter 26 and
- b. the amount initially recognized less, if appropriate, cumulative amortization recognized in accordance with chapter 27, "Revenue."

This requirement does not apply to contracts accounted for in accordance with chapter 32.

### **Indemnification Assets**

**11.56** At the end of each subsequent reporting period, the acquirer should measure an indemnification asset that was recognized at the acquisition date on the same basis as the indemnified liability or asset, subject to any contractual limitations on its amount and, for an indemnification asset that is not subsequently measured at its fair value, management's assessment of the collectability of the indemnification asset. The acquirer should derecognize the indemnification asset only when it collects the asset, sells it, or otherwise loses the right to it.

### **Contingent Consideration**

**11.57** Some changes in the fair value of contingent consideration that the acquirer recognizes after the acquisition date may be the result of additional information that the acquirer obtained after that date about facts and circumstances that existed at the acquisition date. Such changes are measurement period adjustments in accordance with paragraphs 11.45–.50. However, changes resulting from events after the acquisition date, such as meeting an earnings target, reaching a specified share price, or reaching a milestone on a research and development project, are not measurement period adjustments. The acquirer should account for changes in the fair value of contingent consideration that are not measurement period adjustments as follows:

- a. Contingent consideration classified as equity should not be remeasured, and its subsequent settlement should be accounted for within equity.
- b. Contingent consideration classified as an asset or a liability should not be remeasured, and any gain or loss on subsequent settlement should be recognized in net income.

### **Combinations of Entities Under Common Control**

**11.58** This section applies to combinations between entities under common control. The following are examples of those types of transactions:

- a. An entity charters a newly formed entity and then transfers some or all of its net assets to that newly chartered entity.

- b. A parent transfers the net assets of a wholly-owned subsidiary into the parent and liquidates the subsidiary. That transaction is a change in legal organization but not a change in the reporting entity.
- c. A parent transfers its controlling interest in several partially owned subsidiaries to a new, wholly-owned subsidiary. That also is a change in legal organization but not in the reporting entity.
- d. A parent exchanges its ownership interests or the net assets of a wholly-owned subsidiary for additional shares issued by the parent's less-than-wholly-owned subsidiary, thereby increasing the parent's percentage of ownership in the less-than-wholly-owned subsidiary but leaving all the existing, noncontrolling interest outstanding.
- e. A parent's less-than-wholly-owned subsidiary issues its shares in exchange for shares of another subsidiary previously owned by the same parent, and the noncontrolling shareholders are not party to the exchange. That is not a business combination from the perspective of the parent.
- f. A limited liability company is formed by combining entities under common control.

## **Recognition**

**11.59** When accounting for a transfer of assets or exchange of shares between entities under common control, the entity that receives the net assets or the equity interests should initially recognize the assets and liabilities transferred at the date of transfer.

## **Measurement**

**11.60** When accounting for a transfer of assets or exchange of shares between entities under common control, the entity that receives the net assets or the equity interests should initially measure the recognized assets and liabilities transferred at their carrying amounts in the accounts of the transferring entity at the date of transfer.

**11.61** In some instances, the entity that receives the net assets or equity interests (the receiving entity) and the entity that transferred the net assets or equity interests (the transferring entity) may account for similar assets and liabilities using different accounting methods. In such circumstances, the carrying amounts of the assets and liabilities transferred may be adjusted to the basis of accounting used by the receiving entity if the change would be preferable. Any such change in accounting method should be applied retrospectively, and financial statements presented for prior periods should be adjusted unless it is impracticable to do so.

## **Financial Statement Presentation in Period of Transfer**

**11.62** The receiving entity's financial statements should report results of operations for the period in which the transfer occurs as though the transfer of net assets or exchange of equity interests had occurred at the beginning of the period. Thus, results of operations for that period will comprise those of the previously separate entities combined from the

beginning of the period to the date the transfer is completed and those of the combined operations from that date to the end of the period. By eliminating the effects of intraentity transactions in determining the results of operations for the period before the combination, those results will be on substantially the same basis as the results of operations for the period after the date of combination. The effects of intraentity transactions on current assets, current liabilities, revenue, and cost of sales for periods presented and on retained earnings at the beginning of the periods presented should be eliminated to the extent possible.

**11.63** Similarly, the receiving entity should present the balance sheet and other financial information as of the beginning of the period as though the assets and liabilities had been transferred at that date.

### **Comparative Financial Statement Presentation for Prior Years**

**11.64** Financial statements and financial information presented for prior years also should be retrospectively adjusted to furnish comparative information. All adjusted financial statements and financial summaries should indicate clearly that financial data of previously separate entities are combined. However, the comparative information in prior years should only be adjusted for periods during which the entities were under common control.

### **Disclosure**

**11.65** The acquirer should disclose information that enables users of its financial statements to evaluate the nature and financial effect of a business combination that occurs either

- a. during the current reporting period or
- b. after the end of the reporting period but before the financial statements are completed.

**11.66** To meet the objective in paragraph 11.65, the acquirer should disclose the following information for each material business combination:

- a. The name and a description of the acquiree
- b. The acquisition date
- c. The percentage of voting equity interests acquired
- d. The acquisition-date fair value of the total consideration transferred and the acquisition-date fair value of each major class of consideration, such as
  - i. cash;
  - ii. liabilities incurred (for example, a liability for contingent consideration); and
  - iii. equity interests of the acquirer, including the number of instruments or interests issued or issuable

- e.* A description of the arrangement and the basis for determining the amount of the payment for contingent consideration arrangements and indemnification assets
- f.* A condensed balance sheet showing the amounts recognized as of the acquisition date for each major class of assets acquired and liabilities assumed
- g.* The amount of any gain recognized in a bargain purchase in accordance with paragraph 11.32 and the line item in the statement of income in which the gain is recognized
- h.* The amount of the noncontrolling interest in the acquiree recognized at the acquisition date and the measurement basis for that amount
- i.* In a business combination achieved in stages
  - i.* the acquisition-date fair value of the equity interest in the acquiree held by the acquirer immediately before the acquisition date and
  - ii.* the amount of any gain or loss recognized as a result of remeasuring to fair value the equity interest in the acquiree held by the acquirer before the business combination (see paragraph 11.42) and the line item in the statement of income in which that gain or loss is recognized

**11.67** For individually immaterial business combinations occurring during the reporting period that are material collectively, the acquirer should disclose the following information:

- a.* The number of enterprises acquired and a brief description of those enterprises
- b.* The acquisition-date fair value of the total consideration transferred
- c.* The number of equity instruments or interests of the acquirer issued or issuable
- d.* A description of the arrangement and the basis for determining the amount of the payment for contingent consideration arrangements and indemnification assets

**11.68** If the acquisition date of a business combination is after the end of the reporting period but before the financial statements are completed, the acquirer should disclose the information required by paragraphs 11.65–.66, unless the initial accounting for the business combination is incomplete at the time the financial statements are completed. In that situation, the acquirer should describe which disclosures could not be made and the reasons why they cannot be made.

**11.69** If the specific disclosures required by this and other chapters do not meet the objectives set out in paragraph 11.65, the acquirer should disclose whatever additional information is necessary to meet those objectives.

## **Combinations of Entities Under Common Control**

**11.70** The notes to financial statements of the receiving entity should disclose the following for the period in which the transfer of assets and liabilities or exchange of equity interests occurred:

- a.* The name and brief description of the entity included in the reporting entity as a result of the net asset transfer or exchange of equity interests
- b.* The method of accounting for the transfer of net assets or exchange of equity interests

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## Chapter 12—*Subsidiaries*

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### Purpose and Scope

**12.01** This chapter establishes principles for accounting for subsidiaries in the general purpose financial statements. This chapter is closely related to chapter 11, “Business Combinations,” which sets out the basis of accounting for transactions by which subsidiaries are acquired; chapter 13, “Consolidated Financial Statements and Noncontrolling Interests,” which describes the preparation of consolidated financial statements and the accounting for a noncontrolling interest in a subsidiary subsequent to a business combination and chapter 31, “Related Party Transactions,” which establishes principles for the measurement and disclosure of related party transactions in the financial statements.

**12.02** This chapter does not deal with accounting for investments, which is covered in chapter 19, “Investments,” and chapter 32, “Financial Instruments and Long-Term Debt.”

### Definitions

**12.03** The following terms are used in this chapter with the meanings specified:

*Control.* Control of an entity is indicated by the ownership of more than 50 percent of the outstanding residual equity interests.

*Subsidiary.* An entity in which another entity (parent) owns more than 50 percent of its (subsidiary’s) outstanding equity interests.

### Recognition and Presentation

**12.04** An entity should make an accounting policy choice to either

- a. consolidate its subsidiaries or
- b. account for its subsidiaries using the equity method.

An entity choosing the equity method should provide the disclosures required by chapter 19. All subsidiaries should be accounted for using the same method. In making this accounting policy choice, management need not meet the criterion in paragraph 5.06(b).

### Consolidated Financial Statements

**12.05** Consolidated financial statements recognize that even though the parent and its subsidiaries may be separate legal entities, together, they constitute a single economic unit. Such financial statements provide an appropriate basis for informing users of the parent's financial statements about the resources and results of operations of the parent and its subsidiaries as a group. However, some users are more interested in financial statements on a nonconsolidated basis. For example, lenders may want information only about the entity to which they have made a loan. Consolidated financial statements may include cash flows, assets, and liabilities for entities that are separate from the entity the

lender has made the loan to and, thus, may be less informative than nonconsolidated financial statements.

**12.06** When an entity prepares consolidated financial statements, it should describe these financial statements as being prepared on a consolidated basis, and each statement should be labeled accordingly.

**12.07** Consolidation is not appropriate when an entity has a limited right and ability to determine or influence the strategic policies of another entity but does not control it. A holding of an interest in an entity that is not a subsidiary qualifies as an investment and is subject to requirements of chapter 19 or chapter 32.

**12.08** Consolidation of a subsidiary commences at the date the parent acquires control and continues as long as control exists. Accordingly, a parent does not retroactively consolidate a subsidiary for periods prior to its acquisition of control.

**12.09** When an entity ceases to meet the definition of a *subsidiary*, the former parent ceases to consolidate the entity from that time and determines whether it has an investment (see chapter 19) or a financial asset (see chapter 32). Amounts reported on a consolidated basis for periods prior to the cessation of consolidation are not retroactively restated on a nonconsolidated basis.

**12.10** Subsequent to a decision to dispose of a subsidiary and prior to the disposal date, the provisions of chapter 30, “Disposal of Long-Lived Assets and Discontinued Operations,” apply to a business of the subsidiary that meets the criteria in that chapter to be classified as held for sale. Application of the requirements of that chapter does not result in cessation of consolidation.

## **Nonconsolidated Financial Statements**

**12.11** When an entity applies the accounting policy choice as set out in paragraph 12.04(b), it should describe its financial statements as being prepared on a nonconsolidated basis, and each statement should be labeled accordingly.

**12.12** Investments in nonconsolidated subsidiaries should be presented separately from other investments in the balance sheet. Income or loss from those investments should be presented as a gross amount in the statement of income.

**12.13** When an entity applies one of the alternative methods permitted by paragraph 12.04, the requirements of chapter 31 also apply to intercompany transactions that would otherwise have been eliminated on consolidation.

## **Disclosure**

### **Consolidated Financial Statements**

**12.14** Management should provide a listing and description of all subsidiaries, including their names and the proportion of ownership interests held in each subsidiary.

## **Nonconsolidated Financial Statements**

**12.15** An entity that prepares nonconsolidated financial statements should disclose the basis used to account for its subsidiaries.

**12.16** An entity that prepares nonconsolidated financial statements should provide a listing and description of all subsidiaries, including their names, carrying values, and the proportion of ownership interests held in each subsidiary.

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## **Chapter 13—Consolidated Financial Statements and Noncontrolling Interests**

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### **Purpose and Scope**

**13.01** This chapter establishes principles for the preparation of consolidated financial statements and for accounting for a noncontrolling interest in a subsidiary in consolidated financial statements subsequent to a business combination. Five other chapters deal with closely related matters, as follows:

- a.* Chapter 11, “Business Combinations,” deals with the application of the purchase method of accounting for business combinations. In particular, this chapter addresses the determination of the carrying amount of the assets and liabilities of a subsidiary company, goodwill, and accounting for a noncontrolling interest at the time of the business combination.
- b.* Chapter 12, “Subsidiaries,” deals with the circumstances in which consolidation is used in the general purpose financial statements and provides an accounting policy choice for an entity to either consolidate its subsidiaries or account for them using the equity method or the cost method.
- c.* Chapter 19, “Investments,” deals with the circumstances in which the equity method of accounting is used.
- d.* Chapter 21, “Intangible Assets,” addresses accounting for goodwill subsequent to a business combination.
- e.* Chapter 31, “Related Party Transactions,” establishes principles for the measurement and disclosure of related party transactions in the financial statements .

**13.02** This chapter specifically discusses consolidation accounting following a business combination that involves a purchase of an equity interest by one company in another.

**13.03** Consolidated financial statements recognize that the separate legal entities are components of one economic unit and are distinguishable from the separate parent and subsidiary company statements and from combined statements of affiliated companies. The distinction is based both on the nature of such statements and on the difference in circumstances justifying their use.

## Definitions

**13.04** The following terms are used in this chapter with the meanings specified:

*Consolidated financial statements.* Financial statements produced by aggregating the financial statements of one or more subsidiary companies, in which the parent company owns more than 50 percent of the outstanding equity interests, on a line-by-line basis (that is, adding together corresponding items of assets, liabilities, revenues, and expenses) with the financial statements of the parent company, eliminating intercompany balances and transactions and providing for any noncontrolling interest in a subsidiary company.

*Noncontrolling interest.* The equity in a subsidiary not attributable, directly or indirectly, to a parent.

## Combined Financial Statements

**13.05** Combined financial statements (as distinguished from consolidated financial statements) may be useful in certain circumstances, although they are not a substitute for consolidated financial statements. Combined financial statements could be useful when one individual owns a controlling interest in several corporations. They could also be used to present the financial position and the results of operations of a group of subsidiaries or to combine the financial statements of companies under common management.

**13.06** When combined financial statements are prepared, similar principles to those used in preparing consolidated financial statements apply.

## Preparation of Consolidated Financial Statements

**13.07** The accounting principles that apply to the preparation of consolidated financial statements can be presented in three segments:

- a. Those that apply to the initial preparation of consolidated financial statements at the date of an acquisition
- b. Those that apply to transactions reported in subsequent consolidated financial statements
- c. Those that apply to miscellaneous transactions or relationships between the parent and subsidiary company

### **At the Date of Acquisition**

**13.08** When consolidated financial statements are prepared, the investment account of the parent should be replaced by the identifiable assets and liabilities of the subsidiary, any noncontrolling interest therein, and any goodwill arising as a result of the investment. Preparation of such financial statements requires that appropriate carrying amounts at the date of acquisition be determined for each asset and liability for the noncontrolling interest and for goodwill (see chapter 11).

### ***Intercompany Balances***

**13.09** Consolidated financial statements present two or more distinct legal entities as one single economic unit. To the extent that the two legal entities have receivables or payables from or to the other, such amounts should be eliminated upon consolidation.

**13.10** Intercompany balances should be eliminated upon consolidation.

### ***Consolidated Retained Earnings***

**13.11** Because retained earnings represent the accumulation of undistributed earnings of a company, it would be inappropriate to include in consolidated retained earnings the undistributed earnings that existed in a subsidiary company at the date of its acquisition by the parent.

**13.12** The retained earnings or deficit of a subsidiary company at the date(s) of acquisition by the parent should not be included in consolidated retained earnings.

**13.13** Sometimes the carrying amount of the assets of the parent company or the subsidiary company includes gains or losses arising from transactions between the two companies prior to the date of acquisition. Because transactions that took place prior to the date of acquisition are ordinarily assumed to have taken place at arm's length, the amounts involved in such transactions constitute objective evidence of value. Accordingly, such gains or losses should not be eliminated in the preparation of consolidated financial statements unless the transactions were made in contemplation of acquisition.

### **At Dates Subsequent to an Acquisition**

**13.14** Consolidated financial statements prepared on dates subsequent to the date of an acquisition are based on the amount assigned to assets, liabilities, and noncontrolling interest at the date of acquisition and, in addition, indicate the effects of transactions subsequent to that date.

### ***Normal Operating Transactions Subsequent to an Acquisition***

**13.15** The existence of intercompany sales and purchases of goods and services, including inventory and fixed asset items and intercompany lending and borrowing transactions, will require the adjustment in the consolidated financial statements of the amounts included in the individual company financial statements.

### **Intercompany Gains and Losses**

**13.16** Unrealized intercompany gains or losses arising subsequent to the date of an acquisition on assets remaining within the consolidated group should be eliminated. The amount of elimination from assets should not be affected by the existence of a noncontrolling interest. In consolidated financial statements prepared subsequent to the date of an acquisition, intercompany balances and postacquisition transactions should be eliminated.

### **Depreciation and Amortization**

**13.17** The assets and liabilities of the subsidiary company that were consolidated at the date of acquisition are deemed to have been purchased by the consolidated entity on that date. The amounts determined at that date are the basis for subsequent accounting for these assets and liabilities (such as calculation of depreciation charges). Therefore, the sum of the depreciation charges in the parent and subsidiary company records may not equal the appropriate depreciation charge to be presented in the consolidated financial statements, and adjustments may be necessary. Similarly, interest recognized on financial instruments measured at amortized cost may differ from the sum of interest amounts recorded by the parent and subsidiary.

**13.18** The depreciation, depletion, and amortization of the assets of a subsidiary company should be computed for the purposes of consolidated financial statements on the basis of the amounts determined at the date of acquisition by the parent company.

### **Intercompany Balances and Transactions**

**13.19** Intercompany transactions may involve items reported as revenue or expense in the statements of income of the individual companies. Such transactions often result in the creation of intercompany receivable and payable balances. These assets, liabilities, revenues, and expense amounts are eliminated in the preparation of consolidated financial statements.

### **Shareholders' Equity Transactions With Interests Outside the Consolidated Group**

**13.20** Transactions subsequent to the date of acquisition may affect the proportional equity positions of the parent and the noncontrolling interests. These include, for example, the sale by the parent company of some of its holdings in the subsidiary company, the issue by the subsidiary company of some of its own shares, and the repurchase by a subsidiary company of its own shares. Other equity transactions of the consolidated group with outside interests are similar in nature and may be accounted for accordingly.

**13.21** When a parent company acquires additional shares in a subsidiary, that transaction will be accounted for in accordance with the guidelines provided in paragraphs 13.29–.30. Declaration of a stock dividend by a subsidiary company will also affect the number of shares held but not the relative positions of the parent and noncontrolling interests.

**13.22** When the parent company sells part of its shareholdings in a subsidiary company to outside interests or the subsidiary company issues its own shares to outside interests, the shares sold or issued reduce the parent's interest and increase the noncontrolling interest. Guidance on accounting for changes in an ownership interest in a subsidiary is provided in paragraphs 13.29–.35.

### **Acquisition by a Subsidiary of Its Own Shares From Interests Outside the Group**

**13.23** When a subsidiary acquires its own shares for cancellation from outside interests, the proportionate interest of the parent company after the transaction is increased. Because the transaction is similar in effect to the situation when the parent company acquires an additional interest in a subsidiary, it is accounted for in accordance with paragraphs 13.29–.30.

### **Stock Dividends by Subsidiary Companies**

**13.24** The capitalization of retained earnings by a subsidiary company on the declaration of a stock dividend does not result in a change in the assets and liabilities of the parent's interest in the consolidated group.

## **Miscellaneous**

### ***Basis of Accounting***

**13.25** A difference in the basis of accounting between a parent and a subsidiary precludes the preparation of consolidated financial statements.

### ***Statements at Different Dates***

**13.26** A difference in fiscal periods of a parent and a subsidiary does not, of itself, justify the exclusion of the subsidiary from consolidation. Normally, the subsidiary can prepare, for consolidation purposes, statements for a period that coincides with the fiscal period of the parent.

## **Noncontrolling Interests**

### **Procedures**

**13.27** In preparing consolidated financial statements, an entity identifies noncontrolling interests in the net income of consolidated subsidiaries for the reporting period and noncontrolling interests in the net assets of consolidated subsidiaries separately from the parent's ownership interests in them. Noncontrolling interests in the net assets consist of

the amount of those noncontrolling interests at the date of the original combination calculated in accordance with chapter 11 and the noncontrolling interests' share of changes in equity since the date of the combination.

**13.28** When potential voting rights exist, the proportions of net income and changes in equity allocated to the parent and noncontrolling interests are determined on the basis of present ownership interests and do not reflect the possible exercise or conversion of potential voting rights.

### **Change in Ownership Interest in a Consolidated Subsidiary**

**13.29** Changes in a parent's ownership interest in a consolidated subsidiary that do not result in a loss of control should be accounted for as equity transactions (that is, transactions with owners in their capacity as owners).

**13.30** In such circumstances, the carrying amounts of the controlling and noncontrolling interests should be adjusted to reflect the changes in their relative interests in the subsidiary. Any difference between the amount by which the noncontrolling interests are adjusted and the fair value of the consideration paid or received should be recognized directly in equity and attributed to the owners of the parent.

### **Loss of Control of a Consolidated Subsidiary**

**13.31** A parent might lose control of a consolidated subsidiary in two or more arrangements (transactions). However, sometimes circumstances indicate that the multiple arrangements should be accounted for as a single transaction. In determining whether to account for the arrangements as a single transaction, a parent should consider all the terms and conditions of the arrangements and their economic effects. One or more of the following may indicate that the parent should account for the multiple arrangements as a single transaction:

- a.* They are entered into at the same time or in contemplation of each other.
- b.* They form a single transaction designed to achieve an overall commercial effect.
- c.* The occurrence of one arrangement is dependent on the occurrence of at least one other arrangement.
- d.* One arrangement considered on its own is not economically justified, but it is economically justified when considered together with other arrangements. An example is when one disposal of shares is priced below market and is compensated for by a subsequent disposal priced above market.

**13.32** If a parent loses control of a consolidated subsidiary, it should

- a.* derecognize the assets (including any goodwill) and liabilities of the subsidiary at their carrying amounts at the date when control is lost;

- b. derecognize the carrying amount of any noncontrolling interests in the former subsidiary at the date when control is lost (including any components of equity attributable to them);
- c. recognize
  - i. the fair value of the consideration received, if any, from the transaction, event, or circumstances that resulted in the loss of control and
  - ii. if the transaction that resulted in the loss of control involves a distribution of shares of the subsidiary to owners in their capacity as owners, that distribution;
- d. recognize any investment retained in the former subsidiary at its carrying amount at the date when control is lost; and
- e. recognize any resulting difference as a gain or loss in net income attributable to the parent.

**13.33** On the loss of control of a consolidated subsidiary, any investment retained in the former subsidiary and any amounts owed by, or to, the former subsidiary should be accounted for in accordance with other chapters from the date when control is lost.

**13.34** The carrying amount of a consolidated subsidiary is the carrying amount in the nonconsolidated financial statements of the parent. This will be the cost of the subsidiary. The carrying amount of the retained investment is a proportionate share of the carrying amount of the subsidiary at the date of loss of control.

**13.35** The carrying amount of any investment retained in the former subsidiary at the date when control is lost should be regarded as the carrying amount on initial recognition of a financial asset in accordance with chapter 32, “Financial Instruments and Long-Term Debt,” or, when appropriate, the cost on initial recognition of an investment in an entity subject to significant influence or an investment in a joint venture.

## **Presentation of Consolidated Financial Statements and Noncontrolling Interests**

**13.36** Consolidated financial statements adhere to the disclosure and presentation requirements for all financial statements. Also, certain disclosure requirements are specific to consolidated financial statements.

### **Statement of Income Presentation in a Period of an Acquisition or Disposal**

**13.37** Only postacquisition and predisposal income of a subsidiary company is included in consolidated net income. The guidelines for determining the date of disposal may be inferred from the guidelines for determining the date of acquisition contained in chapter 11.

### **Noncontrolling Interests**

**13.38** If an entity consolidates its subsidiaries, noncontrolling interests should be

presented in the consolidated balance sheet within equity, separately from the equity of the owners of the parent.

**13.39** Net income is attributed to the owners of the parent and to the noncontrolling interests. Total income is attributed to the owners of the parent and to the noncontrolling interests, even if this results in the noncontrolling interests having a deficit balance.

## **Disclosure**

**13.40** The entity's consolidation policy should be disclosed.

**13.41** When, for purposes of consolidation, it is not possible to use financial statements for a period that substantially coincides with that of the investor's financial statements, this fact, and the period covered by the financial statements used, should be disclosed.

**13.42** When the fiscal periods of a parent and a subsidiary, the investment in which is accounted for by the consolidation method, are not the same, events relating to, or transactions of, the subsidiary that have occurred during the intervening period that significantly affect the financial position or results of operations of the group should be recorded or disclosed, as appropriate.

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## Chapter 14—*Interests in Joint Ventures*

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### Purpose and Scope

**14.01** This chapter establishes principles for accounting for interests in joint ventures and the reporting of joint venture assets, liabilities, revenue, and expenses in the financial statements of venturers, regardless of the structures and forms under which the joint venture activities take place. However, this chapter does not deal with accounting by the joint venture itself.

**14.02** This chapter applies when economic activities meet the definitions and criteria outlined in paragraphs 14.03–.14, even though such activities may not be referred to as *joint ventures*. However, this chapter does not apply when economic activities do not meet the definitions and criteria set out in paragraphs 14.03–.14 even though they may sometimes be referred to as *joint ventures*. Accounting for investments in such activities is governed by the nature of the investments (see chapter 19, “Investments,” and chapter 32, “Financial Instruments and Long-Term Debt”).

### Definitions

**14.03** The following terms are used in this chapter with the meanings specified:

*Corporate joint venture.* An investment in the stock of entities other than subsidiaries, namely corporate joint ventures and other noncontrolled entities. These are accounted for using the equity method. The guidance in chapter 19 applies to joint venture investments of 50 percent or less of the common stock.

*Joint control.* Joint control of an economic activity is the proportionate contractually-agreed sharing of the continuing power to determine its strategic operating, investing, and financing policies.

*Joint venture.* An economic activity resulting from a contractual arrangement whereby two or more venturers participate, directly or indirectly, in the jointly controlled economic activity.

*Proportionate consolidation.* A method of accounting and reporting in certain industries, whereby a venturer may account in its financial statements for its pro rata share of the assets, liabilities, revenues, and expenses that are subject to joint control. A proportionate gross financial statement presentation is not appropriate for an investment accounted for by the equity method of accounting unless the investee is in either the construction industry or an extractive industry and the entity is unincorporated. The venturer's pro rata share of the assets, liabilities, revenues, and expenses that are subject to joint control is combined on a line-by-line basis with similar items in the venturer's financial statements. This method of accounting differs from full consolidation in that only the venturer's portion of all assets, liabilities,

revenues, and expenses is taken up rather than the full amount, offset by noncontrolling interests.

*Venturer.* A party to a joint venture, has joint control over that joint venture, has the right and ability to obtain future economic benefits from the resources of the joint venture, and is exposed to the related risks.

**14.04** A distinctive characteristic common to all joint ventures is that two or more venturers are bound by a contractual arrangement that establishes that the venturers have joint control over the joint venture, regardless of the difference that may exist in their ownership interest. None of the individual venturers is in a position to exercise unilateral control over the joint venture. Decisions in all areas essential to the accomplishment of the joint venture require the consent of the venturers in such manner as defined in the terms of the contractual arrangement. This characteristic of joint control distinguishes interests in joint ventures from investments in other activities over which an investor may exercise control or significant influence. Activities conducted with no formal contractual arrangements that are jointly controlled in substance are joint ventures for the purposes of this chapter.

**14.05** Interests in an economic activity as described previously may exist without entitling all the investors to share in joint control. In such cases, this would not be considered an interest in a joint venture for those investors who do not share in joint control, even though the economic activity may be viewed as a joint venture by those investors who do have joint control. The interest of an investor who does not have joint control over the joint venture qualifies as an investment and is subject to the requirements of chapter 19 or chapter 32.

**14.06** A venturer has joint control over a joint venture and has the right and ability to obtain future economic benefits from the resources of the joint venture and is exposed to related risks. Future economic benefits normally include cash flows or other forms of output generated by the joint venture, and related risks normally include exposure to losses of the joint venture or the direct exposure of the venturer to loss. An investor who has made a loan to a joint venture does not have similar exposure to the benefits and related risks of the joint venture. For example, an arrangement whereby an investor is not entitled to share in the net income of the joint venture and has recourse to assets of the other venturers would suggest that the risks and rewards of the investor are similar to those associated with a loan. Accordingly, the investor should account for the arrangement as a loan.

**14.07** The contractual arrangement that binds the venturers may take different forms. For example, it may be evidenced by a contract between the venturers or, in some cases, the arrangement may be incorporated in the articles or other bylaws of the joint venture. In other cases, the arrangement may be evidenced by a contract between the venturers and an outside entity. Whatever its form, the contractual arrangement is usually in writing and covers matters such as the activities, duration, policies, and procedures of the joint venture, the allocation of ownership, the decision-making process, the capital contributions by the venturers and the sharing by the venturers of the output, revenue, expenses, or results of the joint venture.

**14.08** The contractual arrangement may designate a venturer as the manager or the operator of the joint venture. The operator does not control the joint venture but acts within the financing and operating policies that have been agreed to by the venturers in accordance with the contractual arrangement and delegated to the operator.

**14.09** Often, the activities of a joint venture are an extension of, or complementary to, those of the venturers. For example, joint ventures are often formed to access new markets, to gain economies of scale, perform a contract, or to access new skills and resources. Joint ventures may take various forms and structures such as partnerships, co-tenancies, corporate or unincorporated enterprises, or undivided interests. Whatever the form, joint ventures may fall into one of the following broad categories, which are commonly described as, and meet the definition of, *joint ventures*: jointly controlled operations, jointly controlled assets, and jointly controlled enterprises.

**14.10** Joint venture agreements can and often designate different allocations among the venturers of (a) the profits and losses, (b) the specified costs and expenses or revenues, (c) the distributions of cash from operations, (d) the distributions of cash proceeds from liquidation, and (e) prices for determination of sales or rentals to the joint venture (such as prices for the use of each venturer's equipment used to perform the venture contractual obligations). Such agreements may also provide for changes in the allocations at specified future dates or on the occurrence of specified future events. For the purpose of determining the amount of income or loss to be recognized by the venturer, the percentage of ownership interest should be based on the percentage by which costs and profits will ultimately be shared by the venturers. An exception to this general rule may be appropriate if changes in the percentages are scheduled or expected to occur so far in the future that they become meaningless for current reporting purposes. In those circumstances, the percentage interest specified in the joint venture agreement should be used with appropriate disclosures.

## **Jointly Controlled Operations**

**14.11** The operations of some joint ventures involve the use of the assets and other resources of the venturers, rather than the establishment of a corporation, partnership, or other enterprise, or a financial structure that is separate from the venturers themselves. Each venturer uses its own property, plant, and equipment for the purposes of the joint venture activities. The assets remain under the ownership and control of each venturer. Each venturer also incurs its own expenses and liabilities and raises its own financing, which represents its own obligations. The joint venture activities may be carried out by the venturer's employees alongside the venturer's similar activities. The contractual arrangement usually provides a means by which the revenue from the sale of goods or performance of services by the joint venture and any expenses incurred in common are shared among the venturers.

## **Jointly Controlled Assets**

**14.12** Some joint ventures involve joint control, and often joint ownership, by the venturers of one or more assets contributed to, or acquired for the purpose of, a joint

venture and dedicated to the purposes of a joint venture. Jointly controlled assets are used to obtain benefits for the venturers. Each venturer may take a share of the output from the assets, and each bears an agreed share of the expenses incurred. Such a joint venture does not involve the establishment of a corporation, partnership, or other enterprise or a financial structure that is separate from the venturers themselves.

## **Jointly Controlled Enterprises**

**14.13** A jointly controlled enterprise is a joint venture that involves the establishment of a corporation, partnership, or other enterprise in which each venturer has an interest. The enterprise operates in the same way as other enterprises, except that a contractual arrangement between the venturers establishes joint control over the economic activity of the enterprise.

**14.14** In a jointly controlled enterprise, each venturer usually contributes cash or other resources to the joint venture. The jointly controlled enterprise owns the assets of the joint venture, incurs liabilities and expenses, and earns revenue. It may enter into contracts in its own name and raise financing for the purposes of the joint venture activity. Each venturer is entitled to a share of the income of the jointly controlled enterprise, although some jointly controlled enterprises also involve a sharing of the output of the joint venture. An example of a jointly controlled enterprise is when two or more enterprises combine their activities in a particular line of business by transferring the relevant assets and liabilities into a jointly controlled enterprise.

## **Recognition**

**14.15** A venturer should make an accounting policy choice to account for its interests in joint ventures using

- a.* the proportionate consolidation method, only applicable to unincorporated entities in certain industries; or
- b.* the consolidation or equity method; or
- c.* the cost method

## **Proportionate Consolidation**

**14.16** Accounting for an interest in a jointly controlled unincorporated entity's operations, assets, or enterprises using the proportionate consolidation method results in the venturer recognizing

- a.* in its balance sheet, the assets that it controls and the liabilities that it incurs; its share of the jointly controlled assets and liabilities incurred jointly with the other venturers in relation to the joint venture; or its share of the assets and liabilities of the jointly controlled joint venture; and
- b.* in its income statement, its share of the revenue of the joint venture and its share of the expenses incurred by the joint venture, or any revenue from the

sale or use of its share of the output of and any expenses incurred by the joint venture, or its share of the revenue and expenses of the joint venture.

**14.17** To the extent that assets are transferred between a venturer and a joint venture, or services are performed by a venturer for the joint venture, the application of proportionate consolidation requires that the venturer's share of interentity transactions and interentity gains and losses be eliminated. The treatment of the portion of gains or losses on the contribution of assets to a joint venture or on transactions between a venturer and a joint venture that relates to the interest of the other venturers is dealt with subsequently.

**14.18** When an investor ceases to have joint control over a jointly controlled enterprise, the investor ceases to proportionately consolidate its interest. Such interests are accounted for as investments or financial instruments (see chapter 19 or chapter 32, as appropriate). Amounts reported on a proportionate consolidation basis for periods prior to the cessation of proportionate consolidation are not retroactively restated on a nonconsolidated basis.

**14.19** An interest in a jointly controlled enterprise that is intended for disposal should continue to be proportionately consolidated in the financial statements of the venturer until such time as the venturer ceases to have joint control over the jointly controlled enterprise.

### **Contributions to a Joint Venture**

**14.20** When a venturer transfers assets to a joint venture in place of, or in addition to, any other contribution in exchange for an interest in the joint ventures, the venturer gives up control over the assets transferred and acquires joint control over these assets. The joint control arrangement binding the venturers is an arm's length arrangement between the venturers that establishes the sharing of control over the joint venture. Accordingly, the contributing venturer is considered to be dealing at arm's length with the other nonrelated venturers. On this basis, a venturer's contribution to a joint venture is an arm's length transaction measured at fair value between the venturer and the other nonrelated venturers. On these grounds, the contributing venturer should recognize that portion of the gain or loss attributable to the interest of the other nonrelated venturers. However, the existence of a loss at the time of the transfer would usually provide evidence of an impairment loss in the portion of the relevant assets retained by the venturer through its interest in the joint venture, and this decline in value is recognized by writing down that portion of the assets retained.

**14.21** When the venturers are not related parties prior to the transfer to a joint venture of nonmonetary assets, other than product or property held for sale in the ordinary course of business to facilitate sales to customers, the change in control of the assets generally constitutes a change in the risk of the cash flows the venturers expect to receive. Accordingly, the transfer has commercial substance and is measured at fair value, provided the fair value is reliably measurable. When the venturers are related parties, the contribution is accounted for as a nonmonetary transaction in accordance with chapter 31, "Related Party Transactions."

## Presentation

**14.22** The following should be presented separately in the balance sheet:

- a. Interests in joint ventures accounted for using the equity or cost method
- b. Assets and liabilities in joint ventures accounted for using the proportionate consolidation method either as
  - i. one lump sum as a net asset or liability investment,
  - ii. a total of its share of each asset and liability type in separate categories, such as current assets arising from joint venture activities or current liabilities arising joint venture activities, or
  - iii. its share of each asset or liability, such as share of accounts receivable from joint venture activities

**14.23** Income from participation in a joint venture in the following should be presented separately in the income statement:

- a. Interests in joint ventures accounted for using the equity method
- b. Interests in joint ventures accounted for at cost
- c. Liabilities in joint ventures accounted for using the proportionate consolidation method either as
  - i. one lump sum as a net income or loss from participation in the joint venture or
  - ii. a total of its share of the joint venture's revenue, gross profit, and other expenses categories.

**14.24** A significant factor in evaluating the investment income is the relationship of the income reported to the investments from which such income is derived. For this reason, investments reported in the balance sheet and investment income reported in the income statement are grouped in the same way.

## Disclosure

**14.25** The basis used to account for an entity's interests in joint ventures should be disclosed and the reasons why the method chosen is appropriate.

**14.26** For joint ventures accounted for under the cost or equity method, an entity should disclose the carrying amount of impaired interests in joint ventures and the amount of any related allowance for impairment.

**14.27** A venturer should provide a listing and description of interests in significant joint ventures, including the names, carrying values, and proportion of ownership interests held in each joint venture.

**14.28** A venturer should disclose its share of any contingencies and commitments of joint ventures and those contingencies that exist when the venturer is contingently liable

for the liabilities of the other venturers of the joint ventures.

**14.29** If investments in common stock of corporate joint ventures are, in the aggregate, material in relation to the balance sheet or statement of income of an investor, it may be necessary for summarized information about assets, liabilities, and results of operations of the investees to be presented in the notes or in separate statements, either individually or in groups, as appropriate.

**14.30** Separate disclosure of the venturer's share of any contingencies and commitments of joint ventures should include, as appropriate, the venturer's share of any contingencies and commitments of joint ventures and the venturer's responsibility for the other venturers' share of the contingencies of joint ventures. If a venturer guarantees more than its proportionate share of a joint venture's liabilities, such a guarantee should be disclosed.

**14.31** When the fiscal periods of a venturer and a joint venture are not the same and the proportional consolidation or equity method is used, events relating to, or transactions of, the joint venture that have occurred during the intervening period and significantly affect the financial position or results of operations of the entity should be disclosed. This disclosure is not necessary if these events or transactions are recorded in the financial statements.

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## Chapter 15—*New Basis (Push-Down) Accounting*

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### Purpose and Scope

**15.01** This chapter establishes recognition, measurement, and disclosure principles dealing with the comprehensive revaluation of assets and liabilities by entities in order to establish a new cost basis.

### Definitions

**15.02** The following terms are used in this chapter with the meanings specified:

*Control.* Control of an entity is indicated by the ownership of more than 50 percent of the outstanding equity interests.

*Push-down accounting.* A technique that attributes revised values to the assets and liabilities reported in the entity's financial statements based on a purchase transaction or transactions of its equity interests. Application of the technique results in the acquirer's cost being assigned to the assets and liabilities of the acquired entity.

### Recognition

**15.03** Assets and liabilities may be comprehensively revalued by means of push-down accounting. The following condition is required to be satisfied for an entity's assets and liabilities to be comprehensively revalued: All, or virtually all, the equity interests in the entity have been acquired, in one or more transactions between nonrelated parties, by an acquirer who controls the entity after the transaction or transactions. The acquirer may be a corporation, an individual, or other type of entity permitted by law.

An acquisition of all, or virtually all, the equity interests in an entity in one or more transactions between nonrelated parties by an acquirer who controls the entity after the transaction or transactions (acquisition of an entity) establishes a new cost basis for a continuing entity.

**15.04** In the case of an acquisition of an entity, the application of push-down accounting results in comparable accounting to what would have resulted had the acquirer either purchased the assets and assumed the liabilities of the entity directly or established a new legal entity to hold the assets and assume the liabilities of the acquired entity and to continue its operations.

**15.05** Acquisition of all, or virtually all, the equity interests of an entity in one or more transactions is necessary in order to establish a sufficiently comprehensive basis for revaluing the entity's assets and liabilities. An acquirer that holds at least 80 percent of the equity interests after the acquisition is presumed to have acquired virtually all the entity's equity interests.

**15.06** A comprehensive revaluation is only appropriate when the acquirer, representing

an individual or group's collective interest, controls the entity. An assessment of whether an acquirer controls an entity is made in accordance with chapter 12, "Subsidiaries."

**15.07** When one or more transactions take place between nonrelated parties, it is presumed that the transaction or transactions have been bargained in an arm's length manner between knowledgeable, willing parties who are under no compulsion to act and, therefore, that values determined in that process represent fair value. However, transactions between related parties are not an appropriate basis for a comprehensive revaluation. (For purposes of this chapter, *related parties* are as defined in chapter 31, "Related Party Transactions.") When an individual or entity already owns an equity interest in an entity, the revaluation or fair value is proportionate to that owner's increase in ownership. For example, if a 10-percent owner acquires the equity interest of a 90-percent owner, the revaluation is stepped up for the 90 percent that represents the new ownership.

**15.08** When new costs are not reasonably determinable for individual assets and liabilities, comprehensive revaluation is not appropriate. An example of when new costs are not reasonably determinable is in an acquisition when an entity is acquired as part of a basket purchase (that is, when a group of assets and liabilities is acquired for a single amount), and the entity does not have, and cannot obtain from the acquirer, details of the purchase price and its allocation among assets and liabilities.

**15.09** Comprehensive revaluation of assets and liabilities through the application of push-down accounting is not required when the condition in paragraph 15.03 is met as a result of the acquisition of an entity. Application of push-down accounting is based on the presumption that the acquirer would find the new costs more useful in evaluating investment returns and entity performance. In situations when the acquirer prefers to retain old cost basis financial statements (either for its own purposes or the purposes of other financial statement users, such as holders of outstanding public debt), push-down accounting is not required.

## **Acquisition of an Entity—Push-Down Accounting**

### **Measurement**

**15.10** When a comprehensive revaluation of an entity's assets and liabilities is undertaken as a result of a transaction or transactions as described in paragraph 15.03, push-down accounting should be applied.

**15.11** The application of push-down accounting provides symmetry between the carrying amounts of assets and liabilities reported in the acquired entity's financial statements and the carrying amounts of assets and liabilities reported in the consolidated financial statements of the parent.

**15.12** When applying push-down accounting, the values used are those resulting from accounting for the purchase transaction or transactions in accordance with chapter 11, "Business Combinations."

**15.13** When an acquisition is financed by debt, in whole or in part, it is not considered appropriate for the acquired entity to record the debt, unless it is a liability of the acquired entity.

### **Retained Earnings and the Revaluation Adjustment**

**15.14** When a comprehensive revaluation of an entity's assets and liabilities is undertaken as a result of a transaction or transactions as described in paragraph 15.03, the portion of retained earnings that has not been included in the consolidated retained earnings of the acquirer or is not related to any continuing, noncontrolling interests in the entity should be reclassified to either capital stock, additional paid-in capital, or a separately identified account within shareholders' equity.

**15.15** The revaluation adjustment arising from a comprehensive revaluation of an entity's assets and liabilities undertaken as a result of a transaction or transactions as described in paragraph 15.03 should be accounted for as a capital transaction (see chapter 23, "Equity") and recorded as either capital stock, additional paid-in capital, or a separately identified account within shareholders' equity.

**15.16** Consistent with attributing the acquirer's cost in a purchase transaction or transactions to the assets and liabilities of the acquired entity, shareholders' equity is also restated to reflect the purchase transaction or transactions.

**15.17** The treatment accorded to retained earnings is also applied to other shareholders' equity accounts that arose prior to the purchase transaction or transactions and that are not specifically related to capital invested, such as exchange gains and losses arising from the translation of the financial statements of a self-sustaining foreign operation.

**15.18** The purpose of the revaluation of assets and liabilities is to provide information for assessing returns that reflect the investment of the controlling shareholder in the entity. It is consistent with this purpose that the revaluation adjustment (the net effect of the revaluation of the entity's assets and liabilities) is accounted for as capital of the acquired entity. The revaluation adjustment is included in either capital stock, additional paid-in capital, or a separately identified account within shareholders' equity.

### **Income Tax Benefits**

**15.19** When the deferred income taxes method is used, any deferred income taxes that arose prior to the date of the comprehensive revaluation that are derecognized through the revaluation process should be expensed through income in the reporting period when the revaluation takes place.

**15.20** Under the deferred income taxes method, deferred income tax assets are appropriately recognized as part of a comprehensive revaluation to the extent that they are more likely than not to be realized (see chapter 29, "Income Taxes"). Deferred income tax assets that are not considered to be more likely than not to be realized at the time of the comprehensive revaluation should be excluded from the revaluation. If such an unrecognized deferred income tax asset were recognized subsequent to the application

of push-down accounting, the benefit should be recognized in net income (or, if chapter 29 so requires, outside net income).

## **Disclosure**

**15.21** In the period that push-down accounting has been first applied, the financial statements should disclose the following:

- a.* The date push-down accounting was applied and the date or dates of the purchase transaction or transactions that led to the application of push-down accounting
- b.* A description of the situation resulting in the application of push-down accounting
- c.* The amount of the change in each major class of assets, liabilities, and shareholders' equity arising from the application of push-down accounting

**15.22** In the fiscal period that push-down accounting has been applied and the following fiscal period, the financial statements should disclose

- a.* the date push-down accounting was applied;
- b.* the amount of the revaluation adjustment and the shareholders' equity account in which the revaluation adjustment was recorded; and
- c.* the amount of retained earnings reclassified and the shareholders' equity account to which it was reclassified.

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## Chapter 16—*Foreign Currency Translation*

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### Purpose and Scope

**16.01** This chapter establishes principles for the translation of transactions of a reporting entity that are denominated in a foreign currency (foreign currency transactions).

**16.02** This chapter assumes that the reporting entity prepares its financial statements in U.S. dollars. If another currency (such as the Canadian dollar) is used for reporting purposes, all references to U.S. dollars in this chapter should be changed to that currency, and the U.S. dollar should be treated as a foreign currency.

**16.03** For foreign currency transactions, the objective of translation is to express such transactions in a manner that achieves consistency with the accounting treatment for domestic transactions. Because domestic transactions are automatically measured in U.S. dollars, the U.S. dollar is the appropriate unit of measure for foreign currency transactions. Accordingly, the temporal method is used to translate foreign currency transactions.

### Definitions

**16.04** The following terms are used in this chapter with the meanings specified:

*Foreign currency transactions.* Transactions of the reporting entity whose terms are denominated in a currency other than its reporting currency.

*Monetary items.* Money, and claims to money, the value of which (in terms of the monetary unit, whether foreign or domestic) is fixed by contract or otherwise. Deferred income tax liabilities and assets are classified as monetary items.

*Reporting entity.* An entity whose financial statements include transactions entered into by the entity in a foreign currency.

*Temporal method.* A method of translation that translates assets, liabilities, revenues, and expenses in a manner that retains their bases of measurement in terms of the U.S. dollar (that is, it uses the U.S. dollar as the unit of measure). In particular

- monetary items are translated at the exchange rate in effect at the balance sheet date;
- nonmonetary items are translated at historical exchange rates, unless such items are carried at market, in which case they are translated at the exchange rate in effect at the balance sheet date;
- revenue and expense items are translated at the exchange rate in effect on the dates they occur; and

- depreciation or amortization of assets translated at historical exchange rates is translated at the same exchange rates as the assets to which it relates.

## **Translation of Foreign Currency Transactions and Related Financial Statement Items of the Reporting Entity**

**16.05** When the reporting entity purchases or sells goods or services on credit, with settlement to be in a foreign currency, it gives rise to a payable or receivable in that foreign currency. Any subsequent change in exchange rate between the U.S. dollar and the foreign currency will affect the U.S. dollar equivalent of that payable or receivable.

**16.06** Once foreign currency purchases and sales or inventories, fixed assets, and other nonmonetary items obtained through foreign currency transactions have been translated and recorded, any subsequent changes in the exchange rate will not affect those recorded amounts.

**16.07** At the transaction date, each asset, liability, revenue, or expense arising from a foreign currency transaction of the reporting entity should be translated into U.S. dollars by the use of the exchange rate in effect at that date.

**16.08** If a transaction denominated in a foreign currency is not settled by the balance sheet date and the exchange rate has changed, the receivable or payable should be remeasured at the equivalent amount of U.S. dollars that would be collected or paid at the balance sheet date.

**16.09** At each balance sheet date, monetary items denominated in a foreign currency should be adjusted to reflect the exchange rate in effect at the balance sheet date.

**16.10** In certain situations, a nonmonetary asset acquired through a foreign currency transaction may be carried in the financial statements at market, rather than at cost, as established at the transaction date (for example, inventories written down to market). If the market price is stated in terms of the foreign currency, it would be illogical to apply the exchange rate in effect at the transaction date (that is, a historical exchange rate) to the foreign currency market price (that is, a current price) in order to obtain the U.S. dollar equivalent market price.

**16.11** At each balance sheet date, for nonmonetary assets of the reporting entity that are carried at market, the U.S. dollar equivalent should be determined by applying the exchange rate in effect at the balance sheet date to the foreign currency market price.

**16.12** An exchange gain or loss arises when a foreign currency-denominated monetary item is settled or translated at an exchange rate different from the one at which it was previously recorded or carried.

**16.13** An exchange gain or loss of the reporting entity that arises on translation or settlement of a foreign currency-denominated monetary item or a nonmonetary item carried at market should be included in the determination of net income for the current period.

## **Disclosure**

**16.14** The amount of an exchange gain or loss included in net income should be disclosed. An entity may exclude from this amount those exchange gains or losses arising on investments in equity securities that are measured at fair value in accordance with chapter 32, "Financial Instruments and Long-Term Debt."

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## Chapter 17—*Nonmonetary Transactions*

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### Purpose and Scope

**17.01** This chapter establishes principles for the recognition, measurement, and disclosure of nonmonetary transactions. It defines when an exchange of assets is measured at fair value and when an exchange of assets is measured at the carrying amount.

**17.02** This chapter applies to nonmonetary transactions except

- a. business combinations that are accounted for in accordance with chapter 11, “Business Combinations;”
- b. transactions involving retirement and other postemployment benefits that are accounted for in accordance with chapter 28, “Retirement and Other Postemployment Benefits;”
- c. transactions between related parties that are accounted for in accordance with chapter 31, “Related Party Transactions,” unless paragraphs 17.12–.13 apply; and
- d. the replacement, through insurance or expropriation proceeds, of nonmonetary assets that are lost, destroyed, or expropriated. These items are monetary transactions.

**17.03** A group of monetary transactions that represents a nonmonetary transaction in substance (that is, the exchange of nonmonetary assets or services accomplished through the exchange of monetary consideration), is accounted for in accordance with this chapter.

### Definitions

**17.04** The following terms are used in this chapter with the meanings specified:

*Fair value.* The amount of the consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act.

*Carrying amount.* The recorded amount of an asset or liability after adjustment, if any, for amortization or depreciation or impairment in value.

*Entity-specific value.* The present value of the cash flows an entity expects to arise from the continuing use of an asset and from its disposal at the end of its useful life or expects to incur when settling a liability.

*Monetary assets and liabilities.* Money, assets to be received, or claims to future cash flows that are fixed or determinable in amounts and timing by contract or other arrangement. Examples are cash and accounts and notes receivable and payable in cash.

*Nonmonetary assets and liabilities.* Assets and liabilities that are not monetary.

Examples are inventories; investments in common stock; property, plant, and equipment; and liabilities for rent collected in advance. A contractual right to receive services in the future is a nonmonetary asset, and a contractual obligation to perform services in the future is a nonmonetary liability.

*Nonmonetary transactions* are either

- *nonmonetary exchanges*, which are exchanges of nonmonetary assets, liabilities, or services for other nonmonetary assets, liabilities, or services with little or no monetary consideration involved or
- *nonmonetary nonreciprocal transfers*, which are transfers of nonmonetary assets, liabilities, or services without consideration. Nonreciprocal transfers include, but are not limited to
  - donations of nonmonetary assets or services;
  - payments of dividends-in-kind;
  - stock dividends when the shareholder has the option of receiving cash or shares; and
  - the distribution of assets to owners in the liquidation of all or part of an entity.

The issue of shares in a stock split and the payment of nonoptional stock dividends are not nonreciprocal transfers.

## **Measurement**

**17.05** An entity should measure an asset exchanged or transferred in a nonmonetary transaction at the more reliably measurable of the fair value of the asset given up and the fair value of the asset received, unless

- a. the transaction lacks commercial substance;
- b. the transaction is an exchange of a product or property held for sale in the ordinary course of business for a product or property to be sold in the same line of business to facilitate sales to customers other than the parties to the exchange;
- c. neither the fair value of the asset received nor the fair value of the asset given up is reliably measurable; or
- d. the transaction is a nonmonetary nonreciprocal transfer to owners to which paragraph 17.12 applies.

**17.06** An entity should measure an asset exchanged or transferred in a nonmonetary transaction that is not measured at fair value in accordance with paragraph 17.05 at the carrying amount of the asset given up (after reduction, when appropriate, for impairment) adjusted by the fair value of any monetary consideration received or given.

**17.07** When an exchange described in paragraph 17.06 involves partial monetary

consideration, the carrying amount of the asset given up is adjusted by the fair value of the monetary consideration. The entity paying the monetary consideration measures the nonmonetary asset received at the carrying amount of the asset given up plus the fair value of the monetary consideration paid. The entity receiving the monetary consideration measures the nonmonetary asset received at the carrying amount of the nonmonetary asset given up less the fair value of the monetary consideration received, unless the monetary consideration exceeds the carrying amount, in which case, a gain is recognized for the amount of such excess.

## **Measurement Criteria**

**17.08** When an entity is able to reliably determine the fair value of both the asset received and the asset given up, the fair value of the asset given up is used to measure the asset received unless the fair value of the asset received is more reliably measurable. If fair value is not reliably measurable, then the transaction is based on the carrying amounts.

## **Commercial Substance**

**17.09** A nonmonetary transaction has commercial substance when the entity's future cash flows are expected to change significantly as a result of the transaction. The entity's future cash flows are expected to change significantly when

- a.* the configuration of the future cash flows of the asset received differs significantly from the configuration of the cash flows of the asset given up (see paragraph 17.10) or
- b.* the entity-specific value of the asset received differs from the entity-specific value of the asset given up, and the difference is significant relative to the fair value of the assets exchanged.

In some cases, a qualitative assessment will be conclusive in determining that the estimated cash flows of the entity are expected to change significantly as a result of the transaction.

**17.10** The configuration of future cash flows is composed of the risk, timing, and amount of the cash flows. A change in any one of these considerations is a change in the configuration.

**17.11** Entity-specific value, resulting from entity-specific measurement, differs from fair value. It attempts to capture the value of an item in the context of the reporting entity. The entity uses its expectations about its use of the asset rather than the use assumed by marketplace participants. When a transaction has commercial substance, it is measured at fair value rather than entity-specific value.

## **Restructuring or Liquidation**

**17.12** An entity should measure a nonmonetary nonreciprocal transfer to owners that represents a spin-off or other form of restructuring or liquidation at the carrying amount

of the nonmonetary assets or liabilities transferred.

**17.13** A nonmonetary nonreciprocal transfer to owners (other than controlling shareholders) resulting from a spin-off or other form of restructuring or liquidation is measured at the carrying amount of the net assets transferred. Examples of this type of nonreciprocal transfer are the distribution of an operating division of an entity to the entity's owners and the distribution to the owners of an entity of shares of a subsidiary or investee that has been, or is being, consolidated or accounted for by the equity method.

## **Recognition of Gains and Losses**

**17.14** An entity should recognize any gain or loss resulting from a nonmonetary transaction in net income for the period.

**17.15** Transfers described in paragraph 17.13 do not give rise to a gain or loss in the financial statements of the transferor (other than an impairment loss recognized at the time of disposal if the carrying amount exceeds fair value, in accordance with chapter 30, "Disposal of Long-Lived Assets and Discontinued Operations").

## **Disclosure**

**17.16** An entity should disclose the following information in the period in which a nonmonetary transaction occurs to enable users of the financial statements to understand the effects of a nonmonetary transaction on the financial statements:

- a.* The nature of the transaction
- b.* Its basis of measurement
- c.* The amount
- d.* Related gains and losses

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## Chapter 18—*Inventories*

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### Purpose and Scope

**18.01** This chapter prescribes the accounting treatment for inventories. A primary issue in accounting for inventories is the amount of cost to be recognized as an asset and carried forward until the related revenues are recognized. This chapter provides guidance on the determination of cost and its subsequent recognition as an expense, including any write-down to net realizable value. It also provides guidance on the cost formulas that are used to assign costs to inventories.

**18.02** This chapter applies to all inventories, except

- a. contracts accounted for using the percentage of completion method (see chapter 27, “Revenue”) and
- b. financial instruments.

**18.03** This chapter does not apply to the measurement of inventories

- a. held by producers of agricultural and forest products, agricultural produce after harvest, and minerals and mineral products, to the extent that they are measured at net realizable value in accordance with well-established practices in those industries. When such inventories are measured at net realizable value, changes in that value are recognized in net income in the period of the change.
- b. held by commodity broker-traders, who measure their inventories at fair value less costs to sell. When such inventories are measured at fair value less costs to sell, changes in fair value less costs to sell are recognized in net income in the period of the change.
- c. of living animals and plants (biological assets) and the harvested product of the entity's biological assets (agricultural produce). This chapter does apply to products that are the result of processing after harvest, such as processed foods, thread, and lumber.

**18.04** The inventories referred to in paragraph 18.03(a) are measured at net realizable value at certain stages of production. For example, this occurs when agricultural crops have been harvested or minerals have been extracted, and sale is assured under a forward contract or a government guarantee, or when an active market exists, and there is a negligible risk of failure to sell. These inventories are excluded from only the measurement requirements of this chapter.

**18.05** Broker-traders are those who buy or sell commodities for others or on their own account. The inventories referred to in paragraph 18.03(b) are principally acquired with the purpose of selling in the near future and generating a profit from fluctuations in price or broker-traders' margin. When these inventories are measured at fair value less costs to sell, they are excluded from only the measurement requirements of this chapter.

## Definitions

**18.06** The following terms are used in this chapter with the meanings specified:

*Inventories.* Inventories are assets

- held for sale in the ordinary course of business;
- in the process of production for such sale; or
- in the form of materials or supplies to be consumed in the production process or in the rendering of services.

*Net realizable value.* The estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

**18.07** Inventories encompass goods purchased and held for resale (for example, merchandise purchased by a retailer and held for resale or land and other property held for resale). Inventories also encompass finished goods produced or work in progress being produced by the entity and include materials and supplies awaiting use in the production process.

## Measurement of Inventories

**18.08** Inventories should be measured at the lower of cost or market, with *market* defined as net realizable value.

## Cost of Inventories

**18.09** The cost of inventories should comprise all costs of purchase, costs of conversion, and other costs incurred in bringing the inventories to their present location and condition.

### *Costs of Purchase*

**18.10** The costs of purchase of inventories comprise the purchase price, import duties, and other taxes (other than those subsequently recoverable by the entity from the taxing authorities) and transport, handling, and other costs directly attributable to the acquisition of finished goods, materials, and services. Trade discounts, rebates, and other similar items are deducted in determining the costs of purchase.

### *Costs of Conversion*

**18.11** The costs of conversion of inventories include costs directly related to the units of production, such as direct labor. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings and equipment and the cost of factory management and administration. Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials

and indirect labor.

**18.12** The allocation of fixed production overheads to the costs of conversion is based on the normal capacity of the production facilities. Normal capacity is the production expected to be achieved on average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates normal capacity. The amount of fixed overhead allocated to each unit of production is not increased as a consequence of low production or idle plant. Unallocated overheads are recognized as an expense in the period in which they are incurred. In periods of abnormally high production, the amount of fixed overhead allocated to each unit of production is decreased so that inventories are not measured above cost. Variable production overheads are allocated to each unit of production on the basis of the actual use of the production facilities.

**18.13** A production process may result in more than one product being produced simultaneously. For example, this is the case when joint products are produced or when there is a main product and a by-product. When the costs of conversion of each product are not separately identifiable, they are allocated between the products on a rational and consistent basis. For example, the allocation may be based on the relative sales value of each product either at the stage in the production process when the products become separately identifiable or at the completion of production. Most by-products are immaterial. When this is the case, they are often measured at net realizable value, and this value is deducted from the cost of the main product. As a result, the carrying amount of the main product is not materially different from its cost.

### ***Other Costs***

**18.14** Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include nonproduction overheads or the costs of designing products for specific customers in the cost of inventories.

**18.15** Examples of costs excluded from the cost of inventories and recognized as expenses in the period in which they are incurred are

- a.* abnormal amounts of wasted materials, labor, or other production costs;
- b.* storage costs, unless those costs are necessary in the production process before a further production stage;
- c.* administrative overheads that do not contribute to bringing inventories to their present location and condition; and
- d.* selling costs.

**18.16** The cost of inventories that require a substantial period of time to get them ready for their intended use or sale includes interest costs, when the entity's accounting policy is to capitalize interest costs. The cost of inventories that are ready for their intended use or sale when acquired does not include interest costs.

**18.17** An entity may purchase inventories on deferred settlement terms. When the arrangement effectively contains a financing element, that element, for example, a difference between the purchase price for normal credit terms and the amount paid, is recognized as interest expense over the period of the financing.

### ***Techniques for the Measurement of Cost***

**18.18** Techniques for the measurement of the cost of inventories, such as the standard cost method or the retail method, may be used for convenience if the results approximate cost. Standard costs take into account normal levels of materials and supplies, labor, efficiency, and capacity utilization. They are regularly reviewed and, if necessary, revised in the light of current conditions.

**18.19** The retail method is often used in the retail industry for measuring inventories of large numbers of rapidly changing items with similar margins for which it is impracticable to use other costing methods. The cost of the inventory is determined by reducing the sales value of the inventory by the appropriate percentage gross margin. The percentage used takes into consideration inventory that has been marked down to below its original selling price. An average percentage for each retail department is often used.

### **Cost Formulas**

**18.20** The cost of inventories of items that are not ordinarily interchangeable, and goods or services produced and segregated for specific projects, should be assigned by using specific identification of their individual costs.

**18.21** *Specific identification of cost* means that specific costs are attributed to identified items of inventory. This is the appropriate treatment for items that are segregated for a specific project, regardless of whether they have been bought or produced. However, specific identification of costs is inappropriate when there are large numbers of items of inventory that are ordinarily interchangeable. In such circumstances, the method of selecting those items that remain in inventories could be used to obtain predetermined effects on net income.

**18.22** The cost of inventories, other than those dealt with in paragraph 18.20, should be assigned by using the first-in, first-out (FIFO), last-in, first-out (LIFO), or weighted average cost formula.

**18.23** Inventories used in one business segment may have a use to the entity different from the same type of inventories used in another business segment. However, a difference in geographical location of inventories (or in the respective tax rules), by itself, is not sufficient to justify the use of different cost formulas.

**18.24** The FIFO formula assumes that the items of inventory that were purchased or produced first are sold first and, consequently, the items remaining in inventory at the end of the period are those most recently purchased or produced. The LIFO formula assumes that the items of inventory that were most recently purchased or produced are sold first and, consequently, the items remaining in inventory at the end of the period are those purchased or produced first. Under the weighted average cost formula, the cost of each

item is determined from the weighted average of the cost of similar items at the beginning of a period and the cost of similar items purchased or produced during the period. The average may be calculated on a periodic basis or as each additional shipment is received, depending upon the circumstances of the entity.

### **Net Realizable Value**

**18.25** The cost of inventories may not be recoverable if those inventories are damaged, if they have become wholly or partially obsolete, or if their selling prices have declined. The cost of inventories may also not be recoverable if the estimated costs of completion or the estimated costs to be incurred to make the sale have increased. The practice of writing inventories down below cost to net realizable value is consistent with the view that assets are not carried in excess of amounts expected to be realized from their sale or use.

**18.26** Inventories are usually written down to net realizable value item by item. However, in some circumstances, it may be appropriate to group similar or related items. This may be the case with items of inventory relating to the same product line that have similar purposes or end uses, are produced and marketed in the same geographical area, and cannot be practicably evaluated separately from other items in that product line. It is not appropriate to write inventories down on the basis of a classification of inventory (for example, finished goods or all the inventories in a particular industry or geographical segment).

**18.27** Estimates of net realizable value are based on the most reliable evidence available, at the time the estimates are made, of the amount the inventories are expected to realize. These estimates take into consideration fluctuations of price or cost directly relating to events occurring after the end of the period, to the extent that such events confirm conditions existing at the end of the period.

**18.28** Estimates of net realizable value also take into consideration the purpose for which the inventory is held. For example, the net realizable value of the quantity of inventory held to satisfy firm sales contracts is based on the contract price. If the sales contracts are for less than the inventory quantities held, the net realizable value of the excess is based on general selling prices. Provisions may arise from firm sales contracts in excess of inventory quantities held or from firm purchase contracts.

**18.29** Materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when a decline in the price of materials indicates that the cost of the finished products exceeds net realizable value, the materials are written down to net realizable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realizable value.

**18.30** A new assessment is made of net realizable value in each subsequent period. When the circumstances that previously caused inventories to be written down below cost no longer exist or when there is clear evidence of an increase in net realizable value because of changed economic circumstances, the amount of the write-down is reversed

(that is, the reversal is limited to the amount of the original write-down) so that the new carrying amount is the lower of the cost and the revised net realizable value. For example, this occurs when an item of inventory that is carried at net realizable value, because its selling price has declined, is still on hand in a subsequent period, and its selling price has increased.

## **Recognition as an Expense**

**18.31** When inventories are sold, the carrying amount of those inventories should be recognized as an expense in the period in which the related revenue is recognized. The amount of any write-down of inventories to net realizable value and all losses of inventories should be recognized as an expense in the period the write-down or loss occurs. The amount of any reversal of any write-down of inventories arising from an increase in net realizable value should be recognized as a reduction in the amount of cost of goods sold in the period in which the reversal occurs.

**18.32** Some inventories may be allocated to other asset accounts (for example, inventory used as a component of self-constructed property, plant, or equipment). Inventories allocated to another asset in this way are recognized as an expense during the useful life of that asset.

## **Disclosure**

**18.33** The financial statements should disclose

- a.* the accounting policies adopted in measuring inventories, including the cost formula used;
- b.* the total carrying amount of inventories and the carrying amount in classifications appropriate to the entity; and
- c.* the amount of cost of goods sold during the period .

**18.34** Information about the carrying amounts held in different classifications of inventories, and the extent of the changes in these assets, is useful to financial statement users. Common classifications of inventories are merchandise, production supplies, materials, works in progress, and finished goods.

**18.35** An entity may present in the statement of income the components of cost of goods sold, which would include items such as the cost of raw materials and consumables, labor costs, and other costs, together with the net change in inventories for the period.

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## Chapter 19—*Investments*

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### Purpose and Scope

**19.01** This chapter establishes principles for accounting for and for measuring and disclosing equity investments and certain other nonfinancial instrument investments (such as works of art and other tangible assets held for investment purposes).

**19.02** This chapter applies to investments, except

- a. subsidiaries of entities that are consolidated (see chapter 12, “Subsidiaries”) and
- b. financial instruments within the scope of chapter 32, “Financial Instruments and Long-Term Debt.”

### Definitions

**19.03** The following terms are used in this chapter with the meanings specified:

*Cost method.* A basis of accounting for investments whereby the investment is initially recorded at cost; earnings from such investments are recognized only to the extent received or receivable.

*Dividends.* Distributions paid or payable in cash or other assets and do not include distributions of shares unless the effect is to change the equity interests of two or more classes of shares.

*Equity method.* A basis of accounting for investments whereby the investment is initially recorded at cost and the carrying value, adjusted thereafter to include the investor's pro rata share of postacquisition earnings of the investee, computed by the consolidation method. The amount of the adjustment is included in the determination of net income by the investor, and the investment account of the investor is also increased or decreased to reflect the investor's share of capital transactions and changes in accounting policies and corrections of errors relating to prior period financial statements applicable to postacquisition periods. Profit distributions received or receivable from an investee reduce the carrying value of the investment.

### Accounting for Investments

**19.04** An investor may be able to exercise significant influence over the strategic operating, investing, and financing policies of an investee even when the investor does not control, or jointly control, the investee. For example, the ability to exercise significant influence may be indicated by representation on the board of directors, participation in policy-making processes, material intercompany transactions, interchange of managerial personnel, or provision of technical information. If the investor holds 20 percent or more of the voting interest in the investee, there is a rebuttable presumption that the investor has the ability to exercise significant influence. If the investor holds less than 20 percent

of the voting interest in the investee, it is presumed that the investor does not have the ability to exercise significant influence, unless such influence is clearly demonstrated.

**19.05** An investor that is able to exercise significant influence over an investee that is not a subsidiary as defined in chapter 12 should account for the investment using the equity method. An investor that is not able to exercise significant influence over an investee should account for the investment using the cost method. An investor should account for all investments within the scope of this chapter using the same method. In making this accounting policy choice, an investor need not meet the criterion in paragraph 5.06(b).

**19.06** When an investor ceases to be able to exercise significant influence over an investee, the investment should be accounted for in accordance with the cost method, unless the investor has obtained control, in which case the investor applies chapter 12.

### **Equity Method**

**19.07** Investment income, as calculated by the equity method, should be the investor's share of the income or losses of the investee.

**19.08** In accounting for an investment by the equity method, the investor's proportionate share of the investee's discontinued operations, changes in accounting policy, corrections of errors relating to prior period financial statements, and capital transactions should be presented in the investor's financial statements according to their nature.

**19.09** In those situations in which the investor has the ability to exercise significant influence, shareholders would be informed of the results of operations of the investee, and it is appropriate to include in the results of operations of the investor its share of the income or losses of the investee. The equity method of accounting for the investment provides this information.

**19.10** Depreciation and amortization of investee assets are based on the assigned costs of such assets at the date(s) of acquisition. The portion of the difference between the investor's cost and the amount of its underlying equity in the net assets of the investee that is similar to goodwill (equity method goodwill) is amortized. Unrealized intercompany gain or loss, and any gain or loss that would arise in accounting for intercompany bond holdings, are eliminated.

**19.11** The investment account of the investor reflects

- a. the cost of the investment in the investee;
- b. the investment income or loss (including the investor's proportionate share of discontinued operations) relating to the investee subsequent to the date when the use of the equity method first became appropriate;
- c. the investor's proportionate share of a change in an accounting policy, a correction of an error relating to prior period financial statements, and capital transactions of the investee subsequent to the date when the use of the equity method first became appropriate; and

- d. the investor's proportion of dividends paid by the investee subsequent to the date when the use of the equity method first became appropriate.

**19.12** Presentation of the individual steps involved in the calculation of investment income on the equity method includes a duplication of much of chapter 13, "Consolidated Financial Statements and Noncontrolling Interests," which deals with consolidations. However, the investor's proportionate share of any discontinued operations, changes in accounting policy, corrections of errors relating to prior period financial statements, or capital transactions of the investee is presented and disclosed separately, according to its nature, in the investor's financial statements.

**19.13** The elimination of an unrealized intercompany gain or loss has the same effect on net income whether the consolidation or equity method is used. However, in consolidated financial statements, the elimination of a gain or loss may affect sales and cost of sales otherwise to be reported. In the application of the equity method, the gain or loss is eliminated by adjustment of investment income from the investee or by separate provision in the investor's financial statements, as is appropriate in the circumstances.

**19.14** When an investor ceases to be able to exercise significant influence, cost is deemed to be the carrying value of the investment at that time. Consideration is given to whether the carrying value requires adjustment to reflect an impairment in value (see paragraphs 19.18–.21).

**19.15** An investor's share of losses in excess of the carrying amount of the investment should be recorded if

- a. the investor has guaranteed the obligations of the investee;
- b. the investor is otherwise committed to provide further financial support to the investee; or
- c. the investee seems assured of imminently returning to profitability.

### **Cost Method**

**19.16** The cost method should be used in accounting for investments within the scope of this chapter other than those for which the investor is able to exercise significant influence over an investee.

**19.17** These types of investments include certain other nonfinancial instrument investments, such as works of art and other tangible assets held for investment purposes.

### **Impairment of an Investment**

**19.18** At the end of each reporting period, management should assess whether there are any indications that an investment may be impaired. When there is an indication of impairment, management should determine whether a significant adverse change has occurred during the period in the expected timing or amount of future cash flows from the investment.

**19.19** Indicators of impairment include

- a. significant financial difficulty of the investee;
- b. the probability that the investee will enter bankruptcy or other financial reorganization; and
- c. a significant, adverse change in the technological, market, economic, or legal environment in which the investee operates or in the market to which an asset is dedicated (for example, a sharp decline in the price of a commodity that may cause economic instability in the investee's industry).

**19.20** When management identifies a significant adverse change in the expected timing or amount of future cash flows from an investment, it should reduce the carrying amount of the investment to the higher of the following:

- a. The present value of the cash flows expected to be generated by holding the investment, discounted using a current market rate of interest appropriate to the asset
- b. The amount that could be realized by selling the asset at the balance sheet date

The carrying amount of the investment should be reduced directly. The amount of the reduction should be recognized as an impairment loss in net income.

**19.21** When the extent of impairment of a previously written down investment decreases and the decrease can be related to an event occurring after the impairment was recognized (such as a return to profitability of the investee), the previously recognized impairment loss should be reversed to the extent of the improvement. The adjusted carrying amount of the investment should be no greater than the amount that would have been reported at the date of the reversal had the impairment not been recognized previously. The amount of the reversal should be recognized in net income in the period the reversal occurs.

## **Gains and Losses on Sales of Investments**

**19.22** For the purposes of calculating a gain or loss on the sale of an investment, the cost of the investment sold should be calculated on the basis of the average carrying value.

**19.23** Under the average carrying value method, the gain or loss is properly recognized as being part of the ultimate gain or loss on the entire holding of each investment and is more likely to be representative of the ultimate entire gain or loss.

## **Presentation**

**19.24** The following should be presented separately on the balance sheet:

- a. Subsidiaries accounted for using the equity method
- b. Subsidiaries accounted for at cost
- c. Investments in companies subject to significant influence accounted for using the equity method

*d.* Other investments accounted for at cost

**19.25** Income from investments in

- a.* subsidiaries accounted for using the equity method;
- b.* subsidiaries accounted for at cost;
- c.* investments in companies subject to significant influence accounted for using the equity method; and
- d.* other investments accounted for at cost

should be presented separately in the statement of income.

**19.26** A significant factor in evaluating the investment income is the relationship of the income reported to the investments from which such income is derived. For this reason, investments reported on the balance sheet and investment income reported in the statement of income are grouped in the same way.

## **Disclosure**

**19.27** The basis used to account for investments should be disclosed.

**19.28** When the fiscal periods of an investor and an investee are not the same and the equity method is used to account for the investee, events relating to, or transactions of, the investee that have occurred during the intervening period and significantly affect the financial position or results of operations of the investor should be disclosed. This disclosure is not necessary if these events or transactions are recorded in the financial statements.

**19.29** An entity should provide a listing and description of significant investments, including the names, carrying values, and proportion of ownership interests held in each investment.

**19.30** An entity should disclose the carrying amount of impaired assets by type of asset and the amount of related allowance for impairment.

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## Chapter 20—*Property, Plant, and Equipment*

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### Purpose and Scope

**20.01** This chapter establishes principles for the recognition, measurement, presentation, and disclosure of property, plant, and equipment (tangible capital assets). This chapter applies to property, plant, and equipment recognized under chapter 22, “Leases.”

**20.02** This chapter does not deal with goodwill or intangible assets (see chapter 21, “Intangible Assets”) or with the disposal of property, plant, and equipment (see chapter 30, “Disposal of Long-Lived Assets and Discontinued Operations”). This chapter also does not deal with special circumstances when it may be appropriate to undertake a comprehensive revaluation of all the assets and liabilities of an entity (see chapter 15, “New Basis (Push-Down) Accounting”).

### Definitions

**20.03** The following terms are used in this chapter with the meanings specified:

*Asset group.* The lowest level (smallest combination) of assets and liabilities for which identifiable cash flows are largely independent of the cash flows of other assets or groups of assets and liabilities.

*Cost.* The amount of consideration given up to acquire, construct, develop, or improve an item of property, plant, and equipment and includes all costs directly attributable to the acquisition, construction, development, or improvement of the asset, including installing it at the location and in the condition necessary for its intended use. Cost includes any asset retirement cost accounted for in accordance with the section, “Asset Retirement Obligations,” in chapter 26, “Contingencies.”

*Depreciation.* A method of allocating the cost of a tangible asset over its useful life and begins when the asset is placed in service.

*Fair value.* The amount of the consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act.

*Impairment.* The condition that exists when the carrying amount of a long-lived asset exceeds its fair value.

*Long-lived asset.* An asset that does not meet the definition of a *current asset* (see chapter 7, “Current Assets and Current Liabilities”). For purposes of this chapter, the term *long-lived asset* includes an asset group.

*Net carrying amount.* Net carrying amount of an item of property, plant, and equipment is cost less both accumulated amortization and the amount of any write-downs.

*Net recoverable amount.* Net recoverable amount of an item of property, plant, and equipment is its estimated future net cash flow from use together with its residual value.

*Residual value.* The estimated net realizable value of an item of property, plant, and equipment at the end of its useful life to an entity.

*Property, plant, and equipment.* Identifiable tangible assets that meet all the following criteria:

- They are held for use in the production or supply of goods and services, for rental to others, for administrative purposes or for the development, construction, maintenance, or repair of other property, plant, and equipment.
- They have been acquired, constructed, or developed with the intention of being used on a continuing basis.
- They are not intended for sale in the ordinary course of business.

Property, plant, and equipment and intangible assets, as defined in paragraph 21.08, are referred to collectively as *capital assets*.

*Salvage value.* The estimated net realizable value of an item of property, plant, and equipment at the end of its life. Salvage value is normally negligible.

*Service potential.* Used to describe the output or service capacity of an item of property, plant, and equipment and is normally determined by reference to attributes such as physical output capacity, associated operating costs, useful life, and quality of output.

*Useful life.* The period over which an asset, singly or in combination with other assets, is expected to contribute directly or indirectly to the future cash flows of an entity.

## **Measurement**

### **Cost**

**20.04** Property, plant, and equipment should be recorded at cost.

**20.05** The cost of an item of property, plant, and equipment includes the purchase price and other acquisition costs, such as option costs when an option is exercised; brokers' commissions; installation costs, including architectural, design, and engineering fees; legal fees; survey costs; site preparation costs; freight charges; transportation insurance costs; duties; testing; and preparation charges. In addition, if the cost of the asset acquired other than through a business combination is different from its tax basis on acquisition, the asset's cost should be adjusted to reflect the related deferred income tax consequences (see chapter 29, "Income Taxes"). It may be appropriate to group together individually insignificant items of property, plant, and equipment.

**20.06** The cost of each item of property, plant, and equipment acquired as part of a

basket purchase (that is, when a group of assets is acquired for a single amount), is determined by allocating the price paid for the basket to each item on the basis of its relative fair value at the time of acquisition.

**20.07** When, at the time of acquisition, a portion of the acquired item of property, plant, and equipment meets the criteria in chapter 30 to be classified as held for sale at the acquisition date, that portion of the item is measured at fair value less cost to sell. The remainder of the acquired item is measured at the cost of acquisition of the entire item less the amount assigned to the portion to be sold. For example, if a portion of land acquired is to be resold, the cost of the land to be retained would be the total cost of the purchase minus the fair value less cost to sell of the portion of land held for sale. When, at the time of acquisition, a portion of the acquired item of property, plant, and equipment is not intended for use because it will be abandoned, its cost and any costs of disposal, net of any estimated proceeds, are attributed to that portion of the acquired asset that is intended for use. For example, the cost of acquired land that includes a building that will be demolished comprises the cost of the acquired property and the cost of demolishing the building.

### ***Acquisition, Construction, or Development Over Time***

**20.08** The cost of an item of property, plant, and equipment includes direct construction or development costs (such as materials and labor) and overhead costs directly attributable to the construction or development activity.

**20.09** The cost of an item of property, plant, and equipment that is acquired, constructed, or developed over time includes carrying costs directly attributable to the acquisition, construction, or development activity (such as interest costs when the entity's accounting policy is to capitalize interest costs.)

**20.10** Capitalization of carrying costs ceases when an item of property, plant, and equipment is substantially complete and ready for productive use. Determining when an asset, or a portion thereof, is substantially complete and ready for productive use requires consideration of the circumstances and the industry in which it is to be operated. Normally, it would be predetermined by management with reference to such factors as productive capacity, occupancy level, or the passage of time.

**20.11** Net revenue or expense derived from an item of property, plant, and equipment prior to substantial completion and readiness for use is included in the cost.

### ***Improvement***

**20.12** The cost incurred to enhance the service potential of an item of property, plant, and equipment is an improvement. Service potential may be enhanced when there is an increase in the previously assessed physical output or service capacity; associated operating costs are lowered; the life or useful life is extended; or the quality of output is improved. The cost incurred in the maintenance of the service potential of an item of property, plant, and equipment is a repair, not an improvement. If a cost has the attributes of both a repair and an improvement, the portion considered to be an improvement is

included in the cost of the asset.

**20.13** A redevelopment project that adds significant economic value to rental real estate is treated as an improvement. When a building is removed for the purpose of redevelopment of rental real estate, the net carrying amount of the building is included in the cost of the redeveloped property, as long as the net amount considered recoverable from the redevelopment project exceeds its cost.

## **Depreciation**

**20.14** Depreciation should be recognized in a rational and systematic manner appropriate to the nature of an item of property, plant, and equipment with a limited life and its use by the entity. The amount of depreciation that should be charged to income is the greater of

- a. the cost, less salvage value over the life of the asset or
- b. the cost, less residual value over the useful life of the asset.

**20.15** Property, plant, and equipment is acquired to earn income or supply a service over its useful life. An item of property, plant, and equipment, other than land that normally has an unlimited life, has a limited life. Its useful life is normally the shortest of its physical, technological, commercial, and legal life. Depreciation is the charge to income that recognizes that life is finite and that the cost, less salvage value or residual value of an item of property, plant, and equipment, is allocated to the periods of service provided by the asset. Depreciation may also be termed *amortization* or *depletion*.

**20.16** The cost of an item of property, plant, and equipment made up of significant separable component parts is allocated to the component parts when practicable and when estimates can be made of the lives of the separate components. For example, initial leasing costs may be identifiable as a separable component of the cost of rental real estate, and engines may be a separable component of an aircraft.

**20.17** Different methods of depreciating an item of property, plant, and equipment result in different patterns of charges to income. The objective is to provide a rational and systematic basis for allocating the depreciable amount of an item of property, plant, and equipment over its estimated life and useful life. A straight-line method reflects a constant charge for the service as a function of time. A variable charge method reflects service as a function of usage. Other methods may be appropriate in certain situations. For example, an increasing charge method may be used when an entity can price its goods or services to obtain a constant rate of return on the investment in the asset; a decreasing charge method may be appropriate when the operating efficiency of the asset declines over time.

**20.18** Factors to be considered in estimating the life and useful life of an item of property, plant, and equipment include expected future usage, effects of technological or commercial obsolescence, expected wear and tear from use or the passage of time, the maintenance program, results of studies made regarding the industry, studies of similar items retired, and the condition of existing comparable items. As the estimate of the life

of an item of property, plant, and equipment is extended into the future, it becomes increasingly difficult to identify a reasonable basis for estimating the life.

### **Review of Depreciation**

**20.19** The depreciation method and estimates of the life and useful life of an item of property, plant, and equipment should be reviewed on a regular basis. See chapter 5, “Accounting Changes, Changes in Accounting Estimates, and Corrections of Errors,” for guidance applicable to changes in estimates.

**20.20** Significant events that may indicate a need to revise the depreciation method or estimates of the life and useful life of an item of property, plant, and equipment include

- a. a change in the extent the asset is used;
- b. a change in the manner in which the asset is used;
- c. removal of the asset from service for an extended period of time;
- d. physical damage;
- e. significant technological developments;
- f. a change in the law, environment, or consumer styles and tastes affecting the period of time over which the asset can be used.

### **Asset Retirement Obligations**

**20.21** Obligations associated with the retirement of property, plant, and equipment are accounted for in accordance with the section, “Asset Retirement Obligations,” in chapter 26.

### **Impairment of Long-Lived Assets**

**20.22** This section establishes principles for the recognition, measurement, and disclosure of the impairment of long-lived assets. This section applies to long-lived assets held for use. It does not deal with long-lived assets to be disposed of (see chapter 30).

**20.23** This section applies to nonmonetary long-lived assets, including property, plant, and equipment, intangible assets with finite useful lives, and long-term prepaid assets. It does not apply to

- a. goodwill and intangible assets with indefinite useful lives (see chapter 21);
- b. investments, including equity method accounted investments (see chapter 19, “Investments”);
- c. accrued benefit assets (see chapter 28, “Retirement and Other Postemployment Benefits”);
- d. deferred income tax assets (see chapter 29);
- e. financial assets, financial liabilities, and contracts to buy or sell nonfinancial items accounted for in accordance with chapter 32, “Financial Instruments and Long-Term Debt.”

## Recognition and Measurement

**20.24** An impairment loss should be recognized when the carrying amount of a long-lived asset is not recoverable and exceeds its fair value. A gain should be recognized for any subsequent increase in fair value (reversal of impairment loss), but not in excess of the cumulative loss previously recognized for a write-down to fair value.

**20.25** The carrying amount of a long-lived asset is not recoverable if the carrying amount exceeds the sum of the undiscounted cash flows expected to result from its use and eventual disposition. This assessment is based on the carrying amount of the asset at the date it is tested for recoverability, whether it is in use or under development.

**20.26** An impairment loss should be measured as the amount by which the carrying amount of a long-lived asset exceeds its fair value. After an impairment loss or a reversal of an impairment loss is recognized, the entity should adjust the depreciation charge for the asset in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.

**20.27** When an entity has capitalized asset retirement costs (see the section, "Asset Retirement Obligations," in chapter 26), these costs are included in the carrying amount of the asset being tested for impairment. Estimated future cash flows related to the liability for an asset retirement obligation that has been recognized in the financial statements are excluded from the cash flows used to test the asset for recoverability and to measure the asset's fair value. However, when an asset group is the only source of cash flow to pay the asset retirement obligation, the liability is included in the asset group in accordance with paragraph 20.31, and the estimated future cash flows related to the liability are included in the cash flows of the asset group. When the fair value of the asset is based on a quoted market price and that price considers the costs that will be incurred in retiring that asset, the quoted market price is increased by the fair value of the asset retirement obligation for purposes of measuring impairment.

## When to Test for Recoverability

**20.28** A long-lived asset should be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable.

**20.29** Examples of such events or changes in circumstances related to a long-lived asset include, but are not restricted to

- a.* a significant decrease in its market price;
- b.* a significant adverse change in the extent or manner in which it is being used or in its physical condition;
- c.* a significant adverse change in legal factors or in the business climate that could affect its value, including an adverse action or assessment by a regulator;
- d.* an accumulation of costs significantly in excess of the amount originally expected for its acquisition or construction;

- e. a current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with its use; or
- f. a current expectation that, more likely than not, it will be sold or otherwise disposed of significantly before the end of its previously estimated useful life (*more likely than not* means a level of likelihood that is more than 50 percent).

There may also be other indications that the carrying amount of an asset is not recoverable.

**20.30** When a long-lived asset is tested for recoverability, it may also be necessary to review depreciation estimates and methods. Any revision to the remaining useful life resulting from that review is also considered in developing estimates of future cash flows used to test for recoverability. However, any change in the depreciation of the asset that results from the review is made only after recording any impairment loss in accordance with this section.

### **Grouping Assets**

**20.31** For purposes of recognition and measurement of an impairment loss, a long-lived asset should be grouped with other assets and liabilities to form an asset group at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities.

**20.32** A long-lived asset may not have identifiable cash flows that are largely independent of the cash flows of other assets and liabilities and of other asset groups (for example, a corporate headquarters facility or assets in a single-operation entity). In those circumstances, the asset group for that long-lived asset includes all assets and liabilities of the entity.

**20.33** An example of when a liability would be included in an asset group is a mortgage for which the building is the only source of cash flow to pay the liability. If other cash flows are available to pay the liability, the mortgage should not be grouped with the building for purposes of impairment.

**20.34** Goodwill is included in the carrying amount of an asset group to be tested for impairment only if the asset group is, or includes, a reporting unit (see chapter 21). Goodwill is not included in the carrying amount of a lower-level asset group that includes only part of a reporting unit. Estimates of future cash flows used to test that lower-level asset group for recoverability are not reduced to reflect the fact that goodwill is not included in the carrying amount of the asset group.

**20.35** An asset group may include assets (such as accounts receivable and inventory) not covered by this section, as well as liabilities (such as accounts payable and long-term debt). With the exception of goodwill (see chapter 21), the carrying amounts of these assets and liabilities are evaluated prior to testing the asset group for recoverability. For example, the allowance for doubtful accounts and impaired loans should be evaluated in accordance with chapter 32, and long-lived assets held for sale should be evaluated in

accordance with chapter 30.

**20.36** An impairment loss for an asset group reduces only the carrying amounts of long-lived assets held for use and not of any other assets or liabilities of the asset group. The loss is allocated to the long-lived assets of the group on a pro rata basis using the relative carrying amounts of those assets. However, the loss allocated to an individual long-lived asset of the group does not reduce the carrying amount of that asset below its fair value, whenever the fair value is determinable without undue cost and effort.

### **Cash Flow Test for Recoverability**

**20.37** Estimates of future cash flows used to test the recoverability of a long-lived asset should include only the future cash flows (cash inflows less associated cash outflows) that are directly associated with, and that are expected to arise as a direct result of, its use and eventual disposition. These cash flows include the principal amount of any liabilities included in the asset group but not interest that will be recognized as an expense when incurred.

**20.38** Estimates of future cash flows used to test the recoverability of a long-lived asset incorporate the entity's own assumptions about its use, considering all available evidence. The assumptions used in developing those estimates are reasonable in relation to the assumptions used in developing other information used by the entity for comparable periods, such as internal budgets and projections, accruals related to incentive compensation plans, or information communicated to others. However, if alternative courses of action to recover the carrying amount are under consideration (such as the future sale of the asset) or if a range is estimated for the amount of possible future cash flows associated with the likely course of action, the likelihood of those possible outcomes is considered. That assessment is not revised for changes after the balance sheet date (such as a subsequent decision to sell the asset). A probability-weighted approach may be useful in considering the likelihood of these possible outcomes.

**20.39** The remaining useful life of a long-lived asset to the entity is used to estimate the future cash flows for purposes of testing its recoverability. The remaining useful life of an asset group is based on the remaining useful life of the primary asset of the group. This is the principal, long-lived tangible asset being depreciated (or intangible asset being amortized) that is the most significant component asset from which the asset group derives its cash flow-generating capacity. An asset not being depreciated, such as land or an indefinite-lived intangible asset, cannot be the primary asset of the group. Factors that an entity generally considers in determining whether a long-lived asset is the primary asset of an asset group include the following:

- a. Whether other assets of the group would have been acquired by the entity without the asset
- b. The level of investment that would be required to replace the asset
- c. The remaining useful life of the asset relative to other assets of the group

If the primary asset is not the asset of the group with the longest remaining useful life, estimates of future cash flows for the group assume the sale of the group at the end of the

remaining useful life of the primary asset.

**20.40** Estimates of future cash flows used to test the recoverability of a long-lived asset that is in use, including one for which development is substantially complete, are based on its existing service potential at the date it is tested. Service potential encompasses the remaining useful life, cash flow-generating capacity, and, for tangible assets, physical output capacity. The estimates include cash flows associated with future expenditures necessary to maintain the existing service potential of a long-lived asset, including those that replace the service potential of its component parts (for example, the roof of a building) and component assets other than the primary asset of an asset group. Cash flows associated with future capital expenditures that would increase the service potential are excluded from estimates of future cash flows used to test recoverability.

**20.41** Estimates of future cash flows used to test the recoverability of a long-lived asset that is under development are based on its expected service potential when development is substantially complete. These estimates include cash flows associated with all future expenditures necessary to complete its development, including interest payments that will be capitalized as part of its cost.

**20.42** If a long-lived asset that is under development is part of an asset group that is in use, estimates of future cash flows used to test the recoverability of that group include the cash flows associated with future expenditures necessary to maintain the existing service potential of the group, as well as the cash flows associated with all future expenditures necessary to substantially complete the asset that is under development.

## **Disclosure**

**20.43** For each major category of property, plant, and equipment, there should be disclosure of

- a.* cost;
- b.* accumulated depreciation, including the amount of any write-downs; and
- c.* the depreciation method used, including the depreciation period or rate.

**20.44** The net carrying amount of an item of property, plant, and equipment not being depreciated because it is under construction or development or has been removed from service for an extended period of time should be disclosed.

**20.45** The amount of depreciation of an item of property, plant, and equipment charged to income for the period should be disclosed (see chapter 8, “Statement of Income”).

**20.46** Major categories of property, plant, and equipment are determined by reference to type (for example, land, buildings, machinery, leasehold improvements), operating segment, or nature of operations (for example, manufacturing, processing, distribution).

**20.47** The financial statements should disclose the following information in the period in which an impairment loss is recognized:

- a.* A description of the impaired long-lived asset
- b.* A description of the facts and circumstances leading to the impairment
- c.* If not separately presented on the face of the statement of income, the amount of the impairment loss and the caption in the statement of income that includes that loss

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## Chapter 21—*Intangible Assets*

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### Purpose and Scope

**21.01** This chapter establishes principles for the recognition, measurement, presentation, and disclosure of intangible assets, including goodwill.

**21.02** This chapter applies to goodwill subsequent to initial recognition. Principles for the initial recognition, measurement, and disclosure of goodwill acquired in a business combination are provided in chapter 11, “Business Combinations.”

**21.03** This chapter also applies to accounting for intangible assets, except intangible assets that are within the scope of another chapter. This chapter does not apply to

- a. the initial recognition, measurement, and disclosure of intangible assets acquired in a business combination (see chapter 11);
- b. the establishment of a new cost basis for intangible assets as part of a comprehensive revaluation (see chapter 15, “New Basis (Push-Down) Accounting”);
- c. intangible assets held by an entity for sale in the ordinary course of business (see chapter 18, “Inventories”);
- d. leases that are within the scope of chapter 22, “Leases;”
- e. assets arising from employee benefits (see chapter 28, “Retirement and Other Postemployment Benefits”);
- f. deferred income tax assets (see chapter 29, “Income Taxes”);
- g. noncurrent intangible assets classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with chapter 30, “Disposal of Long-Lived Assets and Discontinued Operations;” and
- h. *financial assets* as defined in chapter 32, “Financial Instruments and Long-Term Debt.” The recognition and measurement of some financial assets are covered by chapter 12, “Subsidiaries,” chapter 13, “Consolidated Financial Statements and Noncontrolling Interests,” and chapter 19, “Investments.”

**21.04** Principles for the recognition, measurement, presentation, and disclosure of tangible capital assets are provided in chapter 20, “Property, Plant, and Equipment.” Some intangible assets may be contained in or on a physical substance, such as a compact disc (in the case of computer software), legal documentation (in the case of a license or patent), or film. In determining whether an asset that incorporates both intangible and tangible elements is to be accounted for under chapter 20 or as an intangible asset under this chapter, management uses judgment to assess which element is more significant. For example, computer software for a computer-controlled machine tool that cannot operate without that specific software is an integral part of the related hardware, and it is treated as property, plant, and equipment. The same applies to the operating system of a computer. When the software is not an integral part of the related hardware, computer

software is treated as an intangible asset.

**21.05** Rights under licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents, and copyrights are excluded from the scope of chapter 22 and are within the scope of this chapter.

**21.06** This chapter applies to, among other things, expenditure on advertising, training, start-up, and research and development activities. Research and development activities are directed to the development of knowledge. Therefore, although these activities may result in an asset with physical substance (for example, a prototype), the physical element of the asset is secondary to its intangible component (that is, the knowledge embodied in it).

**21.07** The portion of the difference between an investor's cost of an investment subject to significant influence and the amount of its underlying equity in the net assets of the investee that is similar to goodwill (equity method goodwill) is not reviewed for impairment in accordance with this chapter. Investments accounted for by the equity method are reviewed for impairment in accordance with paragraphs 19.18–.21. Impairment write-downs, as a result of the application of chapter 19, are presented in the statement of income separately from goodwill impairment losses.

## Definitions

**21.08** The following terms are used in this chapter with the meanings specified:

*Amortization.* The systematic allocation of the amortizable amount of an intangible asset over its useful life.

*Amortizable amount.* The cost of an asset, or other amount substituted for cost, less its residual value.

*Carrying amount.* The recorded amount of an asset or liability after adjustment, if any, for amortization or depreciation or impairment in value.

*Cost.* The amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction or, when appropriate, the amount attributed to that asset when initially recognized in accordance with the requirements of other chapters.

*Development.* The application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems, or services before the start of commercial production or use.

*Fair value.* The amount of the consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act.

*Goodwill.* An asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized.

*Intangible asset.* An identifiable, nonmonetary asset without physical substance.

*Monetary assets.* Money held and assets to be received in fixed or determinable amounts of money.

*Research.* Original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

*Residual value.* The estimated amount that an entity would currently obtain from disposal of the asset after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

*Useful life.* Useful life is

- the period over which an asset is expected to be available for use by an entity; or
- the number of production or similar units expected to be obtained from the asset by an entity.

## **Intangible Assets**

**21.09** Entities frequently expend resources or incur liabilities on the acquisition, development, maintenance, or enhancement of intangible resources, such as scientific or technical knowledge, design, and implementation of new processes or systems; licenses; intellectual property; market knowledge; and trademarks (including brand names and publishing titles). Common examples of items encompassed by these broad headings are computer software, patents, copyrights, motion picture films, customer lists, mortgage servicing rights, fishing licenses, import quotas, franchises, customer or supplier relationships, customer loyalty, market share, and marketing rights.

**21.10** Not all the items described in paragraph 21.09 meet the definition of an *intangible asset* (that is, identifiability, control over a resource, and existence of future economic benefits). If an item within the scope of this chapter does not meet the definition of an *intangible asset* or *goodwill*, expenditure to acquire it or generate it internally is recognized as an expense when it is incurred.

### **Identifiability**

**21.11** The definition of an *intangible asset* requires an intangible asset to be identifiable to distinguish it from goodwill. Goodwill acquired in a business combination represents a payment made by the acquirer in anticipation of future economic benefits from assets that are not capable of being individually identified and separately recognized. The future economic benefits may result from synergy between the identifiable assets acquired or from assets that, individually, do not qualify for recognition in the financial statements but for which the acquirer is prepared to make a payment in the business combination.

**21.12** An asset meets the identifiability criterion in the definition of an *intangible asset* when it

- a. is separable (that is, is capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, asset, or liability) or
- b. arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

## **Control**

**21.13** An entity controls an asset if the entity has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits. The capacity of an entity to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law. In the absence of legal rights, it is more difficult to demonstrate control. However, legal enforceability of a right is not a necessary condition for control because an entity may be able to control the future economic benefits in some other way.

**21.14** Market and technical knowledge may give rise to future economic benefits. An entity controls those benefits if, for example, the knowledge is protected by legal rights, such as copyrights, a restraint of trade agreement (when permitted), or by a legal duty on employees to maintain confidentiality.

**21.15** An entity may have a portfolio of customers or a market share and expect that, because of its efforts in building customer relationships and loyalty, the customers will continue to trade with the entity. However, in the absence of legal rights to protect or other ways to control the relationships with customers or the loyalty of the customers to the entity, the entity usually has insufficient control over the expected economic benefits from customer relationships and loyalty for such items (for example, portfolio of customers, market shares, customer relationships, and customer loyalty) to meet the definition of *intangible assets*. In the absence of legal rights to protect customer relationships, exchange transactions for the same or similar noncontractual customer relationships (other than as part of a business combination) provide evidence that the entity is, nonetheless, able to control the expected future economic benefits flowing from the customer relationships. Because such exchange transactions also provide evidence that the customer relationships are separable, those customer relationships meet the definition of an *intangible asset*.

## **Future Economic Benefits**

**21.16** The future economic benefits flowing from an intangible asset may include revenue from the sale of products or services, cost savings, or other benefits resulting from the use of the asset by the entity. For example, the use of intellectual property in a production process may reduce future production costs rather than increase future revenues.

## **Recognition and Measurement**

**21.17** The recognition of an item as an intangible asset requires an entity to demonstrate

that the item meets

- a. the definition of an *intangible asset* (see paragraphs 21.09–.16) and
- b. the recognition criteria (see paragraphs 21.20–.22).

This requirement applies to costs incurred initially to acquire or internally generate an intangible asset and those incurred subsequently to add to, replace part of, or service it.

**21.18** Paragraphs 21.24–.29 deal with the application of the recognition criteria to separately acquired intangible assets, and paragraphs 21.30–.32 deal with the treatment of internally-generated goodwill. Paragraphs 21.33–.50 deal with the initial recognition and measurement of internally-generated intangible assets.

**21.19** The nature of intangible assets is such that, in many cases, there are no additions to such an asset or replacements of part of it. Accordingly, most subsequent expenditures are likely to maintain the expected future economic benefits embodied in an existing intangible asset rather than meet the definition of an *intangible asset* and the recognition criteria in this chapter. In addition, it is often difficult to attribute subsequent expenditure directly to a particular intangible asset rather than to the business as a whole. Therefore, only rarely will subsequent expenditure—expenditure incurred after the initial recognition of an acquired intangible asset or after completion of an internally-generated intangible asset—be recognized in the carrying amount of an asset. Consistently with paragraph 21.46, subsequent expenditure on brands, mastheads, publishing titles, customer lists, and items similar in substance (whether externally acquired or internally generated) is always recognized in net income as incurred because such expenditure cannot be distinguished from expenditure to develop the business as a whole.

**21.20** An intangible asset should be recognized if, and only if

- a. it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity, and
- b. the cost of the asset can be measured reliably.

**21.21** Management should assess the probability of expected future economic benefits using reasonable and supportable assumptions that represent management's best estimate of the set of economic conditions that will exist over the useful life of the asset.

**21.22** Management uses judgment to assess the degree of certainty attached to the flow of future economic benefits that are attributable to the use of the asset on the basis of the evidence available at the time of initial recognition, giving greater weight to external evidence.

**21.23** An intangible asset should be measured initially at cost.

### ***Separate Acquisition***

**21.24** Normally, the price an entity pays to acquire separately an intangible asset reflects expectations about the probability that the expected future economic benefits embodied in the asset will flow to the entity. In other words, the effect of probability is reflected in

the cost of the asset. Therefore, the probability recognition criterion in paragraph 21.20(a) is always considered to be satisfied for separately acquired intangible assets.

**21.25** The cost of a separately acquired intangible asset can usually be measured reliably, particularly when the purchase consideration is in the form of cash or other monetary assets.

**21.26** The cost of a separately acquired intangible asset comprises

- a. its purchase price, including import duties and nonrefundable purchase taxes, after deducting trade discounts and rebates, and
- b. any directly attributable cost of preparing the asset for its intended use.

**21.27** Examples of directly attributable costs are

- a. costs of salaries, wages, and employee benefits arising directly from bringing the asset to its working condition;
- b. professional fees arising directly from bringing the asset to its working condition; and
- c. costs of testing whether the asset is functioning properly.

**21.28** Examples of expenditures that are not part of the cost of an intangible asset are

- a. costs of introducing a new product or service (including costs of advertising and promotional activities);
- b. costs of conducting business in a new location or with a new class of customer (including costs of staff training); and
- c. administration and other general overhead costs.

**21.29** Recognition of costs in the carrying amount of an intangible asset ceases when the asset is in the condition necessary for it to be capable of operating in the manner intended by management. Therefore, costs incurred in using or redeploying an intangible asset are not included in the carrying amount of that asset. For example, the following costs are not included in the carrying amount of an intangible asset:

- a. Costs incurred while an asset capable of operating in the manner intended by management has yet to be brought into use
- b. Initial operating losses, such as those incurred while demand for the asset's output builds up

### ***Internally-Generated Goodwill***

**21.30** Internally-generated goodwill should not be recognized as an asset.

**21.31** In some cases, expenditure is incurred to generate future economic benefits, but it does not result in the creation of an intangible asset that meets the recognition criteria in this chapter. Such expenditure is often described as contributing to internally-generated goodwill. Internally-generated goodwill is not recognized as an asset because it is not an identifiable resource (that is, it is not separable, nor does it arise from contractual or other legal rights) controlled by the entity that can be measured reliably at cost.

**21.32** Differences between the market value of an entity and the carrying amount of its identifiable net assets at any time may capture a range of factors that affect the value of the entity. However, such differences do not represent the cost of intangible assets controlled by the entity.

### ***Internally-Generated Intangible Assets***

**21.33** It is sometimes difficult to assess whether an internally-generated intangible asset qualifies for recognition because of problems in

- a. identifying whether and when there is an identifiable asset that will generate expected future economic benefits and
- b. determining the cost of the asset reliably. In some cases, the cost of generating an intangible asset internally cannot be distinguished from the cost of maintaining or enhancing the entity's internally-generated goodwill or of running day-to-day operations.

Therefore, in addition to complying with the general requirements for the recognition and initial measurement of an intangible asset, an entity should apply the requirements and guidance in paragraphs 21.34–.50 to all internally-generated intangible assets.

**21.34** To assess whether an internally-generated intangible asset meets the criteria for recognition, an entity classifies the generation of the asset into

- a. a research phase and
- b. a development phase.

Although the terms *research* and *development* are defined, the terms *research phase* and *development phase* have a broader meaning for the purpose of this chapter.

**21.35** If management cannot distinguish the research phase from the development phase of an internal project to create an intangible asset, the entity treats the expenditure on that project as if it were incurred in the research phase only.

### ***Research Phase***

**21.36** No intangible asset arising from research (or from the research phase of an internal project) should be recognized. Expenditure on research (or on the research phase of an internal project) should be recognized as an expense when it is incurred.

**21.37** In the research phase of an internal project, an entity cannot demonstrate that an intangible asset exists that will generate probable future economic benefits. Therefore, this expenditure is recognized as an expense when it is incurred.

**21.38** Examples of research activities are

- a. activities aimed at obtaining new knowledge;
- b. the search for, evaluation, and final selection of applications of research findings or other knowledge;
- c. the search for alternatives for materials, devices, products, processes, systems, or services; and
- d. the formulation, design, evaluation, and final selection of possible alternatives for new or improved materials, devices, products, processes, systems, or services.

### ***Development Phase***

**21.39** In accounting for expenditures on internally-generated intangible assets during the development phase, management should make an accounting policy choice to either

- a. expense such expenditures as incurred or
- b. capitalize such expenditures as an intangible asset (provided the criteria in paragraph 21.40 are met).

This accounting policy choice should be applied consistently to expenditures on all internal projects in the development phase. In making this accounting policy choice, the entity need not meet the criterion in paragraph 5.06(b).

**21.40** An intangible asset arising from development (or from the development phase of an internal project) is recognized if, and only if, an entity can demonstrate all of the following:

- a. The technical feasibility of completing the intangible asset so that it will be available for use or sale.
- b. Its intention to complete the intangible asset and use or sell it.
- c. Its ability to use or sell the intangible asset.
- d. The availability of adequate technical, financial, and other resources to complete the development and to use or sell the intangible asset.
- e. Its ability to measure reliably the expenditure attributable to the intangible asset during its development.
- f. How the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.

**21.41** In the development phase of an internal project, in some instances, an entity can

identify an intangible asset and demonstrate that the asset will generate probable future economic benefits because the development phase of a project is further advanced than the research phase.

**21.42** Examples of development activities are

- a. the design, construction, and testing of preproduction or preuse prototypes and models;
- b. the design of tools, jigs, molds, and dies involving new technology;
- c. the design, construction, and operation of a pilot plant that is not of a scale economically feasible for commercial production; and
- d. the design, construction, and testing of a chosen alternative for new or improved materials, devices, products, processes, systems, or services.

**21.43** To demonstrate how an intangible asset will generate probable future economic benefits, management assesses the future economic benefits to be received from the asset using the principles in the section, “Impairment of Long-Lived Assets,” in chapter 20. If the asset will generate economic benefits only in combination with other assets, the entity should apply the concept of asset groups in chapter 20.

**21.44** Availability of resources to complete, use, and obtain the benefits from an intangible asset can be demonstrated by, for example, a business plan showing the technical, financial, and other resources needed and the entity's ability to secure those resources. In some cases, an entity demonstrates the availability of external finance by obtaining a lender's indication of its willingness to fund the plan.

**21.45** An entity's costing systems can often measure reliably the cost of generating an intangible asset internally, such as salary and other expenditure incurred in securing copyrights or licenses or developing computer software.

**21.46** Internally-generated brands, mastheads, publishing titles, customer lists, and items similar in substance should not be recognized as intangible assets.

**21.47** Expenditure on internally-generated brands, mastheads, publishing titles, customer lists, and items similar in substance cannot be distinguished from the cost of developing the business as a whole. Therefore, such items are not recognized as intangible assets.

#### ***Cost of an Internally-Generated Intangible Asset***

**21.48** The cost of an internally-generated intangible asset for the purpose of paragraph 21.23 is the sum of expenditures incurred from the date when the intangible asset first meets the recognition criteria in paragraphs 21.20–.21 and 21.40. Paragraph 21.56 prohibits reinstatement of expenditures previously recognized as an expense.

**21.49** The cost of an internally-generated intangible asset comprises all directly attributable costs necessary to create, produce, and prepare the asset to be capable of operating in the manner intended by management. Examples of directly attributable costs are

- a. costs of materials and services used or consumed in generating the intangible asset;
- b. costs of employee salaries, wages, and benefits arising from the generation of the intangible asset;
- c. fees to register a legal right;
- d. amortization of patents and licenses that are used to generate the intangible asset; and
- e. interest costs when the entity's accounting policy is to capitalize interest costs.

**21.50** The following are not components of the cost of an internally-generated intangible asset:

- a. Selling, administrative, and other general overhead expenditure, unless this expenditure can be directly attributed to preparing the asset for use
- b. Identified inefficiencies and initial operating losses incurred before the asset achieves planned performance
- c. Expenditure on training staff to operate the asset

### **Recognition of an Expense**

**21.51** Expenditure on an intangible item should be recognized as an expense when it is incurred unless

- a. for an internally-generated intangible asset in the development phase, management has made an accounting policy choice to capitalize such expenditures (see paragraph 21.39); and
- b. it forms part of the cost of an intangible asset that meets the recognition criteria (see paragraphs 21.17–.50).

**21.52** In some cases, expenditure is incurred to provide future economic benefits to an entity, but no intangible asset or other asset is acquired or created that can be recognized. In the case of the supply of goods, the entity recognizes such expenditure as an expense when it has a right to access those goods. In the case of the supply of services, the entity recognizes the expenditure as an expense when it receives the services. For example, expenditure on research is recognized as an expense when it is incurred (see paragraph 21.36), except when it is acquired as part of a business combination. Other examples of expenditures that are recognized as an expense when it is incurred include expenditure on

- a. training activities;
- b. advertising and promotional activities (including mail-order catalogues and other similar documents intended to advertise goods, services, or events to customers); and
- c. relocating or reorganizing part or all of an entity.

**21.53** An entity has a right to access goods when it owns them. Similarly, it has a right to access goods when they have been constructed by a supplier in accordance with the

terms of a supply contract, and the entity could demand delivery of them in return for payment. Services are received when they are performed by a supplier in accordance with a contract to deliver them to the entity and not when the entity uses them to deliver another service (for example, to deliver an advertisement to customers).

**21.54** Paragraph 21.52 does not preclude recognizing a prepayment as an asset when payment for the delivery of goods has been made in advance of the entity obtaining a right to access those goods. Similarly, paragraph 21.52 does not preclude an entity from recognizing a prepayment as an asset when payment for services has been made in advance of the entity receiving those services.

### **Start-up Costs**

**21.55** Start-up costs may consist of establishment costs, such as legal and other administrative costs incurred in establishing a legal entity, expenditure to open a new facility or business (that is, preopening costs), or expenditures for starting new operations or launching new products or processes (that is, preoperating costs). Start-up costs should be accounted for in the same manner as they are for federal income tax purposes. To the extent start-up costs are expensed for income tax reporting, an entity should expense the same amount for book purposes. To the extent that an entity capitalizes start-up costs for income tax reporting, an entity should capitalize the same amount as that reported to the IRS and amortize it over the same period.

### **Past Expenses Not to Be Recognized as an Asset**

**21.56** Expenditure on an intangible item that was initially recognized as an expense should not be recognized as part of the cost of an intangible asset at a later date.

### **Subsequent Measurement**

**21.57** A recognized intangible asset should be amortized over its useful life. For the purpose of the *Financial Reporting Framework for Small- and Medium-Sized Entities*, all intangible assets should be considered to have a finite useful life. The useful life of an intangible asset that arises from contractual or other legal rights should not exceed the period of the contractual or other legal rights but may be shorter depending on the period over which the entity expects to use the asset. If the contractual or other legal rights are conveyed for a limited term that can be renewed, the useful life of the intangible asset should include the renewal period(s) only if there is evidence to support renewal by the entity without significant cost.

**21.58** The amortization method and estimate of the useful life of an intangible asset should be reviewed annually.

**21.59** When an intangible asset has a finite useful life, but the precise length of that life is not known, the intangible asset is amortized over the best estimate of its useful life. Guidance for determining the useful life of an intangible asset is provided in paragraph 21.62. If an entity is unable to make a reliable estimate of the useful life of an intangible asset, the life should be presumed to be 10 years.

**21.60** The amount of an intangible asset to be amortized is the amount initially assigned to that asset less any residual value. The residual value of an intangible asset is assumed to be zero unless, at the end of its useful life to the reporting entity, the asset is expected to continue to have a useful life to another entity, and

- a. the reporting entity has a commitment from a third party to purchase the asset at the end of its useful life; or
- b. the residual value can be determined by reference to an exchange transaction in an existing market for that asset, and that market is expected to exist at the end of the asset's useful life.

**21.61** The method of amortization will reflect the pattern in which the economic benefits of the intangible asset are consumed or otherwise used up. Chapter 20 provides guidance on amortization methods. When the pattern of economic benefits cannot be reliably determined, a straight-line amortization method is used.

### ***Determining the Useful Life of an Intangible Asset***

**21.62** The estimate of the useful life of an intangible asset is based on an analysis of all pertinent factors, in particular

- a. the expected use of the asset by the entity;
- b. the expected useful life of another asset or a group of assets to which the useful life of the asset may relate;
- c. any legal, regulatory, or contractual provisions that may limit the useful life;
- d. any legal, regulatory, or contractual provisions that enable renewal or extension of the asset's legal or contractual life without substantial cost (provided there is evidence to support renewal or extension, and renewal or extension can be accomplished without material modifications to the existing terms and conditions);
- e. the effects of obsolescence, demand, competition, and other economic factors (such as the stability of the industry, known technological advances, legislative action that results in an uncertain or changing regulatory environment, and expected changes in distribution channels); and
- f. the level of maintenance expenditures required to obtain the expected future cash flows from the asset.

### **Recognition and Measurement of an Impairment Loss**

**21.63** An intangible asset should be tested for impairment in accordance with the provisions contained in chapter 20.

**21.64** When the carrying amount of the intangible asset exceeds its fair value, an impairment loss should be recognized in an amount equal to the excess.

**21.65** An impairment loss for an intangible asset should not be reversed if the fair value subsequently increases.

## Goodwill

**21.66** Goodwill should be recognized on an entity's balance sheet at the amount initially recognized, less amortization.

**21.67** Goodwill should be amortized generally over the same period as that used for federal income tax purposes or if not amortized for federal income tax purposes then a period of 10 years.

**21.68** For equity method investments, the portion of the difference between the investor's cost and the amount of its underlying equity in the net assets of the investee that is similar to goodwill (equity method goodwill) is amortized.

## Presentation

**21.69** The aggregate amount of goodwill should be presented as a separate line item in an entity's balance sheet.

**21.70** Intangible assets should be aggregated and presented as a separate line item in an entity's balance sheet.

## Disclosure

**21.71** The financial statements should disclose the following information:

- The net carrying amount in total and by major intangible asset class
- The aggregate amortization expense for the period
- The amortization method used, including the amortization period or rate
- The basis to account for internally generated intangible assets

**21.72** An intangible asset class is a group of intangible assets that are similar, either by their nature or by their use in the operations of an entity.

**21.73** For each impairment loss recognized related to an intangible asset, the following information should be disclosed in the financial statements that include the period in which the impairment loss is recognized:

- a.* A description of the impaired intangible asset and the facts and circumstances leading to the impairment
- b.* The amount of the impairment loss
- c.* The caption in the statement of income in which the impairment loss is included

**21.74** If the entity has incurred expenditure on start-up costs, the policy for accounting for those costs should be disclosed.

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## Chapter 22—Leases

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### Purpose and Scope

**22.01** This chapter establishes principles for methods of accounting for lease transactions and circumstances in which these methods are appropriate.

**22.02** This chapter does not apply to licensing agreements for items such as motion pictures, videotapes, plays, manuscripts, patents, and copyrights.

### Definitions

**22.03** The following terms are used in this chapter with the meanings specified:

*Bargain purchase option.* A provision allowing the lessee, at its option, to purchase the leased property for a price that is sufficiently lower than the expected fair value of the property, at the date the option becomes exercisable, such that exercise of the option appears, at the inception of the lease, to be reasonably assured.

*Bargain renewal option.* A provision allowing the lessee, at its option, to renew the lease for a rental that is sufficiently lower than the expected fair rental of the property, at the date the option becomes exercisable, such that exercise of the option appears, at the inception of the lease, to be reasonably assured. *Fair rental* means the going rate for rental of equivalent property under similar terms and conditions.

*Capital lease.* A lease that, from the point of view of the lessee, transfers substantially all the benefits and risks incident to ownership of property to the lessee.

*Contingent rental.* A rental based on a factor other than the passage of time (for example, percentage of sales, amount of usage, prime interest rate, price indexes).

*Direct financing lease.* A lease that, from the point of view of the lessor, transfers substantially all the benefits and risks incident to ownership of property to the lessee and, at the inception of the lease, the fair value of leased property is the same as its carrying amount to the lessor (usually not a manufacturer or dealer). A lease is not precluded from being classified as a direct financing lease after it is renewed or extended even though the carrying amount of the property at the end of the original lease term is different from its fair value at that date.

*Economic life of the leased property.* The estimated remaining period during which the property is expected to be economically usable by one or more users, with normal repairs and maintenance, for the purpose for which it was intended at the inception of the lease and without limitation by the lease term.

*Executory costs.* Costs related to the operation of the leased property (for example, insurance, maintenance cost, and property taxes).

*Fair value.* The amount of the consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act.

- When the lessor is a manufacturer or dealer, the fair value of the property at the inception of the lease will usually be its normal selling price, reflecting any volume or trade discounts that may be applicable. However, the determination of fair value would be made in light of market conditions prevailing at the time, which may indicate that the fair value of the property is less than the normal selling price.
- When the lessor is not a manufacturer or dealer, the fair value of the property at the inception of the lease will usually be its cost to the lessor, reflecting any volume or trade discounts that may be applicable. However, when there has been a lapse of time between the date of acquisition of the property by the lessor and the inception of the lease, the determination of fair value would be made in light of market conditions prevailing at the inception of the lease, which may indicate that the fair value of the property is greater or less than its cost or carrying value.

*Inception of the lease.* The earlier of the date of the lease agreement and the date of a commitment that is signed by the parties to the lease transaction and includes the principal terms of the lease (this is the effective date used for classification of the lease).

*Initial direct costs.* Those costs incurred by the lessor that are directly associated with negotiating and executing a specific leasing transaction. Such costs include commissions, legal fees, and costs of preparing and processing documents for new leases. Such costs do not include supervisory and administrative costs, promotion and lease design costs intended for recurring use, costs incurred in collection activities, and provisions for uncollectable rentals.

*Interest rate implicit in the lease.* The discount rate that, at the inception of the lease, causes the aggregate present value of

- the minimum lease payments, from the standpoint of the lessor, excluding that portion of the payments representing executory costs to be paid by the lessor and any profit on such costs and
  - the unguaranteed residual value accruing to the benefit of the lessor
- to be equal to the fair value of the leased property to the lessor at the inception of the lease.

*Lease.* The conveyance, by a lessor to a lessee, of the right to use a tangible asset, usually for a specified period of time in return for rent.

*Lease inducements.* Incentives for a lessee to sign a lease (for example, an upfront cash payment to the lessee, an initial rent-free period or reduced rent payments in early periods, the reimbursement of costs of the lessee, such as moving costs or leasehold improvements, or the assumption by the lessor of the lessee's preexisting lease).

*Lease term.* The fixed, noncancellable period of the lease plus

- all periods covered by bargain renewal options;
- all periods for which failure to renew would impose on the lessee a penalty large enough that renewal appears, at the inception of the lease, reasonably assured;
- all periods covered by ordinary renewal options during which the lessee has undertaken to guarantee the lessor's debt related to the leased property;
- all periods covered by ordinary renewal options preceding the date on which a bargain purchase option is exercisable; and
- all periods representing renewals or extensions of the lease at the lessor's option

provided that the lease term does not extend beyond the date a bargain purchase option becomes exercisable.

The lease term is considered to be noncancellable if cancellation is possible only

- upon the occurrence of some unlikely contingency;
- with permission of the lessor;
- upon the lessee entering into a new lease for the same or equivalent property with the same lessor; or
- upon payment by the lessee of a penalty sufficiently large that continuation of the lease appears, at the inception of the lease, reasonably assured.

*Lessee's rate for incremental borrowing.* The interest rate that, at the inception of the lease, the lessee would have incurred to borrow, over a similar term and with similar security for the borrowing, the funds necessary to purchase the leased asset.

*Minimum lease payments*

- From the point of view of the lessee, minimum lease payments comprise
  - the minimum rental payments called for by the lease over the lease term;
  - any partial or full guarantee, by the lessee or a third party related to the lessee, of the residual value of the leased property at the end of the lease term (when the lessee agrees to make up a deficiency in the

lessor's realization of the residual value below a stated amount, the guarantee to be included in the minimum lease payments is the stated amount rather than an estimate of the deficiency to be made up); and

- any penalty required to be paid by the lessee for failure to renew or extend the lease at the end of the lease term

provided that if the lease contains a bargain purchase option, only the total of the minimum rental payments over the lease term and the payment called for by the bargain purchase option is included in minimum lease payments. Lease payments that depend on factors measurable at the inception of the lease, such as the consumer price index or the prime interest rate, are not, in substance, contingent rentals in their entirety, and are included in the minimum lease payments based on the index or rate existing at the inception of the lease.

- From the point of view of the lessor, minimum lease payments comprise
  - minimum lease payments for the lessee as described previously and
  - any residual value or rental payments beyond the lease term guaranteed by a third party unrelated to either the lessee or lessor, provided that the guarantor is financially capable of discharging the obligations under the guarantee.

*Operating lease.* A lease in which the lessor does not transfer substantially all the benefits and risks incident to ownership of property.

*Residual value of the leased property.* The estimated fair value of the leased property at the end of the lease term.

*Sale-leaseback transaction.* The sale of property with the purchaser leasing the property back to the seller.

*Sales-type lease.* A lease that, from the point of view of the lessor, transfers substantially all the benefits and risks incident to ownership of property to the lessee and, at the inception of the lease, the fair value of the leased property is greater or less than its carrying amount, thus, giving rise to a profit or loss to the lessor (usually a manufacturer or dealer).

*Unguaranteed residual value.* That portion of the residual value of leased property that is not guaranteed or is guaranteed solely by a party related to the lessor.

## Classification

**22.04** This chapter classifies leases as follows:

- a. From the point of view of the lessee—capital and operating leases
- b. From the point of view of the lessor—sales-type, direct financing, and operating leases

**22.05** This chapter adopts the view that property has benefits and risks associated with its ownership. Benefits may be represented by the expectation of profitable operation

over the property's economic life and gain from appreciation in value or realization of a residual value. Risks include possibilities of losses from idle capacity or technological obsolescence and variations in return due to changing economic conditions. This chapter adopts the view that a lease that transfers substantially all the benefits and risks of ownership to the lessee is, in substance, an acquisition of an asset and an incurrence of an obligation by the lessee and a sale or financing by the lessor.

**22.06** From the point of view of a lessee, a lease normally transfers substantially all the benefits and risks of ownership to the lessee when, at the inception of the lease, one or more of the following conditions are present:

- a. It is reasonably probable that the lessee will obtain ownership of the leased property by the end of the lease term. Reasonably probable conditions exist when the terms of the lease result in ownership being transferred to the lessee by the end of the lease term or when the lease provides for a bargain purchase option, and management indicates it will most likely exercise that option.
- b. The lease term is of such a duration that the lessee will receive substantially all the economic benefits expected to be derived from the use of the leased property over its life span. Although the lease term may not be equal to the economic life of the leased property in terms of years, the lessee is normally expected to receive substantially all the economic benefits to be derived from the leased property when the lease term is equal to a substantial portion (usually 75 percent or more) of the economic life of the leased property. This is due to the fact that new equipment, reflecting later technology and in prime condition, may be assumed to be more efficient than old equipment that has been subject to obsolescence and wear.
- c. The lessor is assured of recovering the investment in the leased property and earning a return on the investment as a result of the lease agreement. This condition exists if the present value at the beginning of the lease term of the minimum lease payments, excluding any portion thereof relating to executory costs, is equal to substantially all (usually 90 percent or more) of the fair value of the leased property at the inception of the lease. In determining the present value, the discount rate used by the lessee is the lower of the lessee's rate for incremental borrowing and the interest rate implicit in the lease, if known.

In view of the fact that land normally has an indefinite useful life, it is not possible for the lessee to receive substantially all the benefits and risks associated with its ownership, unless there is reasonable assurance that ownership will pass to the lessee by the end of the lease term.

**22.07** From the point of view of a lessor, a lease normally transfers substantially all the benefits and risks of ownership to the lessee when, at the inception of the lease, all the following conditions are present:

- a. Any one of the conditions in paragraph 22.06.
- b. The credit risk associated with the lease is normal when compared to the risk of collection of similar receivables.

- c. The amounts of any nonreimbursable costs that are likely to be incurred by the lessor under the lease can be reasonably estimated. If such costs are not reasonably estimable, the lessor may retain substantial risks in connection with the leased property. For example, this may occur when the lessor has a commitment to guarantee the performance of, or to effectively protect the lessee from obsolescence of, the leased property.

When assessing whether the condition set out in paragraph 22.06(c) exists, the discount rate used by the lessor is the interest rate implicit in the lease.

**22.08** Other conditions have been advanced as evidence that substantially all the benefits and risks of ownership have been transferred to the lessee. The existence of any of the following conditions, by themselves, is not sufficient evidence that substantially all the benefits and risks of ownership have been transferred to the lessee:

- a. Lessee pays cost incident to ownership. This condition is considered inappropriate because in virtually all leasing agreements, the lessee will either directly or indirectly pay such costs.
- b. Lessee has the option to purchase the asset for the lessor's unrecovered investment. This condition is considered inappropriate because there is no assurance that the lessee will exercise the option.
- c. Leased property is special purpose to the lessee. This condition is considered insufficient because the concept of special purpose is relative and difficult to define. In addition, the fact that the leased property is special purpose does not, in itself, evidence a transfer of substantially all the benefits and risks of asset ownership. Although it is expected that most lessors lease special purpose property only under terms that transfer substantially all of those benefits and risks to the lessee, nothing in the nature of special purpose property necessarily entails such terms.
- d. Lessee records the lease as a capital lease for federal income tax purposes.

**22.09** A lease that transfers substantially all the benefits and risks of ownership related to the leased property from the lessor to the lessee should be accounted for as a capital lease by the lessee and as a sales-type or direct financing lease by the lessor.

**22.10** A lease in which the benefits and risks of ownership related to the leased property are substantially retained by the lessor should be accounted for as an operating lease by the lessee and lessor.

**22.11** A renewal, an extension, or a change in the provisions of an existing lease should be considered as a new lease and classified in accordance with paragraphs 22.09–.10 (for a renewal or extension of an existing sales-type lease, see paragraph 22.45).

**22.12** When the classification of a lease arising from a renewal, an extension, or a change in the provisions of an existing lease results in a capital lease being replaced by an operating lease, the asset and related obligation are removed from the accounts of the lessee. The net adjustment is included in income of the period. When the classification of the new lease is the same as the original lease, the asset and obligation related to the

original lease are adjusted to conform to the recalculated balances.

**22.13** When the classification of a lease arising from a renewal, an extension, or change in the provisions of an existing lease results in a sales-type or direct financing lease being replaced by an operating lease, the remaining net investment is removed from the accounts of the lessor and the leased asset recorded as an asset at the lower of its original cost, present fair value, or present carrying amount. The net adjustment is included in income of the period.

## **Accounting Treatment by a Lessee**

### **Method of Accounting for a Capital Lease**

**22.14** To report the total resources at the lessee's disposal and all aspects of the lessee's long-term obligations, a capital lease should be accounted for by the lessee as an acquisition of an asset and an assumption of an obligation.

**22.15** The lessee should account for a capital lease as an asset and an obligation.

**22.16** The asset value and the amount of the obligation recorded at the beginning of the lease term are the present value of the minimum lease payments, excluding the portion thereof relating to executory costs. The amount relating to executory costs included in the minimum lease payments are estimated if not known to the lessee. The interest rate implicit in the lease is affected by the residual value of the leased property in which the lessee usually has no interest. As a result, to use the interest rate implicit in the lease as the discount rate when it is higher than the lessee's rate for incremental borrowing would produce an amount that is less representative of the value of the asset to the lessee than would be obtained by using the lessee's rate for incremental borrowing as the discount rate. Therefore, the discount rate used by the lessee in determining the present value of minimum lease payments should be the lower of the lessee's rate for incremental borrowing and the interest rate implicit in the lease, if practicable to determine. Notwithstanding the foregoing, the maximum value recorded for the asset and obligation may not exceed the leased asset's fair value.

**22.17** The capitalized value of a depreciable asset under a capital lease should be amortized over the period of expected use on a basis that is consistent with the lessee's depreciation policy for other similar fixed assets (see chapter 20, "Property, Plant, and Equipment"). If the lease contains terms that allow ownership to pass to the lessee or a bargain purchase option, the period of amortization should be the economic life of the asset. Otherwise, the property should be amortized over the lease term.

**22.18** An obligation under a capital lease is similar to a loan. Lease payments should be allocated to a reduction of the obligation, interest expense, and any related executory costs. The interest expense is calculated using the discount rate used in computing the present value of the minimum lease payments applied to the remaining balance of the obligation.

**22.19** A lessee that has a liability to a lessor under a capital lease should remove the liability from its balance sheet when, and only when, it is extinguished (that is, when the

obligation specified in the lease is discharged or cancelled).

**22.20** Contingent rentals should be charged to expense as incurred.

### **Presentation of a Capital Lease**

**22.21** In order to distinguish between assets that the entity owns and those that it only has the right to use, assets leased under capital leases should be presented separately.

**22.22** Obligations related to leased assets should be presented separately from other long-term obligations.

**22.23** Any portion of lease obligations payable within a year out of current funds should be included in current liabilities.

### **Method of Accounting for an Operating Lease**

**22.24** Because most operating leases are short term, charging lease rentals to expense on a straight-line basis over the lease term, even if not payable in such a manner, would normally result in recognition of the expense in a manner that is representative of the time pattern in which the user derives benefit from the leased property. However, circumstances may indicate that another basis is required to achieve this result.

**22.25** The terms of a renegotiated lease are interdependent with those of the original lease. On renegotiation, a lessee should continue to account for the lease in accordance with the terms of the original lease contract until the original lease term expires. To the extent that the payments required under the renegotiated lease arrangement differ from those otherwise due under the original lease, the differences are considered to relate to the term of the lease extension.

**22.26** Payments under a residual value guarantee are included in lease rentals when it becomes likely that the lessee will be required to honor the guarantee because the estimated value of the property at the end of the lease term is less than the residual value guaranteed by the lessee.

**22.27** Lease inducements are an inseparable part of the lease agreement and, accordingly, are accounted for as reductions of the lease expense over the term of the lease.

**22.28** Lease rentals under an operating lease should be included in the determination of net income over the lease term on a straight-line basis unless another systematic and rational basis is more representative of the time pattern of the user's benefit.

## Accounting Treatment by a Lessor

### Method of Accounting for a Direct Financing Lease

**22.29** Direct financing leases normally arise when a lessor acts as a financing intermediary between a manufacturer or dealer and a lessee. Such leases give rise to income in the form of finance income.

**22.30** Finance income arising on a direct financing lease is composed of the difference between

- a. the total minimum lease payments, net of any executory costs and related profit included therein, plus any unguaranteed residual value of the leased property accruing to the lessor and
- b. the cost or carrying amount, if different, of the leased property.

**22.31** A lessor enters into a direct financing lease with the intention of earning a return on funds invested in the lease transaction. When assessing whether proposed terms of a lease will produce an acceptable return on the required investment, a lessor considers the pattern of cash flows associated with the lease transaction. In some instances, the pattern of cash flows will be significantly affected by the fact that income taxes will be reduced as a result of an investment tax credit or deferred as a result of capital cost allowances related to the leased property, or both. When income tax elements that affect the cash flow are predictable with reasonable assurance, it may be appropriate to take these elements into consideration in accounting for income from the lease.

**22.32** Deferral of income tax payments as a result of the lease is considered to be predictable with reasonable assurance when the following conditions are present:

- a. The lessor is reasonably assured of obtaining capital cost allowances on the leased property.
- b. Reasonable assurance exists that the lessor will have sufficient taxable income to make use of the capital cost allowance on the leased property.

**22.33** When income tax factors are taken into consideration in accounting for a direct financing lease, the lessor's initial and continuing investment in the lease, for purposes of income recognition, is the net of the balances of the following accounts:

- a. Minimum lease payments receivable less any executory costs and related profit included therein
- b. The unguaranteed residual value of the lease property accruing to the lessor
- c. Unearned finance income, after deducting initial direct costs, remaining to be allocated to income over the lease term
- d. The investment tax credit remaining to be allocated to income over the lease term

- e. Deferred income taxes as a result of the lease, when predictable with reasonable assurance

**22.34** When income tax factors are not taken into consideration in accounting for a direct financing lease, the lessor's initial and continuing investment in the lease, for purposes of income recognition, is the net balances of the accounts set out in paragraph 22.33(a)–(c).

**22.35** When a lease is a direct financing lease, initial direct costs should be expensed as incurred, and a portion of unearned income equal to the initial direct costs should be recognized in income in the same period. The remaining income should be deferred and taken into income over the lease term to produce a constant rate of return on the investment in the lease.

**22.36** The estimated residual value is reviewed annually to determine whether a decline in its value has occurred. If the decline in value is other than temporary, the accounting for the lease transaction should be revised using the changed estimate. The resulting reduction in the net investment in the lease is charged to income. An upward adjustment of the residual value is not made.

### **Method of Accounting for a Sales-Type Lease**

**22.37** Sales-type leases normally arise when a manufacturer or dealer uses leasing to effect a sale of its products. Such lease transactions give rise to two types of income: the initial profit or loss on the sale of the product at the inception of the lease and finance income over the lease term.

**22.38** The sales revenue recorded at the inception of a sales-type lease is the present value of the minimum lease payments net of any executory costs and related profit included therein, computed at the interest rate implicit in the lease. The cost of sale recognized at the inception of the lease is the cost or carrying value, if different, of the leased property reduced by the present value of the unguaranteed residual accruing to the lessor, computed at the interest rate implicit in the lease.

**22.39** Finance income arising from a sales-type lease is composed of the difference between

- a. total minimum lease payments, net of any executory costs and related profit included therein, plus any unguaranteed residual value of the leased property accruing to the lessor and
- b. the aggregate of their present values.

The discount rate for determining the present values is the interest rate implicit in the lease.

**22.40** When it is appropriate to take income tax factors into consideration in accounting for a sales-type lease, the lessor's initial and continuing investment in a sales-type lease, for purposes of income recognition, is the net of the balances of the accounts set out in paragraph 22.33(a)–(e).

**22.41** When income tax factors are not taken into consideration in accounting for a sales-type lease, the lessor's initial and continuing investment for purposes of recognizing unearned finance income in the lease is the net balances of the accounts set out in paragraph 22.33(a)–(c).

**22.42** Initial direct costs are considered to be incurred in order to produce the sale; therefore, they are recognized as an expense at the inception of the lease.

**22.43** When a lease is a sales-type lease, a sale should be recorded with the manufacturer's or dealer's profit or loss being recognized at the time of the transaction. Initial direct costs should be expensed at the inception of the lease, and unearned finance income should be deferred and taken into income over the lease term to produce a constant rate of return on the investment in the lease.

**22.44** The estimated residual value is reviewed annually to determine whether a decline in its value has occurred. If the decline in value is other than temporary, the accounting for the lease transaction should be revised using the changed estimate. The resulting reduction in the net investment in the lease is charged to income. An upward adjustment of the residual value is not made.

**22.45** Providing it transfers substantially all the benefits and risks of ownership related to the leased property, from the lessor to the lessee, a renewal or an extension of an existing sales-type lease should be classified as a direct financing lease because the manufacturer's or dealer's profit will have been recognized at the inception of the original lease.

## **Impairment**

**22.46** At the end of each reporting period, management should assess whether there are any indications that each direct financing, sales-type lease, operating lease receivables (the lease asset), or group of similar lease assets, is impaired. When there is an indication of impairment, management should determine whether a significant adverse change has occurred during the period in the expected timing or amount of future cash flows from the lease asset or group of assets.

**22.47** Lease assets that are individually significant are assessed individually for impairment. Other lease assets are assessed for impairment either individually or grouped on the basis of similar credit risk characteristics. Group assessment might be appropriate when available information is not sufficient to permit identification of each of the individual assets within a group that is impaired, or numerous assets are affected by the same factors. For example, an entity might collectively evaluate customers that operate in a particular industry or geographic region or that share other identifiable common characteristics.

**22.48** Indicators of impairment include

- a. significant financial difficulty of the lessee;
- b. a breach of contract, such as a default or delinquency in payment;

- c. the entity granting a concession to the lessee;
- d. it becoming probable that the lessee will enter bankruptcy or other financial reorganization; and
- e. a significant adverse change in the technological, market, economic, or legal environment in which the lessee operates. (For example, a sharp decline in the price of a commodity may cause economic instability in the lessee's industry or have an adverse effect on other entities in a region that is dependent on the lessee's industry.)

**22.49** When management identifies a significant adverse change in the expected timing or amount of future cash flows from a lease asset, or group of similar lease assets, it should reduce the carrying amount of the asset, or group of assets, to the highest of the following:

- a. The present value of the cash flows expected to be generated by holding the lease asset, discounted using a current market rate of interest appropriate to the asset
- b. The amount that could be realized by selling the lease at the balance sheet date
- c. The amount the entity expects to realize by exercising its rights to the leased property net of all costs necessary to exercise those rights

The carrying amount of the lease asset, or group of assets, should be reduced directly or through the use of an allowance account. The amount of the reduction should be recognized as an impairment loss in net income.

**22.50** When the extent of impairment of a previously written down asset, or group of assets, decreases and the decrease can be related to an event occurring after the impairment was recognized (such as a return to profitability of the lessee), the previously recognized impairment loss should be reversed to the extent of the improvement. The adjusted carrying amount of the lease asset, or group of assets, should be no greater than the amount that would have been reported had the impairment not been recognized previously. The amount of the reversal should be recognized in net income in the period the reversal occurs.

### **Presentation of a Direct Financing or Sales-Type Lease**

**22.51** The result of these types of lease transactions is to create a long-term receivable, although the lessor may also hold an interest in the residual value of an asset under lease. As a consequence, the net investment in the lease is considered to be distinct from other assets and presented separately.

**22.52** For purposes of statement presentation, the lessor's net investment in the lease includes

- a. the minimum lease payments receivable less any executory costs and related profit included therein; plus

- b. any unguaranteed residual value of the leased property accruing to the lessor; less
- c. unearned finance income remaining to be allocated to income over the lease term.

**22.53** When income tax factors have been considered in accounting for a direct financing or sales-type lease, any unamortized investment tax credit should either be deducted in computing the net investment in the lease or shown as a deferred credit. Deferred income taxes, if any, relating to the net investment in the lease are presented separately from the net investment in accordance with paragraph 29.66.

**22.54** The lessor's net investment in direct financing and sales-type leases should be segregated between current and long-term portions in a classified balance sheet.

### **Method of Accounting for an Operating Lease**

**22.55** Rental revenue from an operating lease should be recognized as income over the term of the lease as it becomes due. However, if rentals vary from a straight-line basis, the income should be recognized on a straight-line basis unless another systematic and rational basis is more representative of the time pattern in which the benefit from the leased property is utilized.

**22.56** When initial direct costs are associated with a specific lease agreement, the costs are applicable to all revenue earned during the lease term and should be deferred and amortized over the lease term in proportion to the recognition of rental income.

### **Participation by a Third Party**

**22.57** The terms of either an assignment of lease payments due under an operating lease or a sale of property that is already, or that is intended to be, subject to an operating lease may result in the assignee or purchaser being given an effective guarantee that the investment will be recovered. For example, this may be evidenced by the fact that the terms of the transaction provide that in the case of default by the lessee or termination of the lease, the seller must reacquire the property, substitute an existing lease, or give priority to securing a replacement lessee or buyer under a remarketing agreement. When the substance of a transaction is such that the purchaser looks to the seller rather than to the property or lease in order to recover his investment, the transaction is regarded as a secured loan by both parties because the seller or assignor has retained substantial risks of ownership.

**22.58** An assignment of lease payments due under an operating lease or a sale of property that is already, or that is intended to be, subject to an operating lease should be accounted for as a loan whenever the assignor or seller retains substantial risks of ownership in connection with the leased property.

**22.59** When a sale of property that is already, or that is intended to be, subject to an operating lease is classified as a secured loan, the seller should record the proceeds of sale as a loan. The interest rate applicable to the loan is that which an unrelated lender

would negotiate with the lessor for a loan under similar terms and conditions. Until the loan is paid, the seller records as revenue rental payments made by the lessee, even if such rentals are paid directly to the third party purchaser, and records as interest expense an appropriate portion of each rental payment with the remainder reducing the amount of the loan. The asset is depreciated over the amortization period of the loan. The assignment by the lessor of lease payments due under an operating lease should be accounted for as a loan.

**22.60** A sale of property already subject to a sales-type or direct financing lease or an assignment of lease payments due under a sales-type or direct financing lease does not negate the original accounting treatment of the lease.

## **Subleases**

**22.61** When leased property is subleased by the original lessee to a third party, the sublease is evaluated by both parties in accordance with paragraphs 22.09–.10. There is no effect on the accounting treatment of the obligation under the original lease.

## **Sale-Leaseback Transaction**

**22.62** A sale-leaseback transaction involves the sale of property with the purchaser concurrently leasing the same property back to the seller.

**22.63** In a sale-leaseback transaction, the lease should be accounted for as a capital, direct financing, or operating lease, as appropriate, by the seller-lessee and by the purchaser-lessor.

**22.64** In view of the interdependence of the terms and the inability to objectively and practically separate the sale and lease, any profit or loss arising on the sale is generally deferred and taken to income over the lease term. However, when the leaseback is of a portion of the remaining use of the property sold, it may be possible to separate the accounting aspects of the terms of the sale and the lease. The "portion" may be a part of the property, such as one floor of an office tower, or may consist of a portion of the property's remaining economic life, such as 3 years of an estimated life of 10 years. In substance, such a leaseback is not a lease of the same property as that sold to the purchaser-lessor.

**22.65** Except as noted in paragraph 22.69 when the leaseback is classified as a capital lease, any profit or loss arising on the sale should be deferred and amortized in proportion to the amortization of the leased asset, except for leases involving land only, in which case, it should be amortized over the lease term on a straight-line basis.

**22.66** Except as noted in paragraph 22.69, when the leaseback is classified as an operating lease, any profit or loss arising on the sale should be deferred and amortized in proportion to rental payments over the lease term.

**22.67** When the seller-lessee retains the right to only a minor portion of the property sold, the sale and leaseback is accounted for as separate transactions based on their respective terms. The entire gain or loss is included in the determination of net income at

the date of the sale unless the amount of rentals called for by the lease is unreasonable under market conditions at the inception of the lease. In these circumstances, an appropriate amount is deferred or accrued by adjusting the profit or loss on the sale and amortized to adjust those rentals to a reasonable amount. If the present value of the minimum lease payments represents 10 percent or less of the fair value of the asset sold, the seller-lessee could be presumed to have transferred to the purchaser-lessor the right to substantially all the remaining use of the property sold, and the seller-lessee could be presumed to have retained only a minor portion of such use.

**22.68** When the seller-lessee retains the right to more than a minor portion of the property but less than substantially all the property, the amount of the gain or loss included in the determination of net income immediately is equal to the excess, if any, of the gain on sale over

- a. the present value of the minimum lease payments over the lease term, if the leaseback is classified as an operating lease or
- b. the recorded amount of the leased asset, if the leaseback is classified as a capital lease.

**22.69** When, at the time of the sale-leaseback transaction, the fair value of the property is less than its carrying value, the difference should be recognized as a loss immediately.

## **Leases Involving Land and Buildings**

**22.70** Under a capital lease, the terms of which allow ownership to pass or provide for a bargain purchase option, a lessee should capitalize the land separately from building(s) in proportion to their fair values at the inception of the lease.

**22.71** When a lease involving land and building(s) does not contain terms that allow ownership to pass or provide for a bargain purchase option, and the fair value of land at the inception of the lease is minor in relation to the total fair value of the leased property, the land and the building(s) are considered a single unit for the purposes of classification of the lease. The economic life of the building(s) is considered the economic life of the unit.

**22.72** When a lease involving land and building(s) does not contain terms that allow the ownership to pass or provide for a bargain purchase option, and the fair value of land at the inception of the lease is significant in relation to the total fair value of the leased property, the land and building(s) are considered separately for purposes of classification. The lessee and lessor allocate the minimum lease payments between the land and building(s) in proportion to their fair values. Both parties classify the portion of the lease applicable to land as an operating lease.

## **Disclosure**

### **Capital Lease—Lessee**

**22.73** For each major category of leased property, plant, and equipment, there should be

disclosure of

- a.* cost;
- b.* accumulated amortization, including the amount of any write-downs; and
- c.* the amortization method used, including the amortization period or rate.

**22.74** For an obligation under a capital lease, an entity should disclose

- a.* the interest rate;
- b.* the maturity date;
- c.* the amount outstanding; and
- d.* if the leases are secured, the fact that they are secured.

**22.75** Interest expense related to lease obligations should be disclosed separately or as part of interest on long-term indebtedness.

**22.76** The aggregate amount of payments estimated to be required in each of the next five years to meet repayment, sinking fund, or retirement provisions should be disclosed.

### **Operating Lease—Lessee**

**22.77** Disclosure should be made of the future minimum lease payments in the aggregate and for each of the five succeeding years under operating leases. The nature of other commitments under such leases should also be described. Leases with an initial term of one year or less may be excluded from this disclosure requirement.

### **Direct Financing or Sales-Type Lease—Lessor**

**22.78** The lessor's net investment in direct financing and sales-type leases should be disclosed along with the interest rates implicit in the leases.

**22.79** An entity should disclose the carrying amount of impaired direct financing and sales-type leases and the amount of any related allowance for impairment.

### **Operating Lease—Lessor**

**22.80** Disclosure should be made of the cost of property, plant, and equipment held for leasing purposes and the amount of accumulated amortization.

**22.81** An entity should disclose the carrying amount of impaired operating lease receivables and the amount of any related allowance for impairment.

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## Chapter 23—Equity

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### Purpose and Scope

**23.01** This chapter establishes principles for the presentation of equity, changes in equity during the reporting period, and capital transactions. It also establishes principles for the acquisition and redemption of shares and disclosure of capital stock. This chapter establishes principles for the presentation and disclosure of the equity and capital accounts of unincorporated businesses, partnerships, and limited liability entities.

**23.02** Capital transactions include items such as

- a.* changes in capital, including premiums, discounts, and expenses relating to the issue, redemption, or cancellation of capital stock;
- b.* gains or losses
  - i.* on purchase and resale by a company of its own issued common shares or
  - ii.* on purchase and cancellation by a company of its own issued common shares;
- c.* contributions by owners or others;
- d.* dividends (including stock dividends);
- e.* distributions—cash and property; and
- f.* taxes arising at the time of changes in shareholder status or capital stock transactions (see paragraphs 29.09 and 29.54–.60).

Paragraph 32.21 determines whether a transaction involving a financial instrument is a capital transaction.

### Definitions

**23.03** The following terms are used in this chapter with the meanings specified:

*Additional paid-in capital.* Comprises amounts paid in by equity holders. Additional paid-in capital in the form of excess paid in by equity holders includes premiums on shares issued, any portion of the proceeds of issue of shares without par value not allocated to capital stock, gain on forfeited shares, proceeds arising from shares donated by equity holders, credits resulting from redemption or conversion of shares at less than the amount set up as capital stock, and any other contribution by equity holders in excess of amounts allocated to capital stock.

*Equity.* The residual interest in the assets of the entity after deducting all of its liabilities.

*Noncontrolling interest.* The equity in a subsidiary not attributable, directly or indirectly, to a parent (see chapter 13, “Consolidated Financial Statements and Noncontrolling Interests”).

*Retained earnings.* Comprise the accumulated balance of income less losses arising from the operation of the business after taking into account dividends and other amounts that may properly be charged or credited thereto. When the accumulation is a negative figure, the single word "deficit" is a suitable designation.

## **Acquisition or Redemption of Shares**

**23.04** When a company redeems or acquires its own shares, the cost will usually be different from their par, stated, or assigned values. Because such transactions are clearly capital transactions, this difference will be excluded from the determination of net income.

### **Acquisition of Shares**

**23.05** This chapter allows two methods of accounting for the acquisition by an entity of its own shares: the cost method and the constructive retirement method.

**23.06** Under the cost method, the acquired shares should be carried at cost and shown as a deduction from shareholders' equity (contra-equity/treasury stock account) until cancelled, retired, or resold. Shares held are considered to be issued capital for purposes of paragraph 23.29. No adjustment is made to capital stock and related accounts that were credited upon original issuance.

**23.07** Under the constructive retirement method, the aggregate par or stated value of the reacquired shares are charged to the capital stock account rather than a treasury stock account. An excess of repurchase price over par or stated value is allocated between additional paid-in capital and retained earnings.

**23.08** When a subsidiary acquires its own shares from interests outside the consolidated group, the accounting treatment to be followed in the parent company's consolidated financial statements is outlined in chapter 13.

### **Resale of Acquired Shares**

**23.09** When a company acquires its own shares and subsequently resells them, no part of the proceeds is taken into income.

**23.10** Under the cost method, when an entity resells shares that it has acquired, the treasury stock account is credited, and any excess of the proceeds over cost should be credited to additional paid-in capital; any deficiency should be charged to additional paid-in capital to the extent that a previous net excess from resale or cancellation of shares of the same class is included therein, otherwise, to retained earnings.

**23.11** Under the constructive retirement method, when an entity resells shares that it has acquired, they are treated as if they were an original issue. Capital stock and additional

paid-in capital are credited with the appropriate amounts.

### **Retirement or Cancellation of Shares**

**23.12** When an entity retires or cancels shares that it has acquired, the accounting depends on the method that was used to reacquire the shares. If the cost method was used, the treasury stock account is credited, and the cost is allocated to the capital stock and related accounts (for example, additional paid-in capital). If the constructive retirement method was used, no further accounting would be necessary if those reacquired shares are retired or cancelled.

### **Dividends**

**23.13** Because a company cannot own a part of itself, it cannot receive dividend income on its own shares.

**23.14** When a company has acquired its own shares and such shares have not been cancelled, any dividends otherwise payable with respect to these shares should be treated as a reduction of dividends and should not be reflected as income by the company.

### **Presentation**

**23.15** An entity should present separately changes in equity for the period arising from each of the following:

- a.* Net income, showing separately the total amounts attributable to owners of the parent and to noncontrolling interests (see chapter 13)
- b.* Other changes in retained earnings
- c.* Changes in additional paid-in capital
- d.* Changes in capital stock
- e.* Other changes in equity

**23.16** An entity should present separately the following components of equity:

- a.* Retained earnings
- b.* Additional paid-in capital
- c.* Capital stock
- d.* Noncontrolling interests (see chapter 13)
- e.* Other components of equity

**23.17** The financial statements of unincorporated businesses and partnerships should include a statement setting out the details of the changes in the owners' equity during the period, and this statement should set out separately contributions of capital, income or losses, and withdrawals.

**23.18** It is important to understand the nature and amounts of those different types of

gains and losses that are included directly in equity. Therefore, this chapter requires an entity to present a separate component of equity for each category of equity.

**23.19** Charges against additional paid-in capital should be limited to instances when that disposition is clearly warranted by the circumstances, such as a charge that is the direct opposite of a credit previously carried to additional paid-in capital.

**23.20** An entity may receive a note, rather than cash, for the purchase of its equity. The transaction may be a sale of capital stock (or its equivalent in an unincorporated entity) or a contribution to paid-in capital. Reporting the note as an asset is generally not appropriate, except in very limited circumstances in which there is substantial evidence of ability and intent to pay within a reasonably short period of time. Consequently, the note should ordinarily be offset against stock in the equity section. However, such notes may be recorded as an asset if collected in cash before the financial statements are available to be issued.

**23.21** Preferred shares issued in certain tax planning arrangements that are classified as equity in accordance with chapter 32, "Financial Instruments and Long-Term Debt," are presented in accordance with the requirements of that chapter.

**23.22** Capital transactions should be excluded from the determination of net income and shown separately in the statement to which they relate (at least for the year in which the transactions occur).

**23.23** For unincorporated businesses, when the owners engage in other business or investment activities not included in the financial statements, it may be necessary to give sufficient details of the nature of the business to distinguish it from such other activities. This information may be included in the headings of the financial statements or set out by way of note.

**23.24** The financial statements of an unincorporated business should indicate clearly the name under which the business is conducted.

**23.25** Any salaries, interest, or similar items accruing to owners of an unincorporated business should be clearly indicated by showing such items separately, either in the body of the statement of income or in a note to the financial statements. If no such charges are made in the accounts of an unincorporated business, this fact should be disclosed in the financial statements.

## **Disclosure**

**23.26** When there is a condition restricting or affecting the distribution of retained earnings, the nature and extent thereof should be disclosed.

**23.27** An entity with one or more stock-based compensation plans should provide a description of the plan(s), including the general terms of awards under the plan(s), such as vesting requirements, and the maximum term of options granted. An entity that uses equity instruments to acquire goods or services other than employee services should provide disclosures similar to those in accordance with this paragraph to the extent that

those disclosures are important in understanding the effects of those transactions on the financial statements.

**23.28** An entity that grants options under multiple, stock-based employee compensation plans should provide information separately for different types of awards to the extent that the differences in the characteristics of the awards make separate disclosure important to an understanding of the entity's use of stock-based compensation.

**23.29** Disclosure should be made of authorized and issued capital stock, including

- a.* the number of shares for each class, giving a brief description and the par value, if any;
- b.* dividend rates on preference shares and whether or not they are cumulative;
- c.* the redemption price of redeemable shares;
- d.* the existence and details of conversion provisions;
- e.* the number of shares and the amount received or receivable that is attributable to capital for each class (when any shares have not been fully paid, disclosure should be made of the amounts that have not been called and the unpaid amounts that have been called or are otherwise due, as well as the number of shares in each of these categories); and
- f.* arrears of dividends for cumulative preference shares.

**23.30** Disclosure should be made of the number of shares of capital stock authorized.

**23.31** Disclosure should be made of commitments to issue or resell shares.

**23.32** Disclosure should be made of details of transactions during the period, including

- a.* the number of shares of each class issued since the date of the last balance sheet, indicating the value attributed thereto and distinguishing shares issued for cash (showing separately shares issued pursuant to options or warrants), shares issued directly or indirectly for services, and shares issued directly or indirectly for other considerations;
- b.* the number of shares of each class redeemed or acquired since the date of the last balance sheet and the consideration given and, when the consideration was other than cash, the nature of the consideration given and the value attributed thereto; and
- c.* the number of shares of each class resold since the date of the last balance sheet, indicating the value attributed thereto and distinguishing shares resold for cash (showing separately shares resold pursuant to options or warrants), shares resold directly or indirectly for services, and shares resold directly or indirectly for other considerations.

**23.33** The fact that a business is unincorporated and that the statements do not include all the assets, liabilities, revenues, and expenses of the owners should be disclosed.

## Limited Liability Entities

**23.34** A limited liability entity should present information related to changes in owners' (members') equity for the period. This information may be presented as a separate statement, combined with the statement of income, or in the notes to financial statements.

**23.35** The equity section in the balance sheet of a limited liability entity should be titled owners' (or members') equity. If more than one class of members exists, each having varying rights, preferences, and privileges, the limited liability entity is encouraged to report the equity of each class separately within the equity section.

**23.36** If a limited liability entity records amounts due from owners for capital contributions, such amounts should be presented as deductions from owners' equity.

**23.37** Even though an owner's liability may be limited, if the total balance of the owners' equity account or accounts is less than zero, a deficit should be reported in the balance sheet.

### Disclosure

**23.38** If a limited liability entity does not report the amount of equity of each class of owners (members) separately within the equity section, it should disclose those amounts in the notes to financial statements.

**23.39** If a limited liability entity maintains separate accounts for components of owners' equity (for example, undistributed earnings, earnings available for withdrawal, or unallocated capital), disclosure of those components, either on the face of the balance sheet or in the notes to financial statements, is permitted.

**23.40** Significant differences in the rights, preferences, and privileges of different classes of members should be disclosed.

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## Chapter 24—*Subsequent Events*

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### Purpose and Scope

**24.01** This chapter establishes recognition and disclosure principles for events subsequent to the financial statement date.

**24.02** Financial statements are prepared to reflect the financial position at a particular date and the operating results and cash flows for a period ended on that date. However, events occurring after the financial statement date may indicate a need to adjust items or to make specific disclosures in those statements. Therefore, in preparing financial statements, the implications and financial effects of subsequent events should be considered.

**24.03** The period during which subsequent events are considered will depend on the management structure and procedures followed in completing the financial statements. The appropriate cut-off point for subsequent events is a matter of judgment, taking into account the particular circumstances and reporting requirements.

**24.04** In general, there are two types of subsequent events:

- a. Those that provide further evidence of conditions that existed at the financial statement date
- b. Those that are indicative of conditions that arose subsequent to the financial statement date

The extent to which, and the manner in which, the effect of a subsequent event is reflected in the financial statements will depend on its type.

**24.05** The effect of subsequent events may be so pervasive, however, that the viability of the whole, or a part, of the business of the entity is brought into question. A rapid deterioration in operating results or financial position after the date of the financial statements may indicate a need to consider whether it is proper to use the going concern assumption.

### Accounting Treatment

**24.06** Subsequent events may provide additional information relating to items included in the financial statements and may reveal conditions existing at the financial statement date that affect the estimates involved in the preparation of financial statements. All such information that becomes available prior to completion of the financial statements should be used in evaluating the estimates made, and the financial statements should be adjusted where necessary. For example, the institution of bankruptcy proceedings against a debtor subsequent to the date of the financial statements may be indicative of the underlying financial situation of the debtor at the date of the financial statements. If the provision for that debt was inadequate, adjustment of the financial statements is required.

**24.07** Financial statements should be adjusted when events occurring between the date of the financial statements and the date the financial statements are available to be issued provide additional evidence relating to conditions that existed at the date of the financial statements.

**24.08** Financial statements are available to be issued when

- a.* a complete set of financial statements, including all required note disclosures, has been prepared (see paragraphs 2.10–.12);
- b.* all final adjusting journal entries have been reflected in the financial statements (for example, adjustments for income taxes and bonuses);
- c.* no changes to the financial statements are planned or expected; and
- d.* the financial statements meeting the preceding requirements have been approved in accordance with the entity's process to finalize its financial statements.

**24.09** Adjustment of the financial statements for subsequent events is not appropriate if such events do not relate to conditions existing at the financial statement date. To reflect the effect of such events would not be consistent with the concept that a balance sheet represents the financial position of an entity at the financial statement date.

**24.10** Financial statements should not be adjusted for those events occurring between the date of the financial statements and the date the financial statements are available to be issued that do not relate to conditions that existed at the date of the financial statements.

## **Disclosure**

**24.11** Disclosure should be made of the date through which subsequent events have been evaluated and the fact that this is the date that the financial statements were available to be issued.

**24.12** Disclosure should be made of those events occurring between the date of the financial statements and the date the financial statements are available to be issued that do not relate to conditions that existed at the date of the financial statements but

- a.* cause significant changes to assets or liabilities in the subsequent period or
- b.* will, or may, have a significant effect on the future operations of the entity.

**24.13** At a minimum, the disclosure should include

- a.* a description of the nature of the event and
- b.* an estimate of the financial effect, when practicable, or a statement that such an estimate cannot be made.

**24.14** Some events occurring after the financial statement date may have a significant effect, in a subsequent period, on the assets and liabilities or future operations of an entity, and disclosure could be important to users in their interpretation of the financial

statements. Examples of such events that would not require adjustment of the financial statements but, if significant in their effect, would require disclosure in notes to the financial statements include

- a.* an event, such as a fire or flood, that results in a loss;
- b.* a decline in the market value of investments;
- c.* purchase of a business;
- d.* commencement of litigation when the cause of action arose subsequent to the date of the financial statements;
- e.* changes in foreign currency exchange rates; and
- f.* the issue of capital stock or long-term debt.

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## **Chapter 25—Commitments**

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### **Purpose and Scope**

**25.01** This chapter establishes disclosure principles in respect of commitments.

### **Disclosure**

**25.02** Particulars of any commitments that are significant in relation to the current financial position or future operations should be disclosed. These would include significant obligations of the following types:

- a.* Commitments that involve a high degree of speculative risk, when the taking of such risks is not inherent in the nature of the business
- b.* Commitments to make expenditures that are abnormal in relation to the financial position or usual business operations (for example, commitments for substantial fixed asset expenditures)

**25.03** For commitments involving related parties, see also chapter 31, “Related Party Transactions.” (With reference to disclosures about guarantees, see also chapter 26, “Contingencies.”)

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## Chapter 26—Contingencies

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### Purpose and Scope

**26.01** This chapter establishes principles for the treatment of contingencies in financial statements. The issues discussed concern both the accrual for, and the disclosure of, contingencies in presenting the financial position and results of operations of an entity. (With reference to contingencies involving related parties, see also chapter 31, “Related Party Transactions.”)

**26.02** Contingencies would include, but are not limited to, pending or threatened litigation, threat of expropriation of assets, guarantees of the indebtedness or performance of others, and possible liabilities arising from discounted bills of exchange or promissory notes.

**26.03** In the preparation of the financial statements of an entity, estimates are required for many ongoing and recurring activities. However, the mere fact that an estimate is involved does not, of itself, constitute the type of uncertainty that characterizes a contingency. For example, amounts owed for goods or services received but not billed are not contingencies, even though the amounts may be estimated. There is nothing uncertain about the fact that these obligations have been incurred; any uncertainty is related solely to the amounts thereof.

**26.04** Although allowances for impaired loans and doubtful accounts (see chapter 32, “Financial Instruments and Long-Term Debt”), as well as nondiscretionary vendor rebates and provisions for warranties, have many of the characteristics of contingencies, such estimates are not usually regarded as contingencies, and for the purposes of this chapter, are excluded.

### Definition

**26.05** The following terms are used in this chapter with the meanings specified:

*Asset retirement obligation.* A legal obligation associated with the retirement of a tangible long-lived asset that an entity is required to settle as a result of an existing or enacted law, statute, ordinance, or written or oral contract or by legal construction of a contract under the doctrine of promissory estoppel. (*Promissory estoppel* is the legal principle that a promise or assurance made without consideration may, nonetheless, be enforced to prevent injustice when the promise or assurance was intended to affect a contract or other legal relationship between the promisor and the promisee and to be acted on, and the promisee acted on the promise or assurance or in some way changed its position.)

*Asset retirement cost.* The amount that is capitalized and increases the carrying amount of a long-lived asset when a liability for an asset retirement obligation is recognized.

*Accretion expense.* The increase in the carrying amount of an asset retirement obligation due to the passage of time.

*Contingency.* An existing condition or situation involving uncertainty about possible gain or loss to an entity that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability.

*Retirement.* Retirement of a long-lived asset is its other-than-temporary removal from service, including its sale, abandonment, recycling, or disposal in some other manner, but not its temporary idling.

## Measurement of Uncertainty

**26.06** The uncertainty relating to the occurrence or nonoccurrence of the future event(s), which determines the outcome of a contingency, can be expressed by a range of probabilities that provide a basis for establishing the appropriate accounting treatment. This chapter identifies three areas of this range by a general description as follows:

- *Probable.* The chance of the occurrence (or nonoccurrence) of the future event(s) is high.
- *Remote.* The chance of the occurrence (or nonoccurrence) of the future event(s) is slight.
- *Reasonably possible.* The chance of the occurrence (or nonoccurrence) of the future event(s) is more than remote but less than likely.

**26.07** Prediction of the outcome of contingencies, including estimation of the financial effects, is a matter for judgment by those responsible for preparing financial statements, taking into account the particular circumstances. In identifying contingencies and determining their amount, consideration should be given to all information available prior to completion of the financial statements (see chapter 24, “Subsequent Events”), supplemented by experience in similar transactions and, in some cases, reports from independent experts.

## Accounting Treatment

### Contingent Losses

**26.08** The treatment of contingent losses in financial statements depends upon the likelihood that a future event will confirm that an asset had been impaired or liability incurred at the financial statement date.

**26.09** The amount of a contingent loss should be accrued in the financial statements by a charge to income when both of the following conditions are met:

- a. It is probable that a future event will confirm that an asset had been impaired or a liability incurred at the date of the financial statements.

*b.* The amount of the loss can be reasonably estimated.

**26.10** If it is probable that a contingency existing at the financial statement date will result in a loss, accrual of its financial effects is required. This accounting treatment recognizes that the probable impairment of an asset or incurrence of a liability is related to a condition or situation existing at the end of the reporting period and not to the confirming future event.

**26.11** The appropriateness of accruing the effects of a contingent loss would be influenced by the extent to which the amount of the loss is known or can be reasonably estimated. If a reasonable estimate cannot be made, accrual could result in the inclusion in the financial statements of amounts so uncertain as to impair the integrity of those statements.

**26.12** A probable loss to an entity may be reduced or avoided by a counterclaim or a claim against a third party. In such a case, the amount of the likely recovery is an element of the likely loss and, therefore, should be taken into account in determining the amount to be recognized in the statement of income. However, if the probability of success in the related action is less than likely, a potential recovery should not be taken into account.

**26.13** The estimation of the amount of a contingent loss to be accrued in the financial statements may be based on information that provides a range of the amount of loss. When a particular amount within such a range appears to be a better estimate than any other, that amount should be accrued. However, when no amount within the range is indicated as a better estimate than any other, the minimum amount in the range should be accrued.

### **Contingent Gains**

**26.14** Contingent gains should not be accrued in financial statements because this accounting treatment could result in the recognition of revenue that might never be realized.

## **Disclosure**

### **Contingent Losses**

**26.15** The existence of a contingent loss at the date of the financial statements should be disclosed in notes to the financial statements when

- a.* the occurrence of the confirming future event is probable, but the amount of the loss cannot be reasonably estimated;
- b.* the occurrence of the confirming future event is probable, and an accrual has been made, but there exists an exposure to loss in excess of the amount accrued; or
- c.* the occurrence of the confirming future event is reasonably possible.

**26.16** At a minimum, the note disclosure should include

- a. the nature of the contingency;
- b. an estimate of the amount of the contingent loss or a statement that such an estimate cannot be made; and
- c. any exposure to loss in excess of the amount accrued.

**26.17** Users of financial statements should be advised of conditions or situations existing at the end of a reporting period when management considers that the probability of realization of a loss or incurrence of a liability is likely or reasonably possible. Such information is important in evaluating the future prospects of an entity.

### **Contingent Gains**

**26.18** When it is probable that a future event will confirm that an asset had been acquired or a liability reduced at the date of the financial statements, the existence of a contingent gain should be disclosed in notes to the financial statements.

**26.19** At a minimum, the note disclosure should include

- a. the nature of the contingency and
- b. an estimate of the amount of the contingent gain or a statement that such an estimate cannot be made.

**26.20** Disclosure of the existence of a contingent gain that is considered likely to be realized provides useful information and, therefore, should be included in a note to the financial statements. However, it is necessary to exercise particular care in the disclosure of contingent gains to avoid a misleading implication about the likelihood of realization. It is not appropriate to disclose the existence of a contingent gain that is unlikely to be realized.

### **Asset Retirement Obligations**

**26.21** This section establishes principles for the recognition, measurement, and disclosure of liabilities for asset retirement obligations and the associated asset retirement costs.

**26.22** This section applies to legal obligations associated with the retirement of a tangible long-lived asset that result from its acquisition, construction, development, or normal operation. This section covers the obligations of both lessors and lessees in connection with leased assets, whether imposed by a lease agreement or by a party other than the lessor, except for those obligations of a lessee that meet the definition of either *minimum lease payments* or *contingent rentals* in chapter 22, “Leases,” and are accounted for in accordance with that chapter. This section also covers obligations arising in connection with leasing and other agreements concerning the rights to explore for or exploit natural resources, to which chapter 22 does not apply. This section does not apply to

- a. obligations that arise solely from a plan to sell, or otherwise dispose of, a long-lived asset subject to chapter 30, “Disposal of Long-Lived Assets and Discontinued Operations,” and

- b. obligations that result from the improper operation of an asset.

## **Recognition**

**26.23** An entity should recognize a liability for an asset retirement obligation in the period in which it is incurred when a reasonable estimate of the amount of the obligation can be made. If a reasonable estimate of the amount of the obligation cannot be made in the period the asset retirement obligation is incurred, the liability should be recognized when a reasonable estimate of the amount of the obligation can be made. Only a legal obligation associated with the retirement of a tangible long-lived asset, including an obligation created by promissory estoppel, establishes a clear duty or responsibility to another party that justifies recognition of a liability.

**26.24** Various accounting principles deal with uncertainty in different ways. This section provides a measurement technique to deal with uncertainties about the amount and timing of the future cash flows necessary to settle a liability. This section requires that all asset retirement obligations within its scope be recognized when a reasonable estimate of the amount of the obligation can be made.

**26.25** When a tangible long-lived asset with an existing asset retirement obligation is acquired, a liability for that obligation is recognized at the asset's acquisition date as if that obligation were incurred on that date.

## **Measurement**

**26.26** The amount recognized as an asset retirement obligation should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date.

**26.27** The best estimate of the expenditure required to settle the present obligation is the amount that an entity would rationally pay to settle the obligation at the balance sheet date or to transfer it to a third party at that time. It will often be impossible or prohibitively expensive to settle or transfer an obligation at the balance sheet date. Therefore, the estimate of the amount that an entity would rationally pay to settle or transfer the obligation is reported.

**26.28** The estimate of the expenditure required to settle the present obligation is determined by the judgment of the management of the entity, supplemented by experience of similar transactions and, in some cases, reports from independent experts.

**26.29** Future events that may affect the amount required to settle an obligation are reflected in its measurement when there is sufficient, objective evidence that they will occur. Expected future events may be particularly important in measuring an asset retirement obligation. For example, an entity may believe that the cost of cleaning up a site at the end of its life will be reduced by future changes in technology. The amount recognized reflects a reasonable expectation of technically qualified, objective observers, taking account of all available evidence about the technology that will be available at the time of the clean-up. Thus, it is appropriate to include expected cost reductions associated with increased experience in applying existing technology, or the expected cost of applying existing technology, to a larger

or more complex clean-up operation than has previously been carried out. However, an entity does not anticipate the development of a completely new technology for cleaning up unless it is supported by sufficient, objective evidence.

**26.30** The effect of possible new legislation is taken into consideration in measuring an existing obligation when sufficient, objective evidence exists that the legislation is virtually certain to be enacted. The variety of circumstances that arise in practice makes it impossible to specify a single event that will provide sufficient, objective evidence in every case. Evidence is required both of what legislation will demand and whether it is virtually certain to be enacted and implemented in due course. In many cases, sufficient, objective evidence will not exist until the new legislation is enacted.

**26.31** A present value technique is often the best available technique with which to estimate the expenditure required to settle the present obligation at the balance sheet date. When a present value technique is used, an entity estimates future cash flows used in that technique on a basis consistent with the objective of measuring the asset retirement obligation. Uncertainties surrounding the amount to be recognized as an asset retirement obligation are incorporated in the best estimate of the expenditure required to settle the obligation.

**26.32** Asset retirement obligations are reviewed at each balance sheet date and adjusted to reflect the current best estimate. Changes in an asset retirement obligation may be due to the passage of time or to revisions to the timing or amount of cash flows, or to the interest rate used in determining the best estimate of the expenditures required to settle the present obligation at the balance sheet date.

### **Recognition and Allocation of an Asset Retirement Cost**

**26.33** Upon initial recognition of a liability for an asset retirement obligation, an entity should recognize an asset retirement cost by increasing the carrying amount of the related long-lived asset by the same amount as the liability. An entity should subsequently allocate that asset retirement cost to expense using a systematic and rational method over its useful life.

**26.34** Application of a systematic and rational allocation method does not preclude an entity from capitalizing an amount of asset retirement cost and allocating an equal amount to expense in the same accounting period. For example, assume an entity acquires a long-lived asset with an estimated life of 10 years. As that asset is operated, the entity incurs additional asset retirement obligations of equal amount each year. Application of a systematic and rational allocation method would not preclude that entity from capitalizing, and then expensing, the asset retirement costs incurred each year.

**26.35** Impairment of asset retirement costs is accounted for in accordance with the section, "Impairment of Long-Lived Assets," in chapter 20.

**26.36** In periods subsequent to initial measurement, an entity should recognize period-to-period changes in the liability for an asset retirement obligation resulting from

- a. the passage of time and
- b. revisions to either the timing, the amount of the original estimate of undiscounted cash flows, or the discount rate.

An entity should measure and incorporate changes due to the passage of time into the carrying amount of the liability before measuring changes resulting from a revision to either the timing or the amount of estimated cash flows.

**26.37** An entity measures changes in the liability for an asset retirement obligation due to passage of time by applying an interest method of allocation to the amount of the liability at the beginning of the period. The interest rate used to measure that change is the discount rate applied to measure the liability at the beginning of the period. That amount is recognized as an increase in the carrying amount of the liability and an expense. The expense is classified as an operating item in the statement of income, not as interest expense. It is referred to in this section as *accretion expense*, but an entity may use any descriptor as long as it conveys the underlying nature of the expense.

**26.38** Changes resulting from revisions to the timing or the amount of the original estimate of undiscounted cash flows or revisions to the discount rate are recognized as an increase or a decrease in the carrying amount of the liability for an asset retirement obligation and the related asset retirement cost capitalized as part of the carrying amount of the related long-lived asset. When asset retirement costs change as a result of a revision to estimated cash flows, an entity adjusts the amount of asset retirement cost allocated to expense in the period of change if the change affects that period only or in the period of change, and future periods, if the change affects more than one period (in accordance with chapter 5, “Accounting Changes, Changes in Accounting Estimates, and Correction of Errors” for a change in estimate). Changes in asset retirement costs that affect future periods will result in adjustments of capitalized asset retirement costs and will affect subsequent depreciation of the related asset. Such adjustments are depreciated on a prospective basis.

### **Effects of Funding and Assurance Provisions**

**26.39** Providing assurance that an entity will be able to satisfy its asset retirement obligation does not satisfy or extinguish the related liability. Methods of providing assurance include surety bonds, insurance policies, letters of credit, guarantees by other entities, and establishment of trust funds or identification of other assets dedicated to satisfy the asset retirement obligation. Setting assets aside to satisfy an asset retirement obligation does not satisfy the criteria for offsetting the assets and the liability on the balance sheet. For a previously recognized asset retirement obligation, changes in funding and assurance provisions have no effect on the measurement of that liability. Costs associated with complying with funding or assurance provisions are accounted for separately from the asset retirement obligation.

## Disclosure

**26.40** An entity should disclose the following information about its asset retirement obligations:

- a.* A general description of the asset retirement obligations and the associated long-lived assets
- b.* The amount of the asset retirement obligation at the end of the year
- c.* The total amount paid towards the liability during the year
- d.* If readily determinable, the fair value of assets that are legally restricted for purposes of settling asset retirement obligations. If this is not readily determinable, the carrying amount of assets legally restricted for purposes of settling asset retirement obligations

When a reasonable estimate of the amount of an asset retirement obligation cannot be made, that fact, and the reasons therefor, should be disclosed.

**26.41** Uncertainties affecting the measurement of a liability for asset retirement obligations are disclosed in accordance with chapter 6, “Measurement Uncertainty.”

## Guarantees

**26.42** Guarantees are recognized and measured in accordance with paragraphs 26.08–.13.

**26.43** A guarantor should disclose the following information about each guarantee, or each group of similar guarantees, even when the likelihood of the guarantor having to make any payments under the guarantee is slight:

- a.* The nature of the guarantee, including the approximate term of the guarantee, how the guarantee arose, and the events or circumstances that require the guarantor to perform under the guarantee.
- b.* The maximum potential amount of future payments (undiscounted) the guarantor could be required to make under the guarantee before any amounts that may possibly be recovered under recourse or collateralization provisions in the guarantee (see (d) and (e) that follow). When the terms of the guarantee provide for no limitation to the maximum potential future payments under the guarantee, that fact should be disclosed. When the guarantor is unable to develop an estimate of the maximum potential amount of future payments under its guarantee, the guarantor should disclose the reasons why it cannot estimate the maximum potential amount.
- c.* The current carrying amount of the liability, if any, for the guarantor's obligations under the guarantee, regardless of whether the guarantee is freestanding or embedded in another contract.
- d.* The nature of any recourse provisions that enable the guarantor to recover from third parties any of the amounts paid under the guarantee.

- e. The nature of any assets held as collateral or by third parties that, upon the occurrence of any triggering event or condition under the guarantee, the guarantor can obtain and liquidate to recover all, or a portion of, the amounts paid under the guarantee.

**26.44** Disclosure of accounting policies for the recognition and measurement of guarantee liabilities is provided in accordance with chapter 2, “General Principles of Financial Statement Presentation and Accounting Policies.”

**26.45** Some guarantees are issued to benefit entities that meet the definition of a *related party* in chapter 31, such as joint ventures and equity method investees. In those cases, the disclosures required by this chapter may be in addition to the disclosures required by chapter 31.

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## Chapter 27—Revenue

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### Purpose and Scope

**27.01** This chapter establishes principles for the timing of recognition of revenue in the financial statements of enterprises. It is concerned with the recognition of revenue arising in the course of the ordinary activities of an entity normally from the sale of goods, the rendering of services, the combination of both, and the use by others of entity resources yielding interest, royalties, and dividends. It does not comprehensively deal with the measurement of revenue. However, when uncertainties exist regarding the determination of the amount of revenue, these uncertainties may influence the timing of revenue recognition.

**27.02** The timing of recognition of the following types of revenue is dealt with elsewhere in other sections:

- a. Revenue arising from investments accounted for under the equity method (see chapter 19, “Investments”)
- b. Revenue arising from lease agreements (see chapter 22, “Leases”)

### Definitions

**27.03** The following terms are used in this chapter with the meanings specified:

*Completed contract method.* A method of accounting that recognizes revenue only when the sale of goods or the rendering of services under a contract is completed or substantially completed.

*Percentage of completion method.* A method of accounting that recognizes revenue proportionately with the degree of measurement of completion of the rendering of goods or services under a contract.

*Revenue.* The inflow of cash, receivables, or other consideration arising in the course of the ordinary activities of an entity, normally from the sale of goods, the rendering of services, and the use by others of entity resources yielding interest, royalties, and dividends. Revenue is net of items such as trade or volume discounts, returns and allowances, claims for damaged goods, and certain excise and sales taxes. Excise and sales taxes to be netted against revenue would normally include those imposed at the time of sale and would normally exclude those imposed prior to the time of sale on either the goods or their constituents.

### Recognition

**27.04** Revenue from sales and service transactions should be recognized when the requirements regarding performance set out in paragraphs 27.05–.06 are satisfied, provided that at the time of performance, ultimate collection is reasonably assured.

**27.05** In a transaction involving the sale of goods, performance should be regarded as having been achieved when the following conditions have been fulfilled:

- a.* The seller of the goods has transferred to the buyer the significant risks and rewards of ownership in that all significant acts have been completed, and the seller retains no continuing managerial involvement in, or effective control of, the goods transferred to a degree usually associated with ownership.
- b.* Reasonable assurance exists regarding the measurement of the consideration that will be derived from the sale of goods and the extent to which goods may be returned.

**27.06** In the case of rendering of services and long-term contracts and modifications to those contracts, performance should be determined using either the percentage of completion method or the completed contract method, whichever relates the revenue to the work accomplished. Such performance should be regarded as having been achieved when reasonable assurance exists regarding the measurement of the consideration that will be derived from rendering the service or performing the long-term contract.

**27.07** Performance should be regarded as being achieved under paragraphs 27.05–.06 when all the following criteria have been met:

- a.* Persuasive evidence of an arrangement exists.
- b.* Delivery has occurred, or services have been rendered.
- c.* The seller's price to the buyer is fixed or determinable.

**27.08** Some of the items management should consider in determining if persuasive evidence of an arrangement exists are as follows:

- a.* Customary business practices and past dealings between parties
- b.* Side arrangements
- c.* Consignment arrangements
- d.* Rights to return the product
- e.* Requirements to repurchase the product

Other characteristics may exist. Accordingly, judgment is necessary in assessing whether the substance of a transaction is a consignment, a financing, or other arrangement for which revenue recognition is not appropriate.

**27.09** Generally, delivery is not considered to have occurred unless the product has been delivered to the customer's place of business or another site specified by the customer. Some of the aspects of the revenue arrangement management should consider in determining if delivery has occurred or services have been rendered are as follows:

- a.* Bill and hold arrangements.
- b.* Customer acceptance of product.
- c.* Layaway sales arrangements.

- d.* Nonrefundable fee arrangements.
- e.* Licensing and similar fee arrangements.
- f.* Risk of loss has passed to the buyer.

**27.10** In determining if the seller's price to the buyer is fixed or determinable, management should consider the impact of the following factors:

- a.* Cancellable sales arrangements
- b.* Right of return arrangements
- c.* Price protections or inventory credit arrangements, or both
- d.* Refundable fee for service arrangements

**27.11** The recognition criteria in this chapter are usually applied separately to each transaction. However, in certain circumstances, it is necessary to apply the recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction. A single sales transaction may involve the delivery or performance of multiple products, services, or rights to use assets, and performance may occur at different points in time or over different periods of time. In some cases, the arrangements include initial installation, initiation, or activation services and involve consideration in the form of a fixed fee or a fixed fee coupled with a continuing payment stream. For example, when the selling price of a product includes an identifiable amount for subsequent servicing, that amount is deferred and recognized as revenue over the period during which the service is performed. Conversely, the recognition criteria are applied to two or more transactions together when they are linked in such a way that the commercial effect cannot be understood without reference to the series of transactions as a whole. For example, an entity may sell goods and, at the same time, enter into a separate agreement to repurchase the goods at a later date, thus, negating the substantive effect of the transaction. In such a case, the two transactions are dealt with together.

**27.12** Revenue arising from the use by others of entity resources yielding interest, royalties, and dividends should be recognized when reasonable assurance exists regarding measurement and collectability. These revenues should be recognized on the following bases:

- a.* Interest, on a time proportion basis
- b.* Royalties, as they accrue, in accordance with the terms of the relevant agreement
- c.* Dividends, when the shareholder's right to receive payment is established

**27.13** Revenue from a transaction involving the sale of goods should be recognized when the seller has transferred to the buyer the significant risks and rewards of ownership of the goods sold. When the seller retains significant risks of ownership, it is normally inappropriate to recognize the transaction as a sale. Examples of a significant risk of ownership being retained by a seller are when there is a liability for unsatisfactory performance not covered by normal warranty provisions; when the purchaser has the right to rescind the transaction; and when the goods are shipped on consignment.

**27.14** Assessing when the risks and rewards of ownership are transferred to the buyer with sufficient certainty requires an examination of the circumstances of the transaction. In most cases, revenue is recognized on passing of possession of the goods. In retail sales, this is usually coincident with the passing of legal title. In other cases, the passing of legal title may occur at a different time from the passing of possession or of the risks and rewards of ownership.

**27.15** The following considerations are relevant in deciding whether significant risks and rewards of ownership have been transferred to the buyer:

- a. Whether any significant acts of performance remain to be completed
- b. Whether the seller retains any continuing managerial involvement in, or effective control of, the goods transferred to a degree usually associated with ownership.

**27.16** Revenue from service transactions and long-term contracts is usually recognized as the service or contract activity is performed, using either the percentage of completion method or the completed contract method.

**27.17** The percentage of completion method is used when performance consists of the execution of more than one act, and revenue would be recognized proportionately by reference to the performance of each act. Revenue recognized under this method should be determined on a rational and consistent basis, such as on the basis of sales value, associated costs, extent of progress, or number of acts. For practical purposes, when services are provided by an indeterminate number of acts over a specific period of time, revenue should be recognized on a straight line basis over the period unless there is evidence that some other method better reflects the pattern of performance. The amount of work accomplished should be assessed by reference to measures of performance that are reasonably determinable and relate as directly as possible to the activities critical to the completion of the contract. (Measures of performance include output measures, such as units produced and project milestones, or input measures, such as cost, labor hours, or machine use.) Amounts billed are not an appropriate basis of measurement unless they reflect the work accomplished.

**27.18** The completed contract method is only be appropriate when performance consists of the execution of a single act or when the entity cannot reasonably estimate the extent of progress toward completion.

### **Effect of Uncertainties**

**27.19** Recognition of revenue requires that the revenue is measurable and that ultimate collection is reasonably assured. When there is reasonable assurance of ultimate collection, revenue is recognized, even though cash receipts are deferred. When there is uncertainty about ultimate collection, it may be appropriate to recognize revenue only as cash is received.

**27.20** When the uncertainty relates to collectability and arises subsequent to the time revenue was recognized, a separate provision to reflect the uncertainty should be made.

The amount of revenue originally recorded should not be adjusted.

**27.21** Uncertainties relating to the measurement of revenue may result from one or both of the following issues:

- a. Consideration.* When consideration is not determinable within reasonable limits, for example, when payment relating to goods sold depends on the resale of the goods by the buyer, revenue should not be recognized.
- b. Returns.* Revenue should not be recognized when an entity is subject to significant and unpredictable amounts of goods being returned, for example, when the market for a returnable good is untested. If an entity is exposed to significant and predictable amounts of goods being returned, it may be sufficient to provide therefor.

**27.22** Consideration may include a note or other financial instrument issued by the purchaser to be settled in cash and, under the terms of the note, the seller effectively has recourse only against the assets sold. The transaction is considered to be a sale because the total amount of the consideration received is determinable within reasonable limits (see paragraph 27.21). However, income from the sale is only recognized when

- a.* a substantial commitment by the purchaser exists, demonstrating its intent to honor its obligations under the note, and
- b.* the seller has reasonable assurance of collecting the note.

A commitment would include, for example, nonrefundable cash consideration from resources other than those transferred from the seller or the assumption of an obligation of the seller to a third party when the third party thereby releases the seller from that obligation.

### **Reporting Revenue Gross or Net**

**27.23** Revenue includes only the gross inflows of economic benefits received and receivable by the entity on its own account. Amounts collected on behalf of third parties, such as sales taxes and goods and services taxes, are not economic benefits that flow to the entity and do not result in increases in equity. Therefore, they are excluded from revenue. Similarly, in an agency relationship, the gross inflows of economic benefits include amounts collected on behalf of the principal that do not result in increases in equity for the entity. The amounts collected on behalf of the principal are not revenue. Instead, revenue is the amount of commission.

**27.24** An entity is acting as a principal when it has exposure to the significant risks and rewards associated with the sale of goods or the rendering of services. Features that indicate that an entity is acting as a principal include the following:

- a.* The entity has the primary responsibility for providing the goods or services to the customer or for fulfilling the order (for example, by being responsible for the acceptability of the products or services ordered, contracted, or purchased by the customer).

- b. The entity has inventory risk before or after the customer order, during shipping, or on return.
- c. The entity has latitude in establishing prices, either directly or indirectly (for example, by providing additional goods or services).
- d. The entity bears the customer's credit risk for the amount receivable from the customer.

One feature indicating that an entity is acting as an agent is that the amount the entity earns is predetermined, being either a fixed fee per transaction or a stated percentage of the amount billed to the customer.

## **Presentation**

**27.25** The amount of revenue recognized during the period should be presented separately in the statement of income.

## **Disclosure**

**27.26** An entity should disclose its revenue recognition policy. If an entity has different policies for different types of revenue transactions, including nonmonetary (barter) sales, the policy for each material type of transaction should be disclosed. If sales transactions have multiple elements, such as a product and service, the entity should clearly state the accounting policy for each element, as well as how multiple elements are determined and measured.

**27.27** If sales transactions have multiple elements, the policy may contain items such as a description and nature of such an arrangement, including performance, cancellation, termination, or refund-type provisions.

**27.28** An entity should disclose separately, either on the face of the statement of income or in the notes to the financial statements, the major categories of revenue recognized during the period.

**27.29** The objective of this disclosure is to assist the reader in understanding the sources of revenue and their effect on the financial statements.

**27.30** Judgment is necessary to determine the categories that an entity uses. An entity may separate out sources based on life expectancy (for example, initial and ongoing franchise fees), and significantly differing profit margins or sources that differ from the standard operation of the business (for example, a manufacturing business that has material investment income).

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## Chapter 28—*Retirement and Other Postemployment Benefits*

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### Purpose and Scope

**28.01** This chapter, and the related section contained in the separate accompanying publication *FRF for SMEs Implementation Guidance*, establishes principles for the recognition, measurement, and disclosure of the cost of retirement and other postemployment benefits. It requires an entity to recognize the cost of retirement benefits and certain postemployment benefits over the periods in which employees render services to the entity in return for the benefits. Other postemployment benefits are recognized when the event that obligates the entity occurs.

**28.02** This chapter applies to benefits earned by active employees and expected to be provided to them when they are no longer providing active service, pursuant to the terms of an entity's undertaking to provide such benefits. These benefits include the following:

- a. Pension and other retirement benefits expected to be provided after retirement to employees and their beneficiaries, such as pension income, health care benefits, life insurance, and other miscellaneous benefits provided to employees after retirement
- b. Postemployment benefits expected to be provided after employment but before retirement to employees and their beneficiaries, such as long- and short-term disability income benefits (including workers' compensation), severance benefits, salary continuation, supplemental unemployment benefits, job training and counseling, and continuation of benefits such as health care benefits and life insurance
- c. Termination benefits

**28.03** Active employees are those currently rendering service to the entity. Former employees are those who are retired, whose employment has been terminated, or who have left the entity. Active, former, and inactive employees are referred to in this chapter collectively as *employees*.

**28.04** An entity's arrangements to provide future benefits to employees may take a variety of forms and may be financed in different ways. Future benefits may be provided either directly by an entity or through an intermediary, such as a pension plan or an insurance entity. This chapter applies to any arrangement that is, in substance, a benefit plan, regardless of its form or the manner or timing of its funding. Absent evidence to the contrary, it is presumed that an entity that has provided benefits in the past and is currently promising those benefits to employees will continue to provide those benefits in the future. This chapter applies to the future benefits for which an entity pays all or part of the cost.

**28.05** This chapter does not apply to benefits provided by an entity to employees during their active employment. Examples of these benefits are

- a. salaries, wages, bonuses, fringe benefits, and similar items that are provided by an entity in the current reporting period, or within 12 months thereafter, in exchange for services rendered by employees in the current reporting period;
- b. occasional sick days and vacation days that do not vest or accumulate beyond 12 months after the current reporting period; and
- c. benefits provided under stock-based compensation arrangements.

## Definitions

**28.06** The following terms are used in this chapter with the meanings specified:

*Accrued benefit obligation.* The actuarial present value of benefits attributed to employee services rendered to a particular date. As of a particular date prior to an employee's full eligibility date, an entity's accrued benefit obligation in respect of the employee is the portion of the obligation for retirement and other postemployment benefits attributed to that employee's service rendered to that date. On and after the full eligibility date, the accrued benefit obligation and obligation for retirement and other postemployment benefits for an employee are the same.

*Defined benefit plan.* A pension plan that defines the amount of pension benefit to be provided. The amount of the benefit is usually a function of one or more factors such as age, years of service, or compensation. Any pension plan that does not meet the defined contribution plan should be considered a defined benefit plan.

*Defined contribution plan.* A plan that provides benefits for services rendered, based solely on the amount contributed to each plan participant's account and the returns on the investment of those contributions. Each participant has his or her own account and, in many cases, directs the investment of the contribution. The plan specifies how the contribution amounts are to be determined.

*Expected future benefit.* A calculated amount representing the benefit the entity expects to realize from a plan excess. An expected future benefit includes any withdrawable excess or reduction in future contributions. An entity determines its expected future benefit as the sum of

- the present value of its expected future annual accruals for service for the current number of active employees, less the present value of required employee contributions and minimum contributions the entity is required to make regardless of any excess; and
- the amount of the plan excess that can be withdrawn in accordance with the existing plan and any applicable laws and regulations.

*Fair value.* The amount of the consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act.

*Multiemployer plan.* A defined benefit plan under which a single plan funds the benefits for employees of different unrelated companies. These types of plans are often set up as a result of union contracts. The plan assumes the liability for benefits to all participants without regard to the company. Although contributions are determined on an annual basis by a formula specified in the plan, if a company terminates its participation in the plan, it may be subject to a termination liability.

*Obligation for retirement and other postemployment benefits.* The actuarial present value as of a particular date of benefits expected to be paid under a defined benefit plan. The obligation is measured on the basis of the expected amount and timing of future benefits, taking into consideration the expected future cost of providing the benefits and the extent to which the costs are shared by employees or others.

*Plan assets.* Assets that have been segregated and restricted in a trust or other legal entity separate from a reporting entity to provide for retirement and other postemployment benefits under the following conditions:

- The assets of the separate entity are to be used only to settle the related accrued benefit obligation, are not available to the reporting entity's own creditors, and either cannot be returned to the reporting entity or can be returned to the reporting entity only if the remaining assets of the trust are sufficient to meet the plan's obligations.
- To the extent that sufficient assets are in the separate entity, the reporting entity will have no obligation to pay the related retirement and other post-employment benefits directly.

Plan assets include any financial instruments issued by the reporting entity and held by the trust or other legal entity. For the purposes of this chapter, plan assets do not include amounts held by the reporting entity and not yet paid into the trust or other legal entity. Plan assets may include certain arrangements with insurance enterprises.

## **Basic Principles**

**28.07** An obligation for retirement and other postemployment benefits possesses all the characteristics of liabilities. First, an entity has a responsibility to its employees to provide the benefits at a specified time in the future (that is, when an employee retires or leaves the entity). Second, although the responsibility is not always contractual, the obligation is constructive or equitable in almost all cases, thereby leaving an entity little or no discretion to avoid it. Finally, an entity is obligated either by the rendering of service by the employee or, in the case of certain postemployment benefits, by an event such as an application for long-term disability benefits or parental leave.

**28.08** The two basic types of pension plans are defined contribution and defined benefit.

**28.09** If deferred compensation contracts, as a group, are equivalent to a pension plan, they are accounted for the same as a pension plan. Other deferred compensation contracts

should be accounted for on an individual basis for each employee.

## **Measurement and Disclosure—Defined Contribution Plans**

### **Measurement**

**28.10** The pension cost to be recorded as expense for an accounting period should normally be the contribution that applies to that period accounted for on the accrual basis.

### **Disclosure**

**28.11** An entity should disclose the following information about defined contribution plans:

- a.* A general description of each type of plan, including how the contribution is determined and the number of employees covered
- b.* The amount of cost recognized in the period

## **Measurement and Disclosure—Multiemployer Plans**

### **Measurement**

**28.12** Pension cost consists solely of the contribution required for the year, unless termination of participation in the plan is probable, then any amounts due should be accrued.

### **Disclosure**

**28.13** An entity should disclose the following information about significant multiemployer plans:

- a.* The name of the plan and a description of the type of plan
- b.* If withdrawal from the plan is probable or reasonably possible, whether withdrawal from the plan would give rise to an obligation
- c.* The amount of cost recognized in the period

## **Measurement and Disclosure—Individual Deferred Compensation Contracts**

### **Measurement**

**28.14** If the contract is based on current and future employment, only amounts attributable to current employment are accrued.

**28.15** If expected future benefits are attributable to more than one year of service, the cost of those benefits should be accrued over the period of the employee's service. At the end of that service period, the total amount accrued should equal the present value of the

benefits expected to be provided.

## **Disclosure**

**28.16** An entity should disclose the following information in aggregate about individual deferred compensation contracts:

- a. A general description of the contracts, including expected timing of benefit payments and the discount rate used to determine present value
- b. The liability at the balance sheet date and the amount charged to expense in the current period

## **Recognition, Measurement, and Disclosure—Defined Benefit Plans**

**28.17** An entity should make an accounting policy choice to account for defined benefit plans using either

- a. current contribution payable method or
- b. one of the accrued benefit obligation methods.

**28.18** In making this accounting policy choice, the entity need not meet the criteria in chapter 5, “Accounting Changes, Changes in Accounting Estimates, and Correction of Errors.”

### **Current Contribution Payable Method**

**28.19** Under this method, only the contribution attributable to the current year is expensed.

**28.20** Under this method, the following disclosures are required:

- a. A description of the plan, including employees covered, nature of determining benefits, and the availability of a separate actuary report
- b. Information about the funded status of the plan, including benefit obligation, fair value of plan assets, and the excess of the benefit obligation over fair value of plan assets
- c. The current year’s contribution and expected contribution for the subsequent year

### **Accrued Benefit Obligation Method**

**28.21** The accrued benefit obligation methods require the recording of the accrued benefit obligation.

**28.22** See the “Defined Benefit Plan” section of the separate accompanying publication, *FRF for SMEs Implementation Guidance*, for a description of how to implement, adopt, and account for these alternatives.

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## Chapter 29—*Income Taxes*

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### Purpose and Scope

**29.01** This chapter establishes principles for the recognition, measurement, presentation, and disclosure of income and refundable taxes in an entity's financial statements.

### Definitions

**29.02** The following terms are used in this chapter with the meanings specified:

*Cost (benefit) of current income taxes.* The amount of income taxes payable (refundable) in respect of the period.

*Cost (benefit) of deferred income taxes.* The change during the period in deferred income tax liabilities and deferred income tax assets.

*Deferred income tax assets.* The amounts of income tax benefits arising in respect of

- deductible temporary differences;
- the carryforward of unused tax losses; and
- the carryforward of unused income tax reductions, except for investment tax credits.

*Deferred income tax liabilities.* The amounts of income taxes arising from taxable temporary differences.

*Deferred income taxes method.* A method of accounting under which an entity reports as an expense (income) of the period the cost (benefit) of current income taxes and the cost (benefit) of deferred income taxes, determined in accordance with the rules established by taxation authorities.

*Income taxes.* Income taxes include

- all domestic and foreign taxes that are based on taxable income;
- taxes that are based on a measure of revenue less certain specified expenses; and
- alternative minimum income taxes, including taxes based on measures other than income and that may be used to reduce income taxes of another period.

*More likely than not.* An event is more likely than not when the probability that it will occur is greater than 50 percent.

*Taxable income (tax loss).* The amount for a period, determined in accordance with the rules established by taxation authorities, upon which income taxes are payable (refundable).

*Taxes payable method.* A method of accounting under which an entity reports as an expense (income) of the period only the cost (benefit) of current income taxes for that period, determined in accordance with the rules established by taxation authorities.

*Temporary differences.* Differences between the tax basis of an asset or liability and its carrying amount in the balance sheet. Temporary differences may be either

- *Deductible temporary differences.* Temporary differences that will result in deductible amounts in determining taxable income of future periods when the carrying amount of the asset or liability is recovered or settled or
- *Taxable temporary differences.* Temporary differences that will result in taxable amounts in determining taxable income of future periods when the carrying amount of the asset or liability is recovered or settled.

## **Accounting Policy**

**29.03** An entity should make an accounting policy choice to account for income taxes using either

- a. the taxes payable method or
- b. the deferred income taxes method.

In making this accounting policy choice, the entity need not meet the criterion in paragraph 5.06(b).

## **Taxes Payable Method**

**29.04** Under the taxes payable method, only current income tax assets and liabilities are recognized.

## **Recognition**

**29.05** Current income taxes, to the extent unpaid or refundable, should be recognized as a liability or asset.

**29.06** The benefit relating to a tax loss arising in the current period that will be carried back to recover income taxes of a previous period should be recognized as a current asset.

**29.07** The liability for current income taxes included in the balance sheet is the cost (benefit) of current income taxes for current and prior periods less amounts already paid in respect of these income taxes. When the amount already paid in respect of the cost (benefit) of current income taxes for a period exceeds the liability for that period, any excess amount is shown as an asset. When a tax loss is used to recover income taxes previously paid, the benefit is recognized in the period in which the tax loss occurs because the benefit will be realized.

## **Measurement**

**29.08** Income tax liabilities and income tax assets should be measured in accordance with paragraphs 29.48–.53.

### **Intraperiod Allocation**

**29.09** The relevant intraperiod allocation provisions of paragraphs 29.54–.60 should be applied when using the taxes payable method.

## **Deferred Income Taxes Method**

### **The Basic Principles of Deferred Income Taxes**

**29.10** The fundamental principle upon which the deferred income taxes method is based is that an entity recognizes a deferred income tax liability whenever recovery or settlement of the carrying amount of an asset or liability would result in deferred income tax outflows. Similarly, an entity recognizes a deferred income tax asset whenever recovery or settlement of the carrying amount of an asset or liability would generate deferred income tax reductions. An extension of this fundamental principle is that in the case of unused tax losses, income tax reductions, and certain items that have a tax basis but cannot be identified with an asset or liability on the balance sheet, the recognition of deferred income tax benefits is determined by reference to the likely realization of a deferred income tax reduction.

### **Recovery or Settlement of the Carrying Amount of an Asset or Liability**

**29.11** The rules established by the taxation authorities to determine the taxable income that will arise from the recovery or settlement of an asset or liability are often different from the accounting policies followed by an entity in the preparation of its financial statements that govern the amounts included in income or expense from the recovery or settlement of an asset or liability. The determination of whether recovery or settlement of an asset or liability will result in deferred income tax outflows or benefits is determined by reference to the difference between the carrying values and tax basis of assets and liabilities. The tax basis of an asset or liability is the amount, determined with reference to the rules established by the taxation authorities, that could be deducted in the determination of taxable income if the asset were recovered or the liability were settled for its carrying amount. At any point in time, there may be a difference between the tax basis of an asset or liability and its carrying amount. Such differences are temporary differences. Temporary differences may be either taxable or deductible. Taxable temporary differences give rise to deferred income tax liabilities. Deductible temporary differences give rise to deferred income tax assets.

**29.12** To determine the extent of any temporary differences, it is first necessary to establish the tax basis of the assets and liabilities. The following guidance assists in determining the tax basis of an asset for the purposes of this chapter:

- a. When an amount related to an asset is deductible in determining taxable income over one or more periods, the tax basis at the end of a period is that

amount less all amounts already deducted in determining taxable income of the current and prior periods.

- b.* When an amount related to an asset is deductible in determining taxable income only when the asset is disposed of or permanently withdrawn from use, the tax basis of the asset is that amount.
- c.* When the cost of an asset is not deductible in determining taxable income but any proceeds of a disposal of the asset would not be included in the determination of taxable income, the tax basis of the asset is equal to the carrying amount.
- d.* When the amount related to an asset that will be deductible in determining future taxable income depends on whether the asset is utilized or sold, the tax basis of the asset is the greater of those amounts.

**29.13** The tax basis of a liability is its carrying amount less any amount that will be deductible for income tax purposes in respect of that liability in future periods. In the case of amounts received but not yet recognized as revenue, the tax basis of the resulting liability is its carrying amount less any amount that will not be taxable in future periods. When a liability can be settled for its carrying amount without tax consequences, the tax basis of the liability is considered to be the same as its carrying amount.

**29.14** As discussed previously, the difference between the carrying value of an asset or liability and its tax basis will determine the extent of any temporary differences, and these differences will, in turn, determine the extent of deferred income tax assets or liabilities. The following guidance assists in determining the nature of any temporary differences for the purposes of this chapter:

- a.* When the carrying amount of an asset and its tax basis are the same, the amount included in taxable income on the recovery of the asset is offset by the amount allowed as a deduction in the determination of taxable income. Therefore, there is no temporary difference because the recovery of the carrying amount has no effect on taxable income of the entity.
- b.* When the carrying amount of an asset is greater than its tax basis, the recovery of the carrying amount in a future period will result in a taxable amount in excess of the future amount allowed as a deduction in the determination of taxable income. Therefore, a taxable temporary difference exists that gives rise to a deferred income tax liability in respect of the income taxes that will be payable in future periods.
- c.* When the carrying amount of an asset is less than its tax basis, the amount allowed as a deduction in the determination of taxable income in respect of that asset will be greater than the taxable amount arising from the recovery of the carrying amount. Therefore, a deductible temporary difference exists that gives rise to a deferred income tax asset in respect of the income tax that will be recoverable in future periods.

- d. When the carrying amount of a liability is equal to its tax basis, there will be no tax consequences associated with settling the liability. Therefore, there is no temporary difference.
- e. When an amount related to a liability is deductible for income tax purposes in future periods when the liability is settled, it has a tax basis of zero. The settlement of the liability will result in a deduction for tax purposes. Therefore, the difference between the carrying amount of the liability and its tax basis is a deductible temporary difference that gives rise to a deferred income tax asset.

### **Unused Tax Losses, Income Tax Reductions, and Certain Other Items**

**29.15** Unused tax losses and income tax reductions that are not related to particular assets or liabilities in the balance sheet may generate benefits that meet the conceptual definition of *assets* and should be recognized if appropriate criteria are met. In addition, some items have a tax basis but cannot be identified with a particular asset or liability in the balance sheet, such as the following:

- a. Research costs are recognized as an expense in the financial statements in the period in which they are incurred but might not be deducted in determining taxable income until a later period. The difference between the tax basis of the research costs (that is, the amount the taxation authorities will permit as a deduction in the future) and the carrying amount of zero is a deductible temporary difference that gives rise to a deferred income tax asset.
- b. For financial statement purposes, an entity might recognize profits on a long-term contract using the percentage of completion method but use the completed contract method when determining taxable income. Income is deferred for tax purposes, with no corresponding amount being deferred for accounting purposes. The income deferred for tax purposes represents a taxable temporary difference that gives rise to a deferred tax liability.

### **Business Combinations**

**29.16** In consolidated financial statements, temporary differences are the differences between the carrying amounts in the consolidated financial statements of assets and liabilities of each entity and the appropriate tax basis. The tax bases of the assets and liabilities are determined by reference to the individual enterprises in the group.

**29.17** In a business combination, the cost of the acquisition is allocated to the assets and liabilities acquired by reference to their fair values at the date of the exchange transaction. Temporary differences might exist between the assigned values and the tax bases of the related assets and liabilities. Such temporary differences can be either taxable temporary differences or deductible temporary differences and, therefore, result in either deferred income tax liabilities or assets. For example, when the carrying amount of an asset is increased to fair value but the tax basis of the asset is not adjusted, a taxable temporary difference arises, resulting in a deferred income tax liability. When a liability is recognized on the acquisition but the related costs are not deductible in determining

taxable income until a later period, a deductible temporary difference arises, resulting in a deferred income tax asset. These deferred income tax assets and liabilities are treated as identifiable assets and liabilities when allocating the cost of the purchase.

## **Compound Financial Instruments**

**29.18** If an entity allocates a portion of the initial carrying amount of a compound financial instrument to the equity component (and does not measure that component at zero, see paragraph 32.21), the carrying amount of the component of the financial instrument classified as a liability will normally be different from the tax basis of the instrument. If the liability component were to be settled for its carrying amount, this would otherwise give rise to taxable or deductible amounts that would be included in the determination of taxable income. However, settlement of the instrument in accordance with its terms, either through settlement on maturity or conversion, might not result in the incidence of tax to the issuer. When the entity is able to settle the instrument without the incidence of tax, the tax basis of the liability component is considered to be the same as its carrying amount, and there is no temporary difference.

## **Recognition**

### ***Current Income Tax Liabilities and Current Income Tax Assets***

**29.19** Current income tax liabilities and current income tax assets are recognized in accordance with paragraphs 29.05–.07 and should not be included in deferred income tax assets and deferred income tax liabilities.

### ***Deferred Income Tax Liabilities and Deferred Income Tax Assets***

#### **Taxable Temporary Differences**

**29.20** At each balance sheet date, except as provided in paragraphs 29.30 and 29.32, a deferred income tax liability should be recognized for all taxable temporary differences other than those arising from any portion of goodwill that is not deductible for tax purposes. Any difference between the carrying amount of goodwill and its tax basis is a taxable temporary difference that would usually result in a deferred income tax liability.

#### **Deductible Temporary Differences, Unused Tax Losses, and Income Tax Reductions**

**29.21** At each balance sheet date, except as provided in paragraphs 29.30 and 29.32, a deferred income tax asset should be recognized for all deductible temporary differences, unused tax losses, and income tax reductions. The amount recognized should be limited to the amount that is more likely than not to be realized.

**29.22** Future realization of the tax benefit of an existing deductible temporary difference, unused tax loss, or unused income tax reduction ultimately depends on the existence of sufficient taxable income of an appropriate nature, relating to the same taxable entity and the same taxation authority, within the carryback and carryforward periods available under the tax law. The following sources of taxable income may be

available under the tax law to realize a tax benefit for deductible temporary differences, unused tax losses, or income tax reductions:

- a.* Future reversals of existing taxable temporary differences
- b.* Future taxable income before the effects of reversing temporary differences, unused tax losses, and income tax reductions
- c.* Taxable income in prior year(s) if carryback is permitted under the tax law
- d.* Tax-planning strategies that, if necessary, would be implemented to realize a deferred income tax asset

**29.23** An entity would consider tax-planning strategies in determining the extent to which it is more likely than not that a deferred income tax asset will be realized. Tax planning strategies are actions that

- a.* are prudent and feasible;
- b.* an entity ordinarily might not take, but would take, to prevent a tax loss or income tax reduction from expiring unused; and
- c.* would result in realization of deferred income tax assets.

The carrying amount of any deferred income tax asset recognized as a result of a tax planning strategy would reflect the cost of implementing that strategy.

**29.24** Forming a conclusion that it is appropriate to recognize a deferred income tax asset is difficult when there is unfavorable evidence, such as cumulative losses in recent years. Other examples of unfavorable evidence include

- a.* a history of tax losses or income tax reductions expiring unused;
- b.* losses expected in early future years (by a currently profitable entity);
- c.* unsettled circumstances that, if unfavorably resolved, would adversely affect future operations and profit levels on a continuing basis in future years; and
- d.* a carryback or carryforward period that is so brief that it would limit realization of tax benefits, particularly if the entity operates in a traditionally cyclical business.

**29.25** Examples of favorable evidence that might support a conclusion that recognition of a deferred income tax asset is appropriate despite the existence of unfavorable evidence include

- a.* existing sufficient taxable temporary differences relating to the same taxable entity and the same taxation authority that result in taxable amounts against which the unused tax losses or income tax reductions can be utilized;
- b.* existing contracts or firm sales backlog that will produce more than enough taxable income to realize the deferred income tax asset based on existing sales prices and cost structures;

- c. an excess of fair value over the tax basis of the entity's net assets in an amount sufficient to realize the deferred income tax asset; or
- d. a strong earnings history exclusive of the loss that created the future deductible amount (unused tax loss carryforward or deductible temporary difference), together with evidence indicating that the loss is an aberration rather than a continuing condition.

**29.26** An entity must use judgment in considering the relative impact of unfavorable and favorable evidence on the recognition of a deferred income tax asset. The weight given to the potential effect of unfavorable and favorable evidence is commensurate with the extent to which it can be verified objectively. The more unfavorable evidence that exists, the more favorable evidence is necessary, and the more difficult it is to support a conclusion that recognition of some portion of, or all of, the deferred income tax asset is appropriate.

**29.27** An entity should recognize a deferred income tax asset for all deductible temporary differences, unused tax losses, and income tax reductions, reduced by a valuation allowance to the extent that it is more likely than not that some portion of, or all, the assets will not be realized. The valuation allowance reduces the deferred income tax asset to the amount that is more likely than not to be realized. This results in the same net asset as that determined in accordance with paragraph 29.21 and after applying the considerations described in paragraphs 29.22–.26 in determining the amount of the valuation allowance.

### **Reassessment of Deferred Income Tax Assets**

**29.28** At each balance sheet date

- a. to the extent that it is no longer more likely than not that a recognized deferred income tax asset will be realized, the carrying amount of the asset should be reduced by a valuation allowance, or
- b. to the extent that it is more likely than not that an unrecognized deferred income tax asset will be realized, a deferred income tax asset should be recognized.

**29.29** At each balance sheet date, an entity reassesses recognized and unrecognized deferred income tax assets. When it is more likely than not that sufficient future taxable income will be available to allow a previously unrecognized deferred income tax asset to be realized, the deferred income tax asset is recognized to the extent of that taxable income. For example, an improvement in existing contracts or firm sales backlog may increase the probability of the entity's ability to generate future taxable income such that the deferred income tax asset meets the recognition criteria in paragraphs 29.22–.27. Conversely, a significant weakening of an entity's financial position may indicate that the entity will not be able to generate sufficient taxable income to allow recognized deferred income tax assets to be realized, in which case, the deferred income tax asset is reduced by a valuation allowance to the amount that is considered more likely than not to be realized.

## Intragroup Transfers

**29.30** When an asset is transferred between enterprises within a consolidated group, a deferred income tax liability or asset should not be recognized in the consolidated financial statements for a temporary difference arising between the tax basis of the asset in the buyer's tax jurisdiction and its cost as reported in the consolidated financial statements. Any taxes paid or recovered by the transferor as a result of the transfer should be recorded as an asset or liability in the consolidated financial statements until the gain or loss is recognized by the consolidated entity.

**29.31** A transfer of assets, such as the sale of inventory or depreciable assets between enterprises within a consolidated group, is a taxable event that might establish a new tax basis for those assets in the buyer's tax jurisdiction. The new tax basis of those assets is deductible on the buyer's income tax return when the cost of those assets, as reported in the consolidated financial statements, is recovered. However, from the point of view of the consolidated financial statements, no profit or loss has been realized, and there will be no change in net assets until such time as that asset is transferred, by sale or otherwise, outside the consolidated group. Although the difference between the buyer's tax basis and the cost of transferred assets as reported in the consolidated financial statements technically meets the definition of a *temporary difference*, the substance of accounting for it as such would be to recognize income taxes related to intercompany gains or losses that are not recognized in accordance with chapter 13, "Consolidated Financial Statements and Noncontrolling Interests." Similar principles apply to investments subject to significant influence and interests in joint ventures.

## Investments in Subsidiaries and Interests in Joint Ventures

**29.32** At each balance sheet date, a deferred income tax liability or deferred income tax asset should be recognized for all temporary differences arising from investments in subsidiaries and interests in joint ventures, except with respect to the difference between the carrying amount of the investment and the tax basis of the investment, when it is apparent that this difference will not reverse in the foreseeable future. Any deferred income tax asset should be recognized only to the extent that it is more likely than not that the benefit will be realized.

**29.33** Temporary differences may arise from investments in subsidiaries and interests in joint ventures in a number of different circumstances. Examples include

- a. differences between the carrying amounts (in the consolidated financial statements) of individual assets and liabilities of subsidiaries and joint ventures and their tax basis (inside basis differences) or
- b. differences between the carrying amount of an investment in a subsidiary or an interest in a joint venture and its tax basis (outside basis differences) because of items such as
  - i. the existence of undistributed income of subsidiaries and joint ventures or

- ii. changes in foreign exchange rates when a parent and its subsidiary are based in different countries.

Such temporary differences are differences between the carrying amounts of assets and liabilities of each entity in the financial statements of the investor and the appropriate tax basis, even when they are eliminated on consolidation. The tax basis of the assets and liabilities is determined by reference to the individual enterprises in the group.

**29.34** In consolidated financial statements, the taxable temporary difference arising from an investment in a subsidiary reflects the parent's share of the undistributed income of the subsidiary and differences arising from other transactions and events that affect the carrying amount of the parent's investment. The taxable temporary difference may be different from the taxable temporary difference in the separate financial statements of the parent if the parent carries its investment in its separate financial statements at cost.

**29.35** As a parent controls the dividend policy of its subsidiary, it is able to control the timing of the reversal of temporary differences associated with its investment. When the parent considers the reinvestment of a subsidiary's profits as part of its permanent investment in the subsidiary, and it has determined that those profits will not be distributed for the foreseeable future, a deferred income tax liability is not recognized. When it is apparent that all or part of the temporary difference will reverse in the foreseeable future, a deferred income tax liability is recognized.

**29.36** A *venturer* is a party to a joint venture and has joint control over that joint venture. *Joint control* is the contractually agreed sharing of the continuing power to determine the strategic, operating, investing, and financing policies of the joint venture. Decisions relating to distributions from the joint venture usually require the consent of the venturers in such a manner as defined in the terms of the contractual arrangement. Therefore, when the venturer can exercise joint control over distributions and it is apparent that distributions will not be made for the foreseeable future, a deferred income tax liability is not recognized.

**29.37** The temporary differences described in paragraph 29.33 might also exist for investments subject to significant influence accounted for by the equity method. A deferred income tax liability or asset is recorded for such temporary differences because the investor is not normally able to control the timing of their reversal.

### ***Assets Acquired Other Than in a Business Combination***

**29.38** When an asset is acquired other than in a business combination and the tax basis of that asset is less than its cost, the cost of deferred income taxes recognized at the time of acquisition should be added to the cost of the asset. When an asset is acquired other than in a business combination and the tax basis of that asset is greater than its cost, the benefit related to deferred income taxes recognized at the time of acquisition should be deducted from the cost of the asset.

**29.39** In some circumstances, an asset acquired, other than an asset acquired in a business combination, has a tax basis that is less than its cost. This gives rise to a taxable temporary difference that results in the recognition of a deferred income tax liability.

Adding the cost of deferred income taxes to the cost of the asset reflects the following:

- a. The carrying amount of the asset will include the cost to acquire the asset and the unavoidable income tax consequences of utilizing the asset.
- b. The carrying amount will represent the minimum future cash flows necessary to recover the investment in the asset, including any tax consequences associated with the asset.

**29.40** There may be circumstances in which an asset acquired, other than an asset acquired in a business combination, has a tax basis in excess of its cost. This chapter requires the recognition of a deferred income tax asset in respect of the origination or reversal of the resulting temporary difference. The most appropriate manner of recognizing this deferred income tax asset is to reduce the cost of the asset by the deferred income tax benefit in order to reflect the consideration paid for the asset and take into account the effect of the tax treatment applied by the taxation authorities to the difference between the cost of the asset and its tax basis. This treatment is consistent with accounting for investment tax credits.

### ***Business Combinations***

**29.41** When, at the time of a business combination, the acquirer considers it more likely than not that it will realize a deferred income tax asset of its own that was previously unrecognized, it should recognize a change in the deferred income tax asset in the period of the business combination but should not include it as part of the accounting for the business combination.

**29.42** In certain circumstances, an acquirer may consider it more likely than not that, as a result of a business combination, it will be able to realize a deferred income tax asset of its own or its subsidiaries that was unrecognized immediately before the acquisition. For example, the acquirer may be able to utilize the benefits of its unused tax losses against the future taxable income of the acquiree or through the use of tax planning strategies. Alternatively, as a result of the business combination, it might no longer be more likely than not that future taxable profit will allow the deferred income tax asset to be recovered. In such cases, the acquirer recognizes a change in the deferred income tax asset in the period of the business combination but does not include it as part of the accounting for the business combination. Therefore, the acquirer does not take the deferred income tax asset into account in measuring the goodwill or bargain purchase gain it recognizes in the business combination.

**29.43** When a deferred income tax asset acquired in a business combination that was not recognized as an identifiable asset by the acquirer at the date of the acquisition is subsequently recognized by the acquirer within the measurement period, the benefit should be applied

- a. first to reduce to zero any unamortized goodwill related to the acquisition and
- b. then to reduce income tax expense.

**29.44** The measurement period is the period after the acquisition date during which the acquirer may adjust the provisional amounts recognized for a business combination (see

chapter 11, “Business Combinations”).

**29.45** When a deferred income tax asset acquired in a business combination that was not recognized as an identifiable asset by the acquirer at the date of the acquisition is recognized by the acquirer after the measurement period, the benefit should be recognized in income tax expense.

**29.46** The principles in paragraphs 29.41, 29.43, and 29.45 should be applied

- a. when accounting for an investment subject to significant influence or an interest in a joint venture and
- b. when recognizing deferred income tax assets in periods subsequent to the application of push-down accounting (see chapter 15, “New Basis (Push-Down) Accounting”).

**29.47** When a deferred income tax asset that was not recognized at the date of a comprehensive revaluation as a result of a financial reorganization is subsequently recognized, the benefit should be applied

- a. first to reduce to zero any unamortized intangible assets (see chapter 21, “Intangible Assets”) that were recorded at the date of the comprehensive revaluation and
- b. then in a manner consistent with the revaluation adjustment recorded at the date of the comprehensive revaluation.

## **Measurement**

**29.48** Income tax liabilities and income tax assets should be measured using the income tax rates and income tax laws that, at the balance sheet date, are expected to apply when the liability is settled or the asset is realized, which are normally those enacted at the balance sheet date.

**29.49** Deferred income tax liabilities and deferred income tax assets should not be discounted.

**29.50** Whether current or future, income tax liabilities and income tax assets are normally measured using the income tax rates and tax laws that have been enacted at the balance sheet date.

**29.51** For changes in income tax rates and tax laws enacted after the date of the financial statements but before the date of their completion, disclosure as a subsequent event may be appropriate in accordance with chapter 24, “Subsequent Events.”

**29.52** When the effective tax rate that applies to capital gains and losses differs from the tax rate that applies to other taxable income, the rate used to measure deferred income tax assets and liabilities reflects the expected manner of recovery of the asset.

**29.53** When different income tax rates apply to different levels of taxable income, deferred income tax assets and liabilities are measured using the rates that are expected to

apply to the taxable income of the periods in which the temporary differences are expected to reverse. When income tax rate reductions must be allocated among companies in a related group, deferred income tax liabilities and deferred income tax assets are measured in the financial statements of the individual companies based on the allocations of these reductions expected to occur in the future, regardless of the actual allocations in the current year.

### **Intraperiod Allocation**

**29.54** The cost (benefit) of current and deferred income taxes should be recognized as income tax expense included in the determination of net income or loss for the period before discontinued operations, except that

- a.* any portion of the cost (benefit) of current and deferred income taxes related to discontinued operations of the current period should be included in the statement of income with the results of discontinued operations;
- b.* any portion of the cost (benefit) of current and deferred income taxes relating to capital transactions in the current period, or relating to items that are credited or charged directly to equity in the current period, should be charged or credited directly to equity;
- c.* any portion of the cost (benefit) of current and deferred income taxes arising at the time of changes in shareholder status should be treated as a capital transaction (see chapter 23, “Equity”);
- d.* any portion of the cost of deferred income taxes arising at the time an entity renounces the deductibility of expenditures to an investor should be treated as a cost of issuing the security to the investor;
- e.* any portion of the cost (benefit) of deferred income taxes arising at the time of acquisition of an asset, other than an asset acquired in a business combination, should be recognized in accordance with paragraph 29.38;
- f.* any portion of the cost (benefit) of deferred income taxes recognized at the time of a business combination should be included in the allocation of the cost of the purchase (see paragraph 29.17);
- g.* any other portion of the cost (benefit) of deferred income taxes related to a business combination, investment in a significantly influenced investee, interest in a joint venture, or comprehensive revaluation of assets and liabilities should be recognized in accordance with paragraphs 29.43 and 29.45–.47;
- h.* any portion of the cost (benefit) of current and deferred income taxes relating to the correction of an error or a change in accounting policy should be recognized in a manner consistent with the underlying item (see chapter 5, “Accounting Changes, Changes in Accounting Estimates, and Correction of Errors”).

**29.55** Changes in deferred income tax balances recognized in accordance with

paragraph 29.48 as a result of changes in tax laws or rates should be included in deferred income tax expense reported in income before discontinued operations.

**29.56** The cost (benefit) of current income taxes represents the amount of income taxes payable or recoverable in respect of the period. The cost (benefit) of deferred income taxes represents the amount of deferred income tax liabilities and deferred income tax assets recognized in the period. The cost (benefit) of current and deferred income taxes is recognized in a manner consistent with the transaction or event that gave rise to the current or deferred income tax liability or asset. Therefore, the cost (benefit) of current and deferred income taxes is recognized as income tax expense except for any portions allocated elsewhere in accordance with paragraph 29.54.

**29.57** The tax benefit of an unused tax loss or income tax reduction, to the extent recognized in the year of the loss, is reported in the same manner as the related loss. When included in net income, the tax benefit of a loss carryforward recognized in a period after the period of the loss is reported in income before discontinued operations regardless of the classification of the loss in the prior period.

**29.58** When an item is treated as a capital transaction or is otherwise credited or charged to equity rather than included in the determination of the net income or loss for the period, the cost (benefit) of current and deferred income taxes relating to that item is also charged or credited directly to equity. Examples of such items are

- a. the amount of the correction of an error that relates to prior periods that is reported by adjusting the opening balance of retained earnings (see chapter 5);
- b. the amount of an adjustment resulting from a change in accounting policy that is applied retroactively and that is reported as an adjustment to the opening balance of retained earnings (see chapter 5);
- c. the costs related to the issue, redemption, or cancellation of capital stock (see chapter 23).

**29.59** Deferred income tax liabilities and assets may change because of changes in shareholder status or capital stock transactions that affect the entity's tax status (for example, changes in the residence of shareholders and changes in control). The changes in deferred income tax assets and liabilities related to the shareholders' action or to the injection of new equity are recorded as capital transactions. The effects of changes in tax status related to the entity's actions or decisions, such as a change in the entity's residency, are included in income tax expense included in the determination of net income before discontinued operations.

**29.60** Changes in deferred income tax balances recognized as a result of changes in tax laws or rates in accordance with paragraph 29.48 are included in income before discontinued operations because such changes are considered to be a result of normal business activities.

### **Alternative Minimum Tax**

**29.61** Any amounts of income tax payable currently that may reduce income taxes of a

future period should be recorded as a deferred income tax asset if it is more likely than not that income taxes will be sufficient to recover the amounts payable currently. Any amounts not more likely than not to be recovered should be included in current income tax expense.

**29.62** Certain jurisdictions levy a minimum tax with reference to income for financial statement purposes or to certain elements of capital. Such amounts are creditable against deferred income taxes payable in certain circumstances. When it is more likely than not that deferred income tax liabilities will be sufficient to recover the minimum tax, the minimum tax recoverable is recorded as an asset.

## **Unincorporated Businesses**

**29.63** An unincorporated business is not liable for income taxes on income earned. Although its income or losses do affect the tax liability of the owners, any calculation of the owners' tax liability relating specifically to the business would necessarily be arbitrary because it would be affected by factors completely unrelated to the operations of the business.

**29.64** No provision for income taxes should be made in the financial statements of businesses for which income is taxed directly to the owners.

## **Presentation**

### **Income Tax Expense**

**29.65** Income tax expense included in the determination of net income or loss before discontinued operations should be presented on the face of the statement of income.

### **Income Tax Liabilities and Income Tax Assets**

**29.66** Income tax liabilities and income tax assets should be presented separately from other liabilities and assets. Current income tax liabilities and current income tax assets should be presented separately from deferred income tax liabilities and deferred income tax assets.

**29.67** When an entity segregates assets and liabilities between current and noncurrent assets and liabilities, the current and noncurrent portions of deferred income tax liabilities and deferred income tax assets should also be segregated. The classification between current and noncurrent should be based on the classification of the liabilities and assets to which the deferred income tax liabilities and deferred income tax assets relate. A deferred income tax liability or deferred income tax asset that is not related to a liability or asset recognized for accounting purposes should be classified according to the expected reversal date of the temporary difference. Deferred income tax assets related to unused tax losses and income tax reductions should be classified according to the date that the benefit is expected to be realized.

**29.68** Current income tax liabilities and current income tax assets should be offset if

they relate to the same taxable entity and the same taxation authority. Deferred income tax liabilities and deferred income tax assets should be offset if they relate to the same taxable entity and the same taxation authority. However, when an entity classifies assets and liabilities as current and noncurrent, the current portion of deferred income tax balances should not offset any deferred income tax balances classified as noncurrent.

**29.69** When enterprises in a group are taxed separately by the same taxation authority, a deferred income tax asset recognized by one entity in the group should not be offset against a deferred income tax liability of another entity in the group unless tax planning strategies could be implemented to satisfy the requirements of paragraph 29.68 when the deferred income tax liability becomes payable.

**29.70** Although current income tax assets and current income tax liabilities are separately recognized and measured, they may be offset in the balance sheet to the extent that they relate to income taxes levied on the same taxable entity by the same taxation authority. Similarly, deferred income tax assets and deferred income tax liabilities are offset to the extent that they relate to income taxes levied on the same taxable entity by the same taxation authority. However, current and noncurrent income tax balances are not offset by an entity that makes a distinction between current and noncurrent assets and liabilities, irrespective of whether the balances relate to income taxes levied by the same taxation authorities. In addition, current income tax liabilities and current income tax assets are not offset with deferred income tax liabilities and deferred income tax assets, irrespective of whether the balances relate to income taxes levied by the same taxation authorities. However, it is appropriate to consider available tax planning strategies that can be implemented. A tax planning strategy is assumed only when it is practical and when management has both the ability and the intent to employ the strategy, if necessary, to offset tax balances. An example of a tax planning strategy that might result in an offset of deferred income tax assets and liabilities in a consolidated group is an amalgamation of companies in the group.

## **Disclosure**

**29.71** An entity should disclose the accounting policy choice made to account for income taxes, either

- a.* the taxes payable method or
- b.* the deferred income taxes method

**29.72** When an entity applies the taxes payable method of accounting for income taxes, the financial statements should disclose the following:

- a.* Income tax expense (benefit) included in the determination of income or loss before discontinued operations
- b.* A reconciliation of the income tax rate or expense related to income or loss for the period before discontinued operations to the statutory income tax rate or the dollar amount that would result from its application, including the nature and amount of each significant reconciling item

- c.* The amount and timing of capital gain reserves and similar reserves to be included in taxable income within five years
- d.* The amount of unused income tax losses carried forward and unused income tax credits
- e.* The portion of income tax expense (benefit) related to transactions charged (or credited) to equity

**29.73** When an entity applies the deferred income taxes method of accounting for income taxes, the following should be disclosed separately:

- a.* Current income tax expense (benefit) included in the determination of income or loss before discontinued operations
- b.* Deferred income tax expense (benefit) included in the determination of income or loss before discontinued operations
- c.* The portion of the cost (benefit) of current and deferred income taxes related to capital transactions or other items that are charged or credited to equity
- d.* The total amount of unused tax losses and income tax reductions and the amount of deductible temporary differences for which no deferred income tax asset has been recognized

**29.74** An entity that is not subject to income taxes because its income is taxed directly to its owners should disclose that fact.

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## Chapter 30—*Disposal of Long-Lived Assets and Discontinued Operations*

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### Purpose and Scope

**30.01** This chapter establishes principles for the recognition, measurement, presentation, and disclosure of the disposal of long-lived assets. It also establishes principles for the presentation and disclosure of discontinued operations, regardless of whether they include long-lived assets.

**30.02** This chapter applies to the disposal of nonmonetary long-lived assets, including property, plant, and equipment; intangible assets with finite useful lives; and long-term prepaid assets. It does not apply to

- a. the disposal of goodwill (see chapter 21, “Intangible Assets”);
- b. investments, including equity method accounted investments (see chapter 19, “Investments”); and
- c. financial assets, financial liabilities, and contracts to buy or sell nonfinancial items accounted for in accordance with chapter 32, “Financial Instruments and Long-Term Debt.”

### Definitions

**30.03** The following terms are used in this chapter with the meanings specified:

*Disposal group.* A group of assets to be disposed of, by sale or otherwise, together as a group in a single transaction, and liabilities directly associated with those assets that will be transferred in the transaction. (Examples of such liabilities include, but are not limited to, legal obligations that transfer with a long-lived asset, such as certain environmental obligations and obligations that, for business reasons, a potential buyer would prefer to settle when assumed as part of a group, such as warranty obligations that relate to an acquired customer base.)

*Fair value.* The amount of the consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act.

*Long-lived asset.* An asset that does not meet the definition of a *current asset* (see chapter 7, “Current Assets and Current Liabilities”). For purposes of this chapter, the term *long-lived asset* includes a disposal group.

*Operating segment.* A component of an entity

- that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity);

- for which operating results are regularly reviewed by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance; and
- for which discrete information is available.

An operating segment may engage in business activities for which it has yet to earn revenues. For example, start-up operations may be operating segments before earning revenue. The term *chief operating decision maker* identifies a function, not necessarily a manager with a specific title. That function is to allocate resources to and assess the performance of the segments of an entity. Often, the chief operating decision maker of an entity is its chief executive officer or chief operating officer, but it may be a group (for example, consisting of the entity's president, executive vice presidents, and others).

## Long-Lived Assets to Be Disposed of by Sale

### Recognition

**30.04** A long-lived asset to be sold should be classified as held for sale in the period in which all of the following criteria are met:

- Management, having the authority to approve the action, commits to a plan to sell.
- It is available for immediate sale in its present condition, subject only to terms that are usual and customary for sales of such assets.
- An active program to locate a buyer and other actions required to complete the sale plan have been initiated.
- The sale is probable and is expected to qualify for recognition as a completed sale within one year, except as permitted by paragraph 30.05.
- It is being actively marketed for sale at a price that is reasonable in relation to its current fair value.
- Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

**30.05** Events or circumstances beyond an entity's control may extend the period required to complete the sale beyond one year. An exception to the one-year requirement in paragraph 30.04(d) applies in the following situations in which such events or circumstances arise:

- At the date an entity commits to a plan to sell a long-lived asset, it reasonably expects that others (not a buyer) will impose conditions on the transfer that will extend the period required to complete the sale, and
  - actions necessary to respond to the conditions cannot be initiated until after a firm purchase commitment is obtained, and

- ii. a firm purchase commitment is probable within one year.
- b. An entity obtains a firm purchase commitment and, as a result, a buyer or others unexpectedly impose(s) conditions on the transfer of a long-lived asset previously classified as held for sale that will extend the period required to complete the sale, and
  - i. actions necessary to respond to the conditions have been initiated or will be initiated in a timely manner, and
  - ii. a favorable resolution of the delaying factors is expected.
- c. During the initial one-year period, circumstances arise that previously were considered unlikely and, as a result, a long-lived asset previously classified as held for sale is not sold by the end of that period, and
  - i. during the initial one-year period, the entity initiated actions necessary to respond to the change in circumstances;
  - ii. the asset is being actively marketed at a price that is reasonable given the change in circumstances; and
  - iii. the criteria in paragraph 30.04 are met.

**30.06** A firm purchase commitment is an agreement with an unrelated party, binding on both parties and usually legally enforceable, that

- a. specifies all the significant terms, including the price and timing of the transaction and
- b. includes a disincentive for nonperformance that is sufficiently large to make performance probable.

**30.07** A long-lived asset that is newly acquired and that will be sold rather than held and used is classified as held for sale at the acquisition date only if the one-year requirement in paragraph 30.04(d) is met (except as permitted by paragraph 30.05), and any other criteria in paragraph 30.04 that are not met at that date are probable of being met within a short period following the acquisition (usually within 3 months).

**30.08** If the criteria in paragraph 30.04 are met after the balance sheet date but before issuance of the financial statements, a long-lived asset continues to be classified as held and used in those financial statements, and the information required by paragraph 30.35(a) is disclosed in the notes to the financial statements (see chapter 24, “Subsequent Events”).

## **Measurement**

**30.09** A long-lived asset classified as held for sale should be measured at the lower of its carrying amount or fair value less cost to sell. A long-lived asset should not be amortized while it is classified as held for sale. Interest and other expenses attributable to the liabilities of a disposal group classified as held for sale should continue to be accrued.

**30.10** Costs to sell are the incremental direct costs to transact a sale (that is, the costs

that result directly from, and are essential to, a sale transaction and that would not have been incurred by the entity had the decision to sell not been made). These costs include broker commissions, legal and title transfer fees, and closing costs that must be incurred before legal title can be transferred. If the sale is expected to occur beyond one year, as permitted in limited situations by paragraph 30.05, the costs to sell are discounted.

**30.11** Costs to sell exclude future losses associated with the operations of a long-lived asset while it is classified as held for sale.

**30.12** The fair value of a long-lived asset includes those future operating losses that marketplace participants would consider in determining fair value. For example, this could include normal start-up losses of a new business. Future operating losses that marketplace participants would not consider in their estimates of the fair value, less cost to sell of a long-lived asset classified as held for sale, are not indirectly recognized as part of a loss on the sale by reducing the carrying amount to an amount less than its current fair value less cost to sell.

**30.14** A loss should be recognized for any initial or subsequent write-down to fair value less cost to sell. A gain should be recognized for any subsequent increase in fair value less cost to sell, but not in excess of the cumulative loss previously recognized for a write-down to fair value less cost to sell in accordance with this section.

**30.15** When a disposal group is a portion of a reporting unit that constitutes a business, goodwill is allocated to the disposal group and included in its carrying amount prior to determining any write-down (see chapter 21, “Intangible Assets”).

**30.16** Other assets within the disposal group that are not included in the scope of this section, as well as liabilities, are evaluated prior to determining any write-down of long-lived assets within the scope of this section. (For example, indefinite-lived intangible assets are evaluated in accordance with chapter 21; equity-accounted investments are evaluated in accordance with chapter 19, “Investments,” and the allowance for doubtful accounts is evaluated in accordance with chapter 32.)

**30.17** The loss or gain determined after applying the guidance in paragraphs 30.15–.16 adjusts only the carrying amount of a long-lived asset within the scope of this section, whether classified as held for sale individually or as part of a disposal group and not any other assets or liabilities that are part of the disposal group. A gain or loss not previously recognized that results from the sale of a long-lived asset is recognized at the date of sale.

### **Changes to a Plan of Sale**

**30.18** If a long-lived asset no longer meets the criteria to be classified as held for sale, it should be reclassified as held and used. A long-lived asset that is reclassified should be measured individually at the lower of

- a. the carrying amount before it was classified as held for sale, adjusted for any depreciation (amortization) expense that would have been recognized had it been continuously classified as held and used or

b. fair value at the date of the subsequent decision not to sell.

**30.19** Any required adjustment to the carrying amount of a long-lived asset that is reclassified as held and used is included in income before discontinued operations in the period of the subsequent decision not to sell. The adjustment is reported in the same statement of income caption used to report a loss, if any, recognized for a long-lived asset that is classified as held for sale but is not reported as a discontinued operation. If a component of an entity (see paragraph 30.29) is reclassified as held and used, the results of operations of the component previously reported in discontinued operations in accordance with paragraph 30.31 are reclassified and included in income before discontinued operations for all periods presented.

**30.20** If an entity removes an individual asset or liability from a disposal group previously classified as held for sale, the remaining assets and liabilities of the disposal group to be sold continue to be measured as a group only if the criteria in paragraph 30.04 are met. Otherwise, the remaining long-lived assets of the group that still meet the criteria to be classified as held for sale are measured individually at the lower of their carrying amounts or fair values less cost to sell. Other long-lived assets are reclassified as held and used.

### **Balance Sheet Presentation**

**30.21** A long-lived asset classified as held for sale should be presented separately in the entity's balance sheet. The assets and liabilities of a disposal group classified as held for sale should be presented separately in the asset and liability sections, respectively, of the balance sheet.

**30.22** Assets and liabilities of a disposal group classified as held for sale are not offset, other than financial assets and liabilities that meet the conditions for offsetting (see chapter 32). Current and long-term assets (and liabilities) are presented separately unless the entity's balance sheet is unclassified.

**30.23** Long-lived assets classified as held for sale are not reclassified as current assets unless the entity has sold the assets prior to the date of completion of the financial statements, and the proceeds of the sale will be realized within a year of the date of the balance sheet or within the normal operating cycle if that is longer than a year. If the assets have been classified as current assets due to the subsequent sale, any liabilities to be assumed by the purchaser or required to be discharged on disposal of the assets are classified as current liabilities.

### **Long-Lived Assets to Be Disposed of Other Than by Sale**

**30.24** A long-lived asset to be disposed of other than by sale should continue to be classified as held and used until it is disposed of.

**30.25** The guidance on impairment in chapter 20, "Property, Plant, and Equipment," continues to apply until the disposal of the asset. Disposal other than by sale includes, for example, abandonment and a distribution to owners in a spin-off.

**30.26** A long-lived asset to be abandoned is disposed of when it ceases to be used. If an entity commits to a plan to abandon a long-lived asset before the end of its previously estimated useful life, depreciation estimates are revised to reflect the use of the asset over its shortened useful life. The continued use of a long-lived asset demonstrates the presence of service potential. Consequently, only in unusual situations would the fair value of a long-lived asset to be abandoned be zero (or equal to its salvage value) while it is being used. A long-lived asset that has been temporarily idled is not accounted for as if abandoned.

**30.27** A long-lived asset to be distributed to owners in a spin-off is disposed of when it is distributed. If the asset is tested for recoverability while it is classified as held and used, the estimates of future cash flows used in that test are based on the remaining useful life, assuming that the exchange or spin-off transaction will not occur. In addition to any impairment losses required to be recognized while classified as held and used, an impairment loss is recognized at the time of disposal if the carrying amount exceeds fair value. The provisions of this paragraph apply to nonmonetary exchanges that are not measured at fair value (see chapter 17, “Nonmonetary Transactions”).

## **Discontinued Operations**

**30.28** The results of operations of a component of an entity that either has been disposed of (by sale, abandonment, or spin-off) or is classified as held for sale should be reported in discontinued operations if both of the following conditions are met:

- a. the operations and cash flows of the component have been (or will be) eliminated from the ongoing operations of the entity as a result of the disposal transaction; and
- b. the entity will not have any significant continuing involvement in the operations of the component after the disposal transaction.

Only items meeting the preceding criteria should be reported in discontinued operations.

**30.29** A component of an entity comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity. A component of an entity may be an operating segment, a reporting unit (see chapter 21), a subsidiary (see chapter 12, “Subsidiaries”), an asset group (see paragraphs 20.31–.36), or operations without long-lived or other assets.

**30.30** The disposal of an equity method investment, by itself, is not reported as a discontinued operation. Financial instruments, including investments in equity securities accounted for by the equity or cost method, are excluded from the scope of this chapter. Further, the operations related to an equity method investment (that is, the investor entity's share of the earnings or losses of the investee entity) are not sufficient to establish a component of the investor. However, if a component of an entity has operations that include, but are not limited to, operations related to an equity method investment or other asset that is excluded from the scope of this chapter and the conditions for reporting discontinued operations are met, all the operations of the component are reported in discontinued operations.

**30.31** The results of discontinued operations, less applicable income taxes, should be reported as a separate element of income for both current and prior periods (see chapter 8, “Statement Of Income”).

**30.32** The results of discontinued operations include any gain or loss recognized in accordance with paragraph 30.14 and are reported in discontinued operations in the period(s) in which they occur. In accordance with paragraph 30.11, future losses associated with the operations of a discontinued operation are not accrued.

**30.33** Adjustments to amounts previously reported in discontinued operations that are directly related to the disposal of a component of an entity in a prior period are classified separately in the current period in discontinued operations. Examples of circumstances in which those types of adjustments may arise include the following:

- a. the resolution of contingencies that arise pursuant to the terms of the disposal transaction, such as the resolution of purchase-price adjustments and indemnification issues with the purchaser;
- b. the resolution of contingencies that arise from and are directly related to the operations of the component prior to its disposal, such as environmental and product warranty obligations retained by the seller; and
- c. the settlement of employee benefit plan obligations (pension, postemployment benefits other than pensions, and other postemployment benefits), provided that the settlement is directly related to the disposal transaction (that is, there is a demonstrated direct cause-and-effect relationship, and the settlement occurs no later than one year following the disposal transaction, unless it is delayed by events or circumstances beyond an entity's control, as permitted by paragraph 30.05).

## **Disclosure**

**30.34** The financial statements should disclose the following information in the period in which a long-lived asset has been disposed of other than by sale:

- a. A description of the long-lived asset and the facts and circumstances leading to the disposal
- b. If not separately presented on the face of the statement of income, the amount of the gain or loss on disposal and the caption in the statement of income that includes that gain or loss
- c. If applicable, amounts of revenue and pretax profit or loss reported in discontinued operations.

**30.35** The financial statements should disclose the following information in the period in which a long-lived asset (or disposal group) either has been sold or is classified as held for sale:

- a. A description of the facts and circumstances leading to the disposal or expected disposal

- b.* If not separately presented on the face of the statement of income, the gain or loss recognized in accordance with paragraph 30.14 and the caption in the statement of income that includes that gain or loss
- c.* If applicable, amounts of revenue and pretax profit or loss reported in discontinued operations

**30.36** In a period in which a decision is made not to sell an asset previously classified as held for sale, the change in accounting treatment should be disclosed.

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## Chapter 31—*Related Party Transactions*

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### Purpose and Scope

**31.01** This chapter establishes principles for the measurement and disclosure of related party transactions in the financial statements.

**31.02** This chapter does not apply to management compensation arrangements, including retirement and other postemployment benefits accounted for in accordance with chapter 28, “Retirement and Other Postemployment Benefits,” expense allowances, and other similar payments, including loans and receivables, to individuals, in the normal course of operations.

### Definitions

**31.03** The following terms are used in this chapter with the meanings specified:

*Carrying amount.* The amount of an item transferred, or cost of services provided, as recorded in the accounts of the transferor after adjustment, if any, for amortization or depreciation or impairment in value.

*Control.* Control of an entity is the continuing power to determine its strategic operating, investing, and financing policies without the cooperation of others.

*Exchange amount.* The amount of consideration paid or received as established and agreed to by related parties.

*Fair value.* The amount of the consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act.

*Joint control.* Joint control of an economic activity is the proportionate contractually agreed sharing of the continuing power to determine its strategic operating, investing, and financing policies.

*Ownership interest.* Ownership interest in an item transferred or the benefit of a service provided exists when an entity has the right and ability to, directly or indirectly, obtain future economic benefits from the item transferred or the service provided.

*Related parties.* Exist when one party has the ability to exercise, directly or indirectly, control, joint control, or significant influence over the other. Two or more parties are related when they are subject to common control, joint control, or common significant influence. Related parties also include management and immediate family members (see paragraph 31.04).

*Related party transaction.* A transfer of economic resources or obligations between related parties, or the provision of services by one party to a related party, regardless of whether any consideration is exchanged. The parties to the

transaction are related prior to the transaction. When the relationship arises as a result of the transaction, the transaction is not one between related parties.

*Significant influence.* Significance over an entity is the ability to affect the strategic operating, investing, and financing policies of the entity.

## Identification of Related Parties

**31.04** The most commonly encountered related parties of a reporting entity include the following:

- a. An entity that directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with, the reporting entity.
- b. An individual who directly, or indirectly through one or more intermediaries, controls the reporting entity.
- c. The other party, when an investment is accounted for by the equity or the proportionate consolidation method and the reporting entity, is either the investor or the investee.
- d. Management. Any person(s) having authority and responsibility for planning, directing, and controlling the activities of the reporting entity. (In the case of a company, management includes the directors, officers, and other persons fulfilling a senior management function. When an independent committee of the board of directors is established in accordance with regulatory requirements to represent the noncontrolling interests of an entity, the directors serving on that committee are deemed not to be related parties for the transaction under consideration.)
- e. An individual having an ownership interest in the reporting entity that results in significant influence or joint control.
- f. Members of the immediate family of individuals described in (b), (d), and (e). (Immediate family comprises an individual's spouse and those dependent on either the individual or the individual's spouse.)
- g. The other party, when a management contract or other management authority exists, and the reporting entity is either the managing or managed party.
- h. Any party that is subject to significant influence, whether by reason of an ownership interest, management contract, or other management authority, by another party that also has significant influence over the reporting entity.
- i. Any party that is subject to joint control by the reporting entity. (In this instance, a party subject to joint control is related to each of the venturers that share that joint control. However, the venturers themselves are not related to one another solely by virtue of sharing of joint control.)

**31.05** A transaction between a venturer and a joint venture involving the exchange of an asset for an interest in the joint venture is considered to be a transaction between the venturers. When the venturers are unrelated, such a transaction is not a related party

transaction. When venturers are related, the requirements of this chapter apply such that a transaction with a joint venture by a venturer that is related to other venturers is measured at either the exchange amount or the carrying amount, depending on the nature of the transaction. A transaction measured at the exchange amount results in income recognition of any gain or loss. A transaction measured at the carrying amount results in any difference between the carrying amounts of items exchanged being included as a charge or credit to equity in accordance with paragraph 31.09.

**31.06** The degree of influence that one party may exert on another is a major factor in determining whether they are related. In some cases, the degree of influence may be so remote that they need not be considered related. For example, two companies may be unrelated even though one director serves on the board of each company; in such a case, the degree of influence exercised by the director over the strategic policies of each company determines whether the companies are related.

**31.07** Management should make reasonable efforts to identify all related parties. Circumstances that might indicate the existence of related parties include abnormal terms of trade or transactions not normally entered into by the reporting entity. In identifying related parties, management takes into account any beneficial ownership of an entity that it knows is held through nominees. When management has identified circumstances indicating that the other party to a transaction may be related, management has a responsibility to ascertain whether that party is, indeed, related.

## **Measurement**

**31.08** A related party transaction should be measured at the carrying amount, except as specified in paragraphs 31.18 and 31.29.

**31.09** When a related party transaction is measured at the carrying amount, any difference between the carrying amounts of items exchanged, together with any tax amounts related to the items transferred, should be included as a charge or credit to equity.

**31.10** In a historical cost transaction-based accounting model, transactions are generally recognized at the amount of cash or cash equivalents paid or received or at the fair value ascribed to them when they took place. Generally, it is presumed that a transaction amount arrived at by parties dealing at arm's length represents the fair value of the items exchanged. Conversely, as related parties do not deal at arm's length, a transaction between related parties cannot be presumed to have been entered into at fair value.

**31.11** It is possible that the transaction amount may approximate fair value. However, if it does not, it is not necessary for a transacting party to establish what the terms of a non-arm's-length transaction would have been had it been bargained on an arm's length basis.

**31.12** Related parties may have flexibility in the price-setting process that is often not present in transactions between unrelated parties. Further, related parties may enter into transactions that unrelated parties would not necessarily enter into.

**31.13** In a transaction between related parties, a change in the carrying amount of an item transferred or service provided is justified only when the criteria of paragraph 31.18

or 31.29 are met. Transactions between related parties that do not meet the criteria in paragraph 31.18 or 31.29 are measured at the carrying amount, which retains the amount attached to the item transferred or the cost of the service provided.

**31.14** A transferor includes any necessary adjustment in the carrying amount of an item transferred or the cost of a service provided to a related party prior to measuring the transfer. For example, when capital assets are transferred to a related party, any write-down is included by the transferor in determining the net recoverable amount of those assets prior to the transfer (see chapter 21, “Intangible Assets,” and the section, “Impairment of Long-Lived Assets” in chapter 20).

**31.15** When the carrying amount is not available, a reasonable estimate of the carrying amount based on the transferor's original cost may be used to measure the transaction.

**31.16** The carrying amounts of items involved in a related party transaction may differ from each other. For example, an entity transfers an investment portfolio carried at \$1,000, in its own records, to a related party in exchange for property carried at \$700 in the related party's records. The entity records the property received at \$700, and the related party records the investment portfolio received at \$1,000. The difference is accounted for in accordance with paragraph 31.09.

**31.17** When a related party transaction is measured at the carrying amount, any difference between the carrying amounts of the items exchanged, together with any tax amounts related to the item transferred, is a contribution of capital to, or a distribution of equity of, the entity. A net credit is a capital contribution and is credited to additional paid-in capital. A net debit is an equity distribution and is charged against any existing credit balance in additional paid-in capital arising from previous related party transactions, with any excess charged against retained earnings.

### **Transaction in the Normal Course of Operations**

**31.18** A monetary related party transaction, or a nonmonetary related party transaction that has commercial substance, should be measured at the exchange amount when it is in the normal course of operations, unless paragraph 31.22 applies.

**31.19** A nonmonetary related party transaction has commercial substance when the entity's future cash flows are expected to change significantly as a result of the transaction. The entity's future cash flows are expected to change significantly when

- a.* the configuration, as defined in paragraph 31.20, of the future cash flows of the asset received differs significantly from the configuration of the future cash flows of the asset given up, or
- b.* the entity-specific value of the asset received differs from the entity-specific value of the asset given up, and the difference is significant in relation to the exchange amount of the items exchanged.

In some cases, a qualitative assessment will be conclusive in determining that the estimated cash flows of the entity are expected to change significantly as a result of the

transaction.

**31.20** The configuration of future cash flows is composed of the risk, timing, and amount of the cash flows. A change in any one of these considerations is a change in the configuration.

**31.21** Entity-specific value resulting from entity-specific measurement differs from fair value. It attempts to capture the value of an item in the context of the reporting entity. The entity uses its expectations about its use of the asset rather than the use assumed by marketplace participants. When a nonmonetary related party transaction has commercial substance, it is measured at the exchange amount rather than entity-specific value.

**31.22** A nonmonetary related party transaction that is an exchange of a product or property held for sale in the normal course of operations for a product or property to be sold in the same line of business to facilitate sales to customers other than the parties to the exchange should be measured at the carrying amount of the asset adjusted by the fair value of any monetary consideration received or given (see paragraph 17.07 for further guidance).

**31.23** The exchange amount reflects the actual amount of the consideration given for the item transferred or service provided. It is not necessary, or practical, to record the amount of a transaction in the normal course of operations at the carrying amount. The use of the exchange amount for a transaction in the normal course of operations, accompanied by the disclosure requirements of paragraph 31.51, assists the financial statement user to understand the circumstances in which the transaction was undertaken.

**31.24** Examples of transactions in the normal course of operations are the sale or purchase of an inventory item; the provision or receipt of a recurring service, including management and administrative services commonly shared by related parties; a sale or purchase of real estate by an entity that is in the business of selling real estate as part of its ongoing activities; and recurring investing activities by an investment company. Matters to be taken into account when determining whether the operations are normal include type and scope of operations, characteristics of the industry, operating policies of the entity, nature of products and services, and the environment in which the entity operates.

**31.25** Usually, a related party transaction that is in the normal course of operations occurs within a normal business relationship and on terms and conditions that are similar to those of transactions with unrelated parties. Generally, an item exchanged in the normal course of operations by related parties is subsequently transferred to unrelated parties within a normal operating cycle and, therefore, the exchange amount is confirmed.

**31.26** Whether or not a transaction is in the normal course of operations is a question of fact. A related party transaction is presumed not to be in the normal course of operations when it is not of a type that is usually, frequently, or regularly undertaken by the entity for the purpose of generating revenue. This presumption can be rebutted only by persuasive evidence to the contrary.

**31.27** Examples of transactions not in the normal course of operations include the sale

or purchase of capital assets, settlement of debts, and the issue or redemption of an entity's capital.

**31.28** A transaction that may appear to be in the normal course of operations, such as the sale of inventory, may not be if the transaction is of a size and type not usually undertaken by the entity. For example, a transaction is not in the normal course of operations when an entity that ordinarily sells its inventory to a number of different unrelated and related enterprises, sells all its inventory in the current period to one particular related entity. A transaction involving the sale or purchase of assets that were not acquired for resale is also not in the normal course of operations.

### **Transaction Not in the Normal Course of Operations**

**31.29** When a monetary related party transaction or a nonmonetary related party transaction that has commercial substance is not in the normal course of operations, it should be measured at the exchange amount when

- a. the change in the ownership interests in the item transferred or the benefit of a service provided is substantive, and
- b. the exchange amount is supported by independent evidence.

**31.30** A related party transaction that is not in the normal course of operations requires additional support for the substance of the transaction in order for the exchange amount to be used for financial reporting purposes. When the criteria in paragraph 31.29 are satisfied, the exchange amount is more representative of the economic reality of the transaction than the carrying amount and is sufficiently reliable to be used for financial reporting purposes.

**31.31** When a transaction results in a substantive change in ownership interests in the item transferred or the benefit of a service provided, often, sufficient interests by unrelated parties provide some support for the reliability of the exchange amount. When a substantive change in ownership interests is coupled with independent evidence, sufficient support exists for measurement of the transaction at the exchange amount.

**31.32** When the ownership interests in an item transferred or the benefit of a service provided change, the ability to obtain future economic benefits from the item transferred or the service provided also changes. When the continuity of influence over an item transferred, or the beneficial interests of a service provided, has not changed, the transaction has insufficient substance to justify a change in measurement for financial reporting purposes and, hence, its carrying amount is retained. Generally, the greater the change in the ownership interests, the more likely the change is substantive.

**31.33** A change in the continuity of influence occurs when

- a. the nature of the relationship of the transferor to the item transferred changes (for example, from control to joint control), or
- b. the residual equity ownership interest of the item transferred changes by at least 20 percent (for example, a parent transfers an asset to a partially owned

subsidiary when the minority interest consists of a 40-percent interest in the common shares of the investee).

**31.34** Ownership interests may be represented by such evidence as equity shareholdings or other contractual agreements. In a corporate relationship, a related party transaction may result in a change in the legal title of an item exchanged without a substantive change in the equity ownership interests in the item. The continuity of influence over the item transferred is retained and, therefore, the carrying amount is also retained. For example, when an item is transferred between two subsidiary companies, both wholly owned by the same parent, although the legal title to the item transferred may have changed, there has been no change in the ownership interests in the item transferred and, accordingly, the transfer is accounted for at the carrying amount of the item transferred.

**31.35** A change in the equity ownership interests in an item transferred, or the benefit of a service provided, is presumed to be substantive when a transaction results in unrelated parties having acquired or given up at least 20 percent of the total equity ownership interests in the item or service benefits, unless persuasive evidence exists to the contrary.

**31.36** A change of less than 20 percent of the total equity ownership interests in the item transferred, or benefit of a service provided, may be substantive when the degree of influence of the parties over the item transferred or service benefits provided has substantively changed. For example, when a joint venturer transfers an item to a joint venture, a related co-venturer may not have acquired at least 20 percent of the total ownership interests in the item after the transfer. However, if the item becomes jointly controlled by the various joint venturers as opposed to being controlled by one joint venturer, the rights and obligations to the item have substantially changed.

**31.37** An entity may enter into an arrangement to set up a wholly owned subsidiary and transfer assets to it in contemplation of the subsidiary issuing shares to unrelated parties either before or after the transfer. Such a transfer is measured at the carrying amount of the assets to the parent company, unless the criteria of chapter 15, “New Basis (Push-Down) Accounting,” are met because there was no substantive change in the ownership interests in the transferred assets at the time the transfer was arranged.

**31.38** Nonvoting participating shares issued to unrelated parties in the course of an estate freeze generally do not give rise to a substantive change in the ownership interests.

**31.39** A substantive change in ownership interests in the item transferred, or the benefit of a service provided, is insufficient alone to support measurement of the transaction at the exchange amount. Support for the exchange amount itself by independent evidence is necessary to add substance to that amount.

**31.40** Independent evidence in support of the use of an exchange amount includes at least one of the following:

- a. Independent appraisals, valuations, or approvals by appropriately qualified parties that are not related to the entity, carried out to determine the exchange amount
- b. Comparable recently quoted market prices, in an open and unrestricted market

- c. Comparable independent bids on the same transaction
- d. Comparable amounts of similar transactions actually undertaken with unrelated parties

**31.41** The sufficiency and appropriateness of independent evidence required to support the exchange amount is a matter of professional judgment. Such evidence may be in the form of independent documentation supporting the exchange amount or may be a result of the participation of unrelated parties in determining the exchange amount. In some instances, several items of consistent evidence may be required to support the exchange amount. In other instances, one piece of very persuasive evidence may be sufficient. Generally, the more involved unrelated parties are in developing the evidence, the more persuasive it will be.

**31.42** An entity may have a formal policy to bargain with related parties, so that the entity would reject an offer from a related party if a better offer were received from an unrelated party. When such bargaining involves unrelated parties, those selected by the unrelated parties, or those appointed pursuant to regulatory requirements, to act on their behalf, it provides independent evidence to support use of the exchange amount.

**31.43** A nonmonetary related party transaction that does not have commercial substance and is not in the normal course of operations is measured at the carrying amount in accordance with paragraph 31.08, regardless of whether the criteria in paragraph 31.29 are met.

**31.44** A business transferred between two enterprises under common control is accounted for as follows:

- a. When the criteria in paragraph 31.29 are met and the transaction is measured at the exchange amount, the business combination is accounted for in accordance with chapter 11, “Business Combinations.”
- b. When the criteria in paragraph 31.29 are not met, the acquiring entity records the acquired assets and liabilities at their carrying amount in the balance sheet of the transferred business and, if appropriate, recognizes a noncontrolling interest in accordance with chapter 13, “Consolidated Financial Statements and Noncontrolling Interests.” Any change in the noncontrolling interest is recognized as an equity transaction in accordance with chapter 13. The financial statements of the combined entity reflect the earnings, assets, and liabilities of the acquired entity for the entire period in which the transfer occurred and for all prior periods.

## **Gains and Losses**

**31.45** When a related party transaction is measured at the exchange amount, any gain or loss resulting from the transaction should be included in income for the period, unless another chapter requires alternative treatment.

**31.46** Other chapters that require alternative treatment for gains and losses include chapter 13, chapter 19, “Investments,” and chapter 30, “Disposal of Long-Lived Assets

and Discontinued Operations.”

## **Consolidation and Equity Accounting**

**31.47** Gains and losses arising in combining entities as a result of a business combination (as defined in chapter 11) between related parties are reversed on consolidation.

**31.48** A transaction between a parent and a subsidiary that results in a difference between the carrying amount in the subsidiary and the amount at which the item or service received is measured requires adjustment on consolidation to reflect any noncontrolling share of the difference. Similarly, when the equity method of accounting is used, a transaction between an investor and its significantly influenced investee requires adjustment of the investor's equity for the difference between the investee's carrying amount and the amount at which the item or service received is measured in the investee.

## **Financial Instruments**

**31.49** Except as provided in paragraph 31.50, when a financial instrument, as defined in paragraph 32.05, is created or transferred in a related party transaction, the transaction should be measured at the carrying amount, in accordance with paragraph 31.09, or at the exchange amount, if the conditions in paragraphs 31.18 or 31.29 are met.

**31.50** A transaction between an entity and a person or an entity whose sole relationship with the entity is in the capacity of management, as defined in paragraph 31.04(d), should be accounted for in accordance with chapter 32, “Financial Instruments and Long-Term Debt.”

## **Disclosure**

**31.51** An entity should disclose the following information about its transactions with related parties:

- a.* A description of the relationship between the transacting parties
- b.* A description of the transaction(s), including those for which no amount has been recognized
- c.* The recognized amount of the transactions classified by financial statement category
- d.* The measurement basis used
- e.* Amounts due to, or from, related parties and the terms and conditions relating thereto
- f.* Commitments with related parties, separate from other commitments
- g.* Contingencies involving related parties, separate from other contingencies

**31.52** Related party transactions may be entered into on the same terms as if the parties

were unrelated, or they may be entered into on terms differing from those that might have prevailed if the parties had been unrelated to one another. Without disclosure of information about related party transactions, financial statement readers would be justified in assuming that the transactions reported in the financial statements took place at prices bargained with unrelated parties.

**31.53** Information about related party transactions is often of more significance to a financial statement user than information about unrelated party transactions, regardless of the size of such transactions. When considering disclosure of related party transactions, the qualitative, as well as the quantitative, characteristics of materiality are considered.

### **Description of Relationship**

**31.54** Terms such as *affiliate*, *associate*, and *related company* are insufficiently precise to describe relationships. With additional explanation, the effect of the related party relationship on the entity is more understandable. Terms such as *controlled investee*, *significantly influenced investee*, *jointly controlled entity*, *common control entity*, *management*, *shareholder*, *member of the immediate family of the shareholder or management*, and *director* describe the relationships better.

**31.55** An explanation of how significant influence, joint control, or control is exercised between the reporting entity and a related party clarifies the nature of their relationship. The entity may clarify the nature of the relationship by including the percentage ownership between the transacting parties, the extent of representation on the board of directors of either party, or details of management contracts between the parties, depending upon the factor that establishes the relationship.

### **Description of Transaction**

**31.56** A clear description of a related party transaction that sets out the significance of the transaction to the operations of the entity clarifies the effects of the transaction on the entity. Such a description includes information about the nature of the items exchanged and whether the exchange is in the normal course of operations.

**31.57** An exchange of goods or services between related parties that has not been given accounting recognition is also a related party transaction. For example, an entity may provide a related party with management services or use of a patent or license in the normal course of operations without receiving consideration in exchange. An explanation of the nature of such a transaction and the fact that no consideration has been received or paid is useful to explain the effect of the transaction on the entity.

### **Amount of Transactions**

**31.58** To convey the extent of related party transactions, the recognized amounts of such transactions are disclosed. Disclosure of information aggregated by financial statement category (for example, revenue, purchases, major operating costs, interest expense or income, and management fee income or expense) and nature of relationship is more useful than disclosure of individual transactions with related parties, except for

individually significant transactions.

### **Consolidated Financial Statements**

**31.59** In consolidated financial statements, intercompany transactions are eliminated, and disclosure of such transactions is normally not required. However, when an entity participates in transactions with an investee accounted for by the equity method, the transactions between the investor and the investee are disclosed, even though the associated profit or loss is eliminated from the financial statements.

### **Representations About Fair Value**

**31.60** Representations that the exchange amount is equivalent to fair value (or an arm's length equivalent value) are not made unless they can be substantiated. When an entity has undertaken a related party transaction on the same terms as current transactions with unrelated parties, with similar volumes, terms, and conditions, that fact is disclosed. In many cases, a fair value cannot be determined unless there are identical transactions, and the values of the items exchanged are determined by the market (for example, the fair value of an exchange of gold and cash is determined by the market).

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## **Chapter 32—*Financial Instruments and Long-Term Debt***

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### **Purpose and Scope**

**32.01** This chapter establishes principles for

- a.* recognizing and measuring financial assets, financial liabilities, and specified contracts to buy or sell nonfinancial items;
- b.* the classification of financial instruments from the perspective of the issuer between liabilities and equity;
- c.* the classification of related interest, dividends, losses, and gains;
- d.* the circumstances in which financial assets and financial liabilities are offset; and
- e.* disclosures about financial assets and financial liabilities.

**32.02** Common examples of financial instruments include

- a.* cash;
- b.* demand and fixed-term deposits;
- c.* commercial paper, bankers' acceptances, treasury notes, and bills;
- d.* accounts, notes, and loans receivable and payable;
- e.* bonds and similar debt instruments, both issued and held as investments;
- f.* common and preferred shares and similar equity instruments, both issued and held as investments; and
- g.* options, warrants, futures contracts, forward contracts, and swaps.

**32.03** An entity should apply this chapter to all financial instruments except the following:

- a.* Interests in subsidiaries that are accounted for in accordance with chapter 12, “Subsidiaries.”
- b.* Leases (see chapter 22, “Leases”).
- c.* Employer's rights and obligations for retirement and other postemployment benefits and related plan assets (See chapter 28, “Retirement and Other Postemployment Benefits”).
- d.* Insurance contracts, including the cash surrender value of a life insurance policy.
- e.* Contracts and obligations for stock-based compensation to employees and stock-based payments to nonemployees.

- f. Guarantees, other than guarantees that replace financial liabilities (see also the section, “Guarantees,” in chapter 26, “Contingencies”).
- g. Contracts based on revenues of a party to the contract.
- h. Loan commitments (see chapter 25, “Commitments,” and chapter 26).
- i. Contractual arrangements that prevent sale treatment (for example, an option to repurchase transferred receivables).
- j. Contracts issued by an acquirer (but not the seller) for contingent consideration in a business combination (see paragraphs 11.39–.40). This exception applies only to the acquirer (the entity that is accounting for the combination) and not to the seller.

**32.04** This chapter does not apply to contracts to buy or sell nonfinancial items, except for exchange-traded futures contracts.

## Definitions

**32.05** The following terms are used in this chapter with the meanings specified:

*Amortized cost.* The amount at which a financial asset or financial liability is measured at initial recognition, plus or minus the cumulative amortization of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment.

*Derecognition.* The removal of a previously recognized financial asset or financial liability from an entity's balance sheet.

*Derivative.* A contract with all three of the following characteristics:

- Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index, or other variable (sometimes called the "underlying"), provided in the case of a nonfinancial variable that the variable is not specific to a party to the contract.
- It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
- It is settled at a future date.

*Equity instrument.* Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

*Fair value.* The amount of the consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act.

*Financing fees.* Amounts that compensate the lender for the risk of providing funds to the borrower. Financing fees, sometimes referred to as *fees in lieu of interest, loan fees, or financing costs*, include

- fees charged to originate, arrange, or syndicate a loan or debt financing;
- commitment, standby, and guarantee fees; and
- refinancing, restructuring, and renegotiation fees.

Financing fees may be refundable or nonrefundable. Financing fees do not include transaction costs.

*Financial asset.* Any asset that is

- cash;
- a contractual right to receive cash or another financial asset from another party;
- a contractual right to exchange financial instruments with another party under conditions that are potentially favorable; or
- an equity instrument of another entity.

The cost incurred by an entity to purchase a right to reacquire its own equity instruments from another party is a deduction from its equity, not a financial asset.

*Financial instrument.* A contract that creates a financial asset for one entity and a financial liability or equity instrument of another entity.

*Financial liability.* Any liability that is a contractual obligation

- to deliver cash or another financial asset to another party or
- to exchange financial instruments with another party under conditions that are potentially unfavorable to the entity.

*Insurance contract.* A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder. Insurance contracts include any contract based on climatic, geological, or other physical variables.

*Transaction costs.* Incremental costs that are directly attributable to the acquisition, issue, or disposal of a financial asset or financial liability. An incremental cost is one that would not have been incurred if the entity had not acquired, issued, or disposed of the financial instrument. Transaction costs include expenditures such as legal fees, reimbursement of the lender's administrative costs, and appraisal costs associated with a loan. Transaction costs do not include financing fees, debt premiums, or discounts.

## Recognition

**32.06** An entity should recognize a financial asset or a financial liability when the entity becomes a party to the contractual provisions of the financial instrument.

## Measurement

### Initial Measurement

**32.07** When a financial asset is originated or acquired or a financial liability is issued or assumed in an arm's length transaction, an entity should measure it at its fair value adjusted by, in the case of a financial asset or financial liability that will not be measured subsequently at fair value, financing fees and transaction costs that are directly attributable to its origination, acquisition, issuance, or assumption.

**32.08** When a financial asset is originated or acquired or a financial liability is issued or assumed in a related party transaction, an entity should measure it in accordance with chapter 31, "Related Party Transactions."

**32.09** For the purpose of this chapter, parties whose sole relationship with the entity is in the capacity of management, as defined in paragraph 31.04(d), as an individual, group, or by contract, and members of the immediate family of any individual to which this paragraph applies, are deemed to be unrelated third parties. The requirements of paragraph 32.07 apply to transactions with such parties.

**32.10** Except as specified in this chapter, transaction costs should be recognized in net income in the period incurred.

### Subsequent Measurement and Income Recognition

**32.11** Except as specified in paragraphs 32.12–.14, at each reporting date, an entity should measure

- a. investments in equity instruments at cost, less any reduction for impairment;
- b. all other financial assets at amortized cost; and
- c. financial liabilities at amortized cost.

**32.12** An entity should measure investments in equity instruments held for sale at fair value without any adjustment for transaction costs it may incur on sale or other disposal. Changes in fair value should be recognized in net income in the period incurred.

**32.13** The issuer of a financial liability that is indexed to a measure of the entity's financial performance or to changes in the value of the entity's equity should account for the instrument as follows:

- a. The liability is initially measured in accordance with paragraphs 32.07 or 32.08.

- b. Interest expense is calculated using the stated interest rate, plus or minus the amortization of any initial premium or discount.
- c. At each reporting date, the entity adjusts the carrying amount of the liability to the higher of
  - i. the amortized cost of the debt or
  - ii. the amount that would be due at the balance sheet date if the formula determining the additional amount was applied at that date (the conversion or intrinsic value).

The amount of the adjustment in accordance with paragraph 32.13(c) preceding should be recognized in net income and presented as a separate component of interest expense.

**32.14** An entity should report interest, dividends, losses, and gains relating to a financial instrument or a component part that is classified as a financial liability in net income as expense or income. The issuer should report distributions to holders of a financial instrument it classifies as an equity instrument directly in equity.

## **Impairment**

**32.15** At the end of each reporting period, management should assess whether there are any indications that a financial asset, or group of similar financial assets, measured at cost or amortized cost may be impaired. When an indication of impairment exists, management should determine whether a significant adverse change has occurred during the period in the expected timing or amount of future cash flows from the financial asset or group of assets.

**32.16** When management identifies a significant adverse change in the expected timing or amount of future cash flows from a financial asset, or group of similar financial assets, it should reduce the carrying amount of the asset, or group of assets, to the highest of the following:

- a. The present value of the cash flows expected to be generated by holding the asset, or group of assets, discounted using a current market rate of interest appropriate to the asset or group of assets
- b. The amount that could be realized by selling the asset, or group of assets, at the balance sheet date
- c. The amount the entity expects to realize by exercising its right to any collateral held to secure repayment of the asset, or group of assets, net of all costs necessary to exercise those rights.

The carrying amount of the asset, or group of assets, should be reduced directly or through the use of an allowance account. The amount of the reduction should be recognized as an impairment loss in net income.

**32.17** Estimates of the amounts and timing of expected future cash flows from impaired financial assets reflect management's best judgment based on reasonable and supportable assumptions and take into account the range of possible outcomes. Short-term receivables

with no stated interest rate may be measured at the revised expected amount if the effect of discounting is immaterial.

**32.18** When the extent of impairment of a previously written-down asset, or group of assets, decreases and the decrease can be related to an event occurring after the impairment was recognized (such as a return to profitability of the customer or issuer), the previously recognized impairment loss should be reversed to the extent of the improvement directly or by adjusting the allowance account. The adjusted carrying amount of the financial asset, or group of assets, should be no greater than the amount that would have been reported at the date of the reversal had the impairment not been recognized previously. The amount of the reversal should be recognized in net income in the period the reversal occurs.

## Presentation

### Liabilities and Equity

**32.19** The issuer of a financial instrument should classify the instrument, or its component parts, as a liability or as equity in accordance with the substance of the contractual arrangement on initial recognition and the definitions of a *financial liability* and an *equity instrument*.

**32.20** The issuer of a financial instrument that contains both a liability and an equity element, including warrants or options issued with, and detachable from, a financial liability should classify the instrument's component parts separately in accordance with paragraph 32.19.

**32.21** Acceptable methods for initial measurement of the separate liability and equity elements of an instrument to which paragraph 32.20 applies include the following:

- a. The equity component is measured as zero. The entire proceeds of the issue are allocated to the liability component.
- b. The less easily measurable component is allocated the residual amount after deducting from the entire proceeds of the issue the amount separately determined for the component that is more easily measurable.

The sum of the carrying amounts assigned to the liability and equity components on initial recognition is always equal to the carrying amount that would be ascribed to the instrument as a whole. No gain or loss arises from recognizing and presenting the components of the instrument separately.

### Offsetting of a Financial Asset and a Financial Liability

**32.22** A financial asset and a financial liability should be offset, and the net amount reported in the balance sheet, only when an entity

- a. currently has a legally enforceable right to set off the recognized amounts and

- b. intends either to settle on a net basis or to realize the asset and settle the liability simultaneously.

## **Derecognition**

### **Transfers of Receivables**

**32.23** An entity should derecognize receivables transferred to another entity only when control has been surrendered.

### **Financial Liabilities**

**32.24** An entity should remove a financial liability (or a part of a financial liability) from its balance sheet when it is extinguished (that is, when the obligation is discharged or cancelled or expires).

**32.25** A transaction between a borrower and lender to replace a debt instrument with another instrument having substantially different terms is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

**32.26** The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the fair value of the consideration paid, including any noncash assets transferred, liabilities assumed, or equity instruments issued, should be recognized in net income for the period. (A transaction with a related party is accounted for in accordance with chapter 31.)

**32.27** When an issuer of a debt instrument repays or settles that instrument, the debt is extinguished. If an entity repays a part of a financial liability, the entity allocates the carrying amount of the financial liability at the date of repayment based on their relative fair values between the part that continues to be recognized and the part that is derecognized. The difference between the carrying amount allocated to the part derecognized and the consideration paid to extinguish that part, including any noncash assets transferred, liabilities assumed, or equity instruments issued, is recognized in net income.

## **Disclosure**

**32.28** An entity should disclose information that enables users of its financial statements to evaluate the significance of financial instruments to its financial position and performance.

### **Financial Assets**

**32.29** An entity should disclose the carrying amounts of each of the following categories of financial instruments, either on the face of the balance sheet or in the notes:

- a. Financial assets measured at amortized cost
- b. Financial assets measured at fair value
- c. Investments in equity instruments measured at cost, less any reduction for impairment

**32.30** Accounts and notes receivable should be segregated to show separately trade accounts, amounts owing by related parties, and other unusual items of significant amount. The amounts and, when practicable, maturity dates of accounts maturing beyond one year should be disclosed separately.

### **Transfers of Receivables**

**32.31** If an entity has transferred financial assets during the period and accounts for the transfer as a sale, it should disclose

- a. the gain or loss from all sales during the period;
- b. the accounting policies for
  - i. initially measuring any retained interest (including the methodology used in determining its fair value) and
  - ii. subsequently measuring the retained interest; and
- c. a description of the transferor's continuing involvement with the transferred assets, including, but not limited to, servicing, recourse, and restrictions on retained interests.

**32.32** If an entity has transferred financial assets in a way that does not qualify for derecognition, it should disclose

- a. the nature and carrying amount of the assets;
- b. the nature of the risks and rewards of ownership to which the entity remains exposed; and
- c. the carrying amount of the liabilities assumed in the transfer.

### **Impairment**

**32.33** An entity should disclose the carrying amount of impaired financial assets by type of asset and the amount of any related allowance for impairment.

### **Financial Liabilities**

**32.34** For bonds, debentures, and similar securities, mortgages, and other long-term debt, an entity should disclose

- a. the title or description of the liability;
- b. the interest rate;
- c. the maturity date;

- d.* significant terms (for example, covenant details)
- e.* the amount outstanding, separated between principal and accrued interest;
- f.* the currency in which the debt is payable if it is not repayable in the currency in which the entity measures items in its financial statements; and
- g.* the repayment terms, including the existence of sinking fund, redemption, and conversion provisions.

**32.35** An entity should disclose the carrying amount of any financial liabilities that are secured. An entity should also disclose

- a.* the carrying amount of assets it has pledged as collateral for liabilities and
- b.* the terms and conditions relating to its pledge.

**32.36** An entity should disclose the aggregate amount of payments estimated to be required in each of the next five years to meet repayment, sinking fund, or retirement provisions of financial liabilities.

**32.37** For financial liabilities recognized at the balance sheet date, an entity should disclose

- a.* whether any financial liabilities were in default or in breach of any term or covenant during the period that would permit a lender to demand accelerated repayment and
- b.* whether the default was remedied, or the terms of the liability were renegotiated, before the financial statements were completed.

**32.38** An entity should disclose the following items:

- a.* Interest capitalized
- b.* Unused letters of credit
- c.* Long-term debt agreements subject to subjective acceleration clauses, unless the likelihood of the acceleration of the due date is remote

**32.39** An entity that issues any of the following financial liabilities or equity instruments should disclose information to enable users of the financial statements to understand the effects of features of the instrument, as follows:

- a.* For a financial liability that contains both a liability and an equity element (see paragraph 32.20), an entity should disclose the following information about the equity element including, when relevant
  - i.* the exercise date or dates of the conversion option;
  - ii.* the maturity or expiry date of the option;
  - iii.* the conversion ratio or the strike price;
  - iv.* conditions precedent to exercising the option; and

- v. any other terms that could affect the exercise of the option, such as the existence of covenants that, if contravened, would alter the timing or price of the option.
- b. For a financial instrument that is indexed to the entity's equity or an identified factor, as described in paragraph 32.13, an entity should disclose information that enables users of the financial statements to understand the nature, terms, and effects of the indexing feature, the conditions under which a payment will be made, and the expected timing of any payment.

## **Derivatives**

**32.40** For derivative financial instruments, an entity should disclose the face or contract amount (or notional principal amount if there is no face or contract amount), the nature and terms, including a discussion of the credit and market risk of those instruments, and the cash requirements of those instruments. In addition, an entity should provide a description of the entity's objectives for holding the derivative financial instruments.

## **Items of Income**

**32.41** An entity should disclose the following items of income, expense, gains, or losses either on the face of the statements or in the notes to the financial statements:

- a. Net gains or net losses recognized on financial instruments
- b. Total interest income
- c. Total interest expense on current financial liabilities
- d. Interest expense on long-term financial liabilities, separately identifying amortization of premiums, discounts, and financing fees
- e. The amount of any impairment loss or reversal of a previously recognized loss

## **Risks and Uncertainties**

**32.42** For each significant risk arising from financial instruments, and separately for derivatives, an entity should disclose

- a. the exposures to risk and how they arise and
- b. any change in risk exposures from the previous period.

**32.43** For each type of risk arising from financial instruments, an entity should disclose concentrations of risk. Concentrations of risk arise from financial instruments that have similar characteristics and are affected similarly by changes in economic or other conditions.

## Glossary

**accounting policies.** The specific principles, bases, conventions, rules, and practices applied by an entity in preparing and presenting financial statements.

**accretion expense.** The increase in the carrying amount of an asset retirement obligation due to the passage of time.

**accrued benefit obligation.** The actuarial present value of benefits attributed to employee services rendered to a particular date. As of a particular date prior to an employee's full eligibility date, an entity's accrued benefit obligation in respect of the employee is the portion of the obligation for retirement and other postemployment benefits attributed to that employee's service rendered to that date. On and after the full eligibility date, the accrued benefit obligation and obligation for retirement and other postemployment benefits for an employee are the same.

**acquiree.** The business or businesses that the acquirer obtains control of in a business combination.

**acquirer.** The entity that obtains control of the acquiree.

**acquisition date.** The date on which the acquirer obtains control of the acquiree.

**additional paid-in capital.** Comprises amounts paid in by equity holders. Additional paid-in capital in the form of excess paid in by equity holders includes premiums on shares issued, any portion of the proceeds of issue of shares without par value not allocated to capital stock, gain on forfeited shares, proceeds arising from shares donated by equity holders, credits resulting from redemption or conversion of shares at less than the amount set up as capital stock, and any other contribution by equity holders in excess of amounts allocated to capital stock.

**amortizable amount.** The cost of an asset, or other amount substituted for cost, less its residual value.

**amortization.** The systematic allocation of the amortizable amount of an intangible asset over its useful life.

**amortized cost.** The amount at which a financial asset or financial liability is measured at initial recognition, plus or minus the cumulative amortization of any difference between that initial amount and the maturity amount and minus any reduction (directly or through the use of an allowance account) for impairment.

**asset group.** The lowest level (smallest combination) of assets and liabilities for which identifiable cash flows are largely independent of the cash flows of other assets or groups of assets and liabilities.

**asset retirement cost.** The amount that is capitalized and increases the carrying amount of a long-lived asset when a liability for an asset retirement obligation is recognized.

**asset retirement obligation.** A legal obligation associated with the retirement of a tangible long-lived asset that an entity is required to settle as a result of an existing or enacted law, statute, ordinance, or written or oral contract or by legal construction of a contract under the doctrine of promissory estoppel.

**bargain purchase option.** A provision allowing the lessee, at its option, to purchase the leased property for a price that is sufficiently lower than the expected fair value of the property, at the date the option becomes exercisable, such that exercise of the option appears, at the inception of the lease, to be reasonably assured.

**bargain renewal option.** A provision allowing the lessee, at its option, to renew the lease for a rental that is sufficiently lower than the expected fair rental of the property, at the date the option becomes exercisable, such that exercise of the option appears, at the inception of the lease, to be reasonably assured. *Fair rental* means the going rate for rental of equivalent property under similar terms and conditions.

**business.** An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants.

**business combination.** A transaction or other event in which an acquirer obtains control of one or more businesses. Transactions sometimes referred to as *true mergers* or *mergers of equals* are also business combinations as that term is used in the *FRF for SMEs*.

**capital lease.** A lease that, from the point of view of the lessee, transfers substantially all the benefits and risks incident to ownership of property to the lessee.

**carrying amount.** The recorded amount of an asset or liability after adjustment, if any, for amortization or depreciation or impairment in value.

In the context of related party transactions, *carrying amount* is defined as the amount of an item transferred, or cost of services provided, as recorded in the accounts of the transferor, after adjustment, if any, for amortization and depreciation or impairment in value.

**cash.** Comprises cash on hand and demand deposits.

**cash equivalents.** Short-term, highly liquid investments that are readily convertible to known amounts of cash and that are subject to an insignificant risk of changes in value.

**cash flows.** Inflows and outflows of cash and cash equivalents.

**change in accounting estimate.** An adjustment of the carrying amount of an asset or a liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities. Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of errors.

**completed contract method.** A method of accounting that recognizes revenue only when the sale of goods or the rendering of services under a contract is completed or substantially completed.

**consolidated financial statements.** Financial statements produced by aggregating the financial statements of one or more subsidiary companies, in which the parent

company owns more than 50 percent of the outstanding equity interests, on a line-by-line basis (that is, adding together corresponding items of assets, liabilities, revenues, and expenses) with the financial statements of the parent company, eliminating intercompany balances and transactions, and providing for any noncontrolling interest in a subsidiary company.

**contingency.** An existing condition or situation involving uncertainty about possible gain or loss to an entity that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability.

**contingent consideration.** Usually an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. However, contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met.

**contingent rental.** A rental based on a factor other than the passage of time (for example, percentage of sales, amount of usage, prime interest rate, price indexes).

**control.** For chapters 12, “Subsidiaries,” and 15, “New Basis (Push-Down) Accounting,” of this document, *control* is defined as being indicated by the ownership of more than 50 percent of the outstanding equity interests.

For chapters 11, “Business Combinations,” and 31, “Related Party Transactions,” of this document, *control* is defined as the continuing power to determine its strategic operating, investing, and financing policies without the cooperation of others.

**corporate joint venture.** An investment in the stock of entities other than subsidiaries, namely corporate joint ventures and other noncontrolled entities.

**cost.** The amount of consideration given up to acquire, construct, develop, or improve an item of property, plant, and equipment and includes all costs directly attributable to the acquisition, construction, development, or improvement of the asset, including installing it at the location and in the condition necessary for its intended use. Cost includes any asset retirement cost accounted for in accordance with the section “Asset Retirement Obligations,” in chapter 26, “Contingencies.”

In the context of accounting for intangible assets, *cost* is defined as the amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction, or, when appropriate, the amount attributed to that asset when initially recognized in accordance with the requirements of other chapters.

**cost (benefit) of current income taxes.** The amount of income taxes payable (refundable) in respect of the period.

**cost (benefit) of deferred income taxes.** The change during the period in deferred income tax liabilities and deferred income tax assets.

**cost method.** A basis of accounting for investments whereby the investment is initially recorded at cost; earnings from such investments are recognized only to the extent received or receivable.

**date of transition to the *FRF for SMEs*.** The beginning of the earliest period for which an entity presents financial statements under the *FRF for SMEs*.

**deemed cost.** An amount used as a surrogate for cost, or depreciated cost, at a given date. Subsequent depreciation or amortization assumes that the entity had initially recognized the asset or liability at the given date and that its cost was equal to the deemed cost.

**deferred income tax assets.** The amounts of income tax benefits arising in respect of

- deductible temporary differences;
- the carryforward of unused tax losses; and
- the carryforward of unused income tax reductions, except for investment tax credits.

**deferred income tax liabilities.** The amounts of income taxes arising from taxable temporary differences.

**deferred income taxes method.** A method of accounting under which an entity reports as an expense (income) of the period the cost (benefit) of current income taxes and the cost (benefit) of deferred income taxes, determined in accordance with the rules established by taxation authorities.

**defined benefit plan.** A pension plan that defines the amount of pension benefit to be provided. The amount of the benefit is usually a function of one or more factors such as age, years of service, or compensation. Any pension plan that does not meet the defined contribution plan should be considered a defined benefit plan.

**defined contribution plan.** A plan that provides benefits for services rendered based solely on the amount contributed to each plan participant's account and the returns on the investment of those contributions. Each participant has his or her own account and, in many cases, directs the investment of the contribution. The plan specifies how the contribution amounts are to be determined.

**depreciation.** A method of allocating the cost of a tangible asset over its useful life and begins when the asset is placed in service.

**derecognition.** The removal of a previously recognized financial asset or financial liability from an entity's balance sheet.

**derivative.** A contract with all three of the following characteristics:

- Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index, or other variable (sometimes called the "underlying"), provided in the case of a nonfinancial variable that the variable is not specific to a party to the contract.

- It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
- It is settled at a future date.

**development.** The application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems, or services before the start of commercial production or use.

**direct financing lease.** A lease that, from the point of view of the lessor, transfers substantially all the benefits and risks incident to ownership of property to the lessee and, at the inception of the lease, the fair value of leased property is the same as its carrying amount to the lessor (usually not a manufacturer or dealer). A lease is not precluded from being classified as a direct financing lease after it is renewed or extended even though the carrying amount of the property at the end of the original lease term is different from its fair value at that date.

**disposal group.** A group of assets to be disposed of, by sale or otherwise, together as a group in a single transaction and liabilities directly associated with those assets that will be transferred in the transaction. (Examples of such liabilities include, but are not limited to, legal obligations that transfer with a long-lived asset, such as certain environmental obligations, and obligations that, for business reasons, a potential buyer would prefer to settle when assumed as part of a group, such as warranty obligations that relate to an acquired customer base.)

**dividends.** Distributions paid or payable in cash or other assets and do not include distributions of shares unless the effect is to change the equity interests of two or more classes of shares.

**economic life of the leased property.** The estimated remaining period during which the property is expected to be economically usable by one or more users, with normal repairs and maintenance, for the purpose for which it was intended at the inception of the lease and without limitation by the lease term.

**entity-specific value.** The present value of the cash flows an entity expects to arise from the continuing use of an asset and from its disposal at the end of its useful life or expects to incur when settling a liability.

**equity.** The residual interest in the assets of the entity after deducting all of its liabilities.

**equity instrument.** Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

**equity interests.** Used broadly to mean ownership interests of investor-owned entities and owner, member, or participant interests of mutual entities.

**equity method.** A basis of accounting for investments whereby the investment is initially recorded at cost and the carrying value, adjusted thereafter to include the investor's pro rata share of postacquisition earnings of the investee, computed by the consolidation method. The amount of the adjustment is included in the determination of net income by the investor, and the investment account of the investor is also

increased or decreased to reflect the investor's share of capital transactions and changes in accounting policies and corrections of errors relating to prior period financial statements applicable to postacquisition periods. Profit distributions received or receivable from an investee reduce the carrying value of the investment.

**exchange amount.** The amount of consideration paid or received as established and agreed to by related parties.

**executory costs.** Costs related to the operation of the leased property (for example, insurance, maintenance cost, and property taxes).

**expected future benefit.** A calculated amount representing the benefit the entity expects to realize from a plan excess. An expected future benefit includes any withdrawable excess or reduction in future contributions. An entity determines its expected future benefit as the sum of

- the present value of its expected future annual accruals for service for the current number of active employees, less the present value of required employee contributions and minimum contributions the entity is required to make regardless of any excess and
- the amount of the plan excess that can be withdrawn in accordance with the existing plan and any applicable laws and regulations.

**fair value.** The amount of the consideration that would be agreed upon in an arm's length transaction between knowledgeable, willing parties who are under no compulsion to act.

**financial asset.** Any asset that is

- cash;
- a contractual right to receive cash or another financial asset from another party;
- a contractual right to exchange financial instruments with another party under conditions that are potentially favorable; or
- an equity instrument of another entity.

The cost incurred by an entity to purchase a right to reacquire its own equity instruments from another party is a deduction from its equity, not a financial asset.

**financial instrument.** A contract that creates a financial asset for one entity and a financial liability or equity instrument of another entity.

**financial liability.** Any liability that is a contractual obligation to

- deliver cash or another financial asset to another party or
- exchange financial instruments with another party under conditions that are potentially unfavorable to the entity.

**financing activities.** Activities that result in changes in the size and composition of the equity capital and borrowings of the entity.

**financing fees.** Amounts that compensate the lender for the risk of providing funds to the borrower. Financing fees, sometimes referred to as *fees in lieu of interest*, *loan fees*, or *financing costs*, include

- fees charged to originate, arrange, or syndicate a loan or debt financing;
- commitment, standby, and guarantee fees; and
- refinancing, restructuring, and renegotiation fees.

Financing fees may be refundable or nonrefundable. Financing fees do not include transaction costs.

**foreign currency transactions.** Transactions of the reporting entity whose terms are denominated in a currency other than its reporting currency.

**goodwill.** An asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized.

**identifiable.** An asset is identifiable if it either

- is separable (that is, capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability, regardless of whether the entity intends to do so) or
- arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

**impairment.** The condition that exists when the carrying amount of a long-lived asset exceeds its fair value.

**impracticable.** A requirement is considered impracticable when the entity cannot apply it after making every reasonable effort to do so. For a particular prior period, it is impracticable to apply a change in an accounting policy retrospectively if

- the effects of the retrospective application are not determinable;
- the retrospective application requires assumptions about what management's intent would have been in that period; or
- the retrospective application requires significant estimates of amounts, and it is impossible to distinguish objectively information about those estimates that
  - provides evidence of circumstances that existed on the date(s) at which those amounts are to be recognized, measured, or disclosed and
  - would have been available when the financial statements for that prior period were completed

**inception of the lease.** The earlier of the date of the lease agreement and the date of a commitment that is signed by the parties to the lease transaction and includes the principal terms of the lease (this is the effective date used for classification of the lease).

**income taxes.** Income taxes include

- all domestic and foreign taxes that are based on taxable income;
- taxes that are based on a measure of revenue less certain specified expenses;
- alternative minimum income taxes, including taxes based on measures other than income and that may be used to reduce income taxes of another period.

**initial direct costs.** Those costs incurred by the lessor that are directly associated with negotiating and executing a specific leasing transaction. Such costs include commissions, legal fees, and costs of preparing and processing documents for new leases. Such costs do not include supervisory and administrative costs, promotion and lease design costs intended for recurring use, costs incurred in collection activities, and provisions for uncollectable rentals.

**insurance contract.** A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder. Insurance contracts include any contract based on climatic, geological, or other physical variables.

**intangible asset.** An identifiable, nonmonetary asset without physical substance.

**interest rate implicit in the lease.** The discount rate that, at the inception of the lease, causes the aggregate present value of

- the minimum lease payments, from the standpoint of the lessor, excluding that portion of the payments representing executory costs to be paid by the lessor and any profit on such costs and
- the unguaranteed residual value accruing to the benefit of the lessor

to be equal to the fair value of the leased property to the lessor at the inception of the lease.

**inventories.** Assets that are

- held for sale in the ordinary course of business;
- in the process of production for such sale; or
- in the form of materials or supplies to be consumed in the production process or in the rendering of services.

**investing activities.** The acquisition and disposal of long-term assets and other investments not included in cash equivalents.

**joint control.** Joint control of an economic activity is the proportionate contractually agreed sharing of the continuing power to determine its strategic operating, investing, and financing policies.

**joint venture.** An economic activity resulting from a contractual arrangement whereby two or more venturers participate, directly or indirectly, in the jointly-controlled economic activity.

**lease.** The conveyance, by a lessor to a lessee, of the right to use a tangible asset, usually for a specified period of time in return for rent.

**lease inducements.** Incentives for a lessee to sign a lease (for example, an upfront cash payment to the lessee, an initial rent-free period or reduced rent payments in early periods, the reimbursement of costs of the lessee such as moving costs or leasehold improvements, or the assumption by the lessor of the lessee's preexisting lease).

**lease term.** The fixed, noncancellable period of the lease plus

- all periods covered by bargain renewal options;
- all periods for which failure to renew would impose on the lessee a penalty sufficiently large that renewal appears, at the inception of the lease, reasonably assured;
- all periods covered by ordinary renewal options during which the lessee has undertaken to guarantee the lessor's debt related to the leased property;
- all periods covered by ordinary renewal options preceding the date on which a bargain purchase option is exercisable; and
- all periods representing renewals or extensions of the lease at the lessor's option;

provided that the lease term does not extend beyond the date a bargain purchase option becomes exercisable.

The lease term is considered to be noncancellable if cancellation is possible only

- upon the occurrence of some unlikely contingency;
- with permission of the lessor;
- upon the lessee entering into a new lease for the same or equivalent property with the same lessor; or
- upon payment by the lessee of a penalty sufficiently large that continuation of the lease appears, at the inception of the lease, reasonably assured.

**lessee's rate for incremental borrowing.** The interest rate that, at the inception of the lease, the lessee would have incurred to borrow, over a similar term and with similar security for the borrowing, the funds necessary to purchase the leased asset.

**long-lived asset.** An asset that does not meet the definition of a *current asset* (see chapter 7, “Current Assets and Current Liabilities”). The term *long-lived asset* could include an asset group or disposal group.

**materiality.** Materiality is the term used to describe the significance of financial statement information to decision makers. An item of information, or an aggregate of items, is material if it is probable that its omission or misstatement would influence or change a decision. Materiality is a matter of professional judgment in the particular circumstances.

**measurement uncertainty.** Uncertainty in the determination of the amount at which an item is recognized in financial statements.

**minimum lease payments.**

- From the point of view of the lessee, minimum lease payments comprise
  - the minimum rental payments called for by the lease over the lease term;
  - any partial or full guarantee, by the lessee or a third party related to the lessee, of the residual value of the leased property at the end of the lease term (when the lessee agrees to make up a deficiency in the lessor's realization of the residual value below a stated amount, the guarantee to be included in the minimum lease payments is the stated amount rather than an estimate of the deficiency to be made up); and
  - any penalty required to be paid by the lessee for failure to renew or extend the lease at the end of the lease term

provided that if the lease contains a bargain purchase option, only the total of the minimum rental payments over the lease term and the payment called for by the bargain purchase option is included in minimum lease payments. Lease payments that depend on factors measurable at the inception of the lease, such as the consumer price index or the prime interest rate, are not, in substance, contingent rentals in their entirety, and are included in the minimum lease payments based on the index or rate existing at the inception of the lease.

- From the point of view of the lessor, minimum lease payments comprise
  - minimum lease payments for the lessee as described previously and
  - any residual value or rental payments beyond the lease term guaranteed by a third party unrelated to either the lessee or lessor, provided that the guarantor is financially capable of discharging the obligations under the guarantee.

**monetary items.** Money, and claims to money, the value of which (in terms of the monetary unit, whether foreign or domestic) is fixed by contract or otherwise. Deferred income tax liabilities and assets are classified as monetary items.

**monetary assets and liabilities.** Money, assets to be received, or claims to future cash flows that are fixed or determinable in amounts and timing by contract or other

arrangement. Examples are cash and accounts and notes receivable and payable in cash.

**more likely than not.** An event is more likely than not when the probability that it will occur is greater than 50 percent.

**multiemployer plan.** A defined benefit plan under which a single plan funds the benefits for employees of different unrelated companies. These types of plans are often set up as a result of union contracts. The plan assumes the liability for benefits to all participants without regard to the company. Although contributions are determined on an annual basis by a formula specified in the plan, if a company terminates its participation in the plan, it may be subject to a termination liability.

**mutual entity.** An entity, other than an investor-owned entity, that provides dividends, lower costs, or other economic benefits directly to its owners, members, or participants. For example, a cooperative entity is a mutual entity.

**near term.** A period of time not to exceed one year from the date of the financial statements.

**net carrying amount.** Net carrying amount of an item of property, plant, and equipment is cost less both accumulated amortization and the amount of any write-downs.

**net realizable value.** The estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

**net recoverable amount.** Net recoverable amount of an item of property, plant, and equipment is its estimated future net cash flow from use together with its residual value.

**noncontrolling interest.** The equity in a subsidiary not attributable, directly or indirectly, to a parent.

**nonmonetary assets and liabilities.** Assets and liabilities that are not monetary. Examples are inventories; investments in common stock; property, plant, and equipment; and liabilities for rent collected in advance. A contractual right to receive services in the future is a nonmonetary asset, and a contractual obligation to perform services in the future is a nonmonetary liability.

**nonmonetary transactions** are either

- **nonmonetary exchanges**, which are exchanges of nonmonetary assets, liabilities, or services for other nonmonetary assets, liabilities, or services with little or no monetary consideration involved or
- **nonmonetary nonreciprocal transfers**, which are transfers of nonmonetary assets, liabilities, or services without consideration. Nonreciprocal transfers include, but are not limited to
  - donations of nonmonetary assets or services;
  - payments of dividends-in-kind;
  - stock dividends, when the shareholder has the option of receiving cash or shares; and

- the distribution of assets to owners in the liquidation of all, or part, of an entity.

The issue of shares in a stock split and the payment of nonoptional stock dividends are not nonreciprocal transfers.

**obligation for retirement and other postemployment benefits.** The actuarial present value as of a particular date of benefits expected to be paid under a defined benefit plan. The obligation is measured on the basis of the expected amount and timing of future benefits, taking into consideration the expected future cost of providing the benefits and the extent to which the costs are shared by employees or others.

**operating activities.** The principal revenue-producing activities of the entity and all other activities that are not investing or financing activities.

**operating lease.** A lease in which the lessor does not transfer substantially all the benefits and risks incident to ownership of property.

**operating segment.** A component of an entity

- that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity);
- for which operating results are regularly reviewed by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance; and
- for which discrete information is available.

An operating segment may engage in business activities for which it has yet to earn revenues. For example, start-up operations may be operating segments before earning revenue. The term *chief operating decision maker* identifies a function, not necessarily a manager, with a specific title. That function is to allocate resources to, and assess the performance of, the segments of an entity. Often, the chief operating decision maker of an entity is its chief executive officer or chief operating officer, but it may be a group (for example, consisting of the entity's president, executive vice presidents, and others).

**ownership interest.** Ownership interest in an item transferred or the benefit of a service provided exists when an entity has the right and ability to, directly or indirectly, obtain future economic benefits from the item transferred or the service provided.

**owners.** Used broadly to include holders of equity interests of investor-owned entities and owners or members of, or participants in, mutual entities.

**plan assets.** Assets that have been segregated and restricted in a trust or other legal entity separate from a reporting entity to provide for retirement and other postemployment benefits under the following conditions:

- a. The assets of the separate entity are to be used only to settle the related accrued benefit obligation, are not available to the reporting entity's own

creditors, and either cannot be returned to the reporting entity or can be returned to the reporting entity only if the remaining assets of the trust are sufficient to meet the plan's obligations.

- b. To the extent that sufficient assets are in the separate entity, the reporting entity will have no obligation to pay the related retirement and other postemployment benefits directly.

Plan assets include any financial instruments issued by the reporting entity and held by the trust or other legal entity. For the purposes of the *FRF for SMEs*, plan assets do not include amounts held by the reporting entity and not yet paid into the trust or other legal entity. Plan assets may include certain arrangements with insurance enterprises.

**percentage of completion method.** A method of accounting that recognizes revenue proportionately with the degree of completion of the rendering of goods or services under a contract.

**prior period errors.** Omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that

- was available when financial statements for those periods were completed and
- could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.

**property, plant, and equipment.** Identifiable tangible assets that meet all the following criteria:

- Are held for use in the production or supply of goods and services for rental to others, for administrative purposes, or for the development, construction, maintenance, or repair of other property, plant, and equipment
- Have been acquired, constructed, or developed with the intention of being used on a continuing basis
- Are not intended for sale in the ordinary course of business

**proportionate consolidation.** A method of accounting and reporting in certain industries, whereby a venturer may account in its financial statements for its pro rata share of the assets, liabilities, revenues, and expenses that are subject to joint control.

**prospective application.** A change in an accounting policy, and of recognizing the effect of a change in an accounting estimate, that consists of

- applying the new accounting policy to transactions, other events, and conditions occurring after the date the policy is changed and

- recognizing the effect of the change in the accounting estimate in the current and future periods affected by the change.

**push-down accounting.** A technique that attributes revised values to the assets and liabilities reported in the entity's financial statements based on a purchase transaction or transactions of its equity interests. Application of the technique results in the acquirer's cost being assigned to the assets and liabilities of the acquired entity.

**related parties.** Related parties exist when one party has the ability to exercise, directly or indirectly, control, joint control, or significant influence over the other. Two or more parties are related when they are subject to common control, joint control, or common significant influence. Related parties also include management and immediate family members.

**related party transaction.** A transfer of economic resources or obligations between related parties, or the provision of services by one party to a related party, regardless of whether any consideration is exchanged. The parties to the transaction are related prior to the transaction. When the relationship arises as a result of the transaction, the transaction is not one between related parties.

**reporting entity.** An entity whose financial statements include transactions entered into by the entity in a foreign currency.

**research.** Original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

**residual value.** The estimated net realizable value of an item of property, plant, and equipment at the end of its useful life to an entity.

In the context of intangible assets, *residual value* is defined as the estimated amount that an entity would currently obtain from disposal of the asset after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

**residual value of the leased property.** The estimated fair value of the leased property at the end of the lease term.

**retained earnings.** Comprises the accumulated balance of income less losses arising from the operation of the business after taking into account dividends, refundable taxes, and other amounts that may properly be charged or credited thereto. When the accumulation is a negative figure, the single word "deficit" is a suitable designation. As used in the *FRF for SMEs*, the term *retained earnings* also refers to owners' capital accounts, depending upon the nature of the entity.

**retirement.** Retirement of a long-lived asset is its other-than-temporary removal from service, including its sale, abandonment, recycling, or disposal in some other manner, but not its temporary idling.

**retrospective application.** A type of application that applies a new accounting policy to transactions, other events, and conditions as if that policy had always been applied.

**retrospective restatement.** Correcting the recognition, measurement, and disclosure of amounts of elements of financial statements as if a prior period error had never occurred.

**revenue.** The inflow of cash, receivables, or other consideration arising in the course of the ordinary activities of an entity, normally from the sale of goods, the rendering of services, and the use by others of entity resources yielding interest, royalties, and dividends. Revenue is net of items such as trade or volume discounts, returns and allowances, claims for damaged goods, and certain excise and sales taxes. Excise and sales taxes to be netted against revenue would normally include those imposed at the time of sale and would normally exclude those imposed prior to the time of sale on either the goods or their constituents.

**salvage value.** The estimated net realizable value of an item of property, plant, and equipment at the end of its life. Salvage value is normally negligible.

**sale-leaseback transaction.** The sale of property with the purchaser leasing the property back to the seller.

**sales-type lease.** A lease that, from the point of view of the lessor, transfers substantially all the benefits and risks incident to ownership of property to the lessee and, at the inception of the lease, the fair value of the leased property is greater or less than its carrying amount, thus, giving rise to a profit or loss to the lessor (usually a manufacturer or dealer).

**service potential.** The output or service capacity of an item of property, plant, and equipment and is normally determined by reference to attributes such as physical output capacity, associated operating costs, useful life, and quality of output.

**significant influence.** Significant influence over an entity is the ability to affect the strategic operating, investing, and financing policies of the entity.

**subsidiary.** An entity in which another entity (parent) owns more than 50 percent of its (subsidiary's) outstanding equity interests.

**taxable income (tax loss).** The amount for a period, determined in accordance with the rules established by taxation authorities, upon which income taxes are payable (refundable).

**taxes payable method.** A method of accounting under which an entity reports as an expense (income) of the period only the cost (benefit) of current income taxes for that period, determined in accordance with the rules established by taxation authorities.

**temporal method.** A method of translation that translates assets, liabilities, revenues, and expenses in a manner that retains their bases of measurement in terms of the U.S. dollar (that is, it uses the U.S. dollar as the unit of measure). In particular

- monetary items are translated at the exchange rate in effect at the balance sheet date;
- nonmonetary items are translated at historical exchange rates, unless such items are carried at market, in which case, they are translated at the exchange rate in effect at the balance sheet date;

- revenue and expense items are translated at the exchange rate in effect on the dates they occur; and
- depreciation or amortization of assets translated at historical exchange rates is translated at the same exchange rates as the assets to which it relates.

**temporary differences.** Differences between the tax basis of an asset or liability and its carrying amount in the balance sheet. Temporary differences may be either

**deductible temporary differences**, which are temporary differences that will result in deductible amounts in determining taxable income of future periods when the carrying amount of the asset or liability is recovered or settled, or

**taxable temporary differences**, which are temporary differences that will result in taxable amounts in determining taxable income of future periods when the carrying amount of the asset or liability is recovered or settled.

**transaction costs.** Incremental costs that are directly attributable to the acquisition, issue, or disposal of a financial asset or financial liability. An incremental cost is one that would not have been incurred if the entity had not acquired, issued, or disposed of the financial instrument. Transaction costs include expenditures, such as legal fees, reimbursement of the lender's administrative costs, and appraisal costs associated with a loan. Transaction costs do not include financing fees, debt premiums, or discounts.

**unguaranteed residual value.** That portion of the residual value of leased property that is not guaranteed or is guaranteed solely by a party related to the lessor.

**useful life.** The period over which an asset, singly or in combination with other assets, is expected to contribute directly or indirectly to the future cash flows of an entity.

In the context of intangible assets, *useful life* is defined as

- the period over which an asset is expected to be available for use by an entity or
- the number of production or similar units expected to be obtained from the asset by an entity.

**venturer.** A party to a joint venture, who has joint control over that joint venture, has the right and ability to obtain future economic benefits from the resources of the joint venture, and is exposed to the related risks.