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Document Reference and Title	***Instructions***	***Explanations***
VOLUME II		
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HONG KONG FINANCIAL REPORTING STANDARDS (HKFRS)		
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HONG KONG (IFRIC) INTERPRETATIONS (HK(IFRIC)-INT)		
HK(IFRIC)-Int 12 *Service Concession Arrangements*	Insert these pages after HK(IFRIC)-Int 11 *HKFRS 2 –Group and Treasury Share Transactions*	New Interpretation

Hong Kong Institute of
Certified Public Accountants
香港會計師公會

MEMBERS' HANDBOOK
CONTENTS OF VOLUME II

(Updated to March 2007)

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PREFACE AND FRAMEWORK

HONG KONG ACCOUNTING STANDARDS (HKAS)

HKFRS 8
Issued March 2007

Effective for annual periods
beginning on or after 1 January 2009

Hong Kong Financial Reporting Standard 8

Operating Segments

Hong Kong Institute of
Certified Public Accountants
香港會計師公會

CONTENTS

Hong Kong Financial Reporting Standard 8 *Operating Segments* (HKFRS 8) is set out in paragraphs 1-37 and Appendices A and B. All the paragraphs have equal authority. Paragraphs in **bold type** state the main principles. HKFRS 8 should be read in the context of its core principle and the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Framework for the Preparation and Presentation of Financial Statements*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Introduction

Reasons for issuing the HKFRS

IN1 Hong Kong Financial Reporting Standard 8 *Operating Segments* sets out requirements for disclosure of information about an entity's operating segments and also about the entity's products and services, the geographical areas in which it operates, and its major customers.

IN2 Achieving convergence of accounting standards around the world is one of the prime objectives of the International Accounting Standards Board (IASB). In pursuit of that objective, the IASB and the Financial Accounting Standards Board (FASB) in the United States have undertaken a joint short-term project with the objective of reducing differences between International Financial Reporting Standards (IFRSs) and US generally accepted accounting principles (US GAAP) that are capable of resolution in a relatively short time and can be addressed outside major projects. One aspect of that project involves the two boards considering each other's recent standards with a view to adopting high quality financial reporting solutions. International Financial Reporting Standard (IFRS) 8 *Operating Segments* arises from the IASB's consideration of FASB Statement No. 131 *Disclosures about Segments of an Enterprise and Related Information* (SFAS 131) issued in 1997, compared with IAS 14 *Segment Reporting*, which was issued in substantially its present form by the IASB's predecessor body, the International Accounting Standards Committee, in 1997.

IN3 The HKFRS, which is adopted from IFRS 8 under the Institute's policy of convergence with IFRSs, achieves convergence with the requirements of SFAS 131, except for minor differences listed in paragraph 60 of the Basis for Conclusions. The wording of the HKFRS is the same as that of SFAS 131 except for changes necessary to make the terminology consistent with that in other HKFRSs.

Main features of the HKFRS

IN4 The HKFRS specifies how an entity should report information about its operating segments in annual financial statements and, as a consequential amendment to HKAS 34 *Interim Financial Reporting*, requires an entity to report selected information about its operating segments in interim financial reports. It also sets out requirements for related disclosures about products and services, geographical areas and major customers.

IN5 The HKFRS requires an entity to report financial and descriptive information about its reportable segments. Reportable segments are operating segments or aggregations of operating segments that meet specified criteria. Operating segments are components of an entity about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance. Generally, financial information is required to be reported on the same basis as is used internally for evaluating operating segment performance and deciding how to allocate resources to operating segments.

IN6 The HKFRS requires an entity to report a measure of operating segment profit or loss and of segment assets. It also requires an entity to report a measure of segment liabilities and particular income and expense items if such measures are regularly provided to the chief operating decision maker. It requires reconciliations of total reportable segment revenues, total profit or loss, total assets, liabilities and other amounts disclosed for reportable segments to corresponding amounts in the entity's financial statements.

IN7 The HKFRS requires an entity to report information about the revenues derived from its products or services (or groups of similar products and services), about the countries in which it earns revenues and holds assets, and about major customers, regardless of whether that information is used by management in making operating decisions. However, the HKFRS does not require an entity to report information that is not prepared for internal use if the necessary information is not available and the cost to develop it would be excessive.

IN8 The HKFRS also requires an entity to give descriptive information about the way the operating segments were determined, the products and services provided by the segments, differences between the measurements used in reporting segment information and those used in the entity's financial statements, and changes in the measurement of segment amounts from period to period.

IN9 An entity shall apply this HKFRS for annual periods beginning on or after 1 January 2009. Earlier application is permitted. If an entity applies this HKFRS for an earlier period, it shall disclose that fact.

Changes from previous requirements

IN10 The HKFRS replaces HKAS 14 *Segment Reporting*. The main changes from HKAS 14 are described below.

Identification of segments

IN11 The requirements of the HKFRS are based on the information about the components of the entity that management uses to make decisions about operating matters. The HKFRS requires identification of operating segments on the basis of internal reports that are regularly reviewed by the entity's chief operating decision maker in order to allocate resources to the segment and assess its performance. HKAS 14 required identification of two sets of segments–one based on related products and services, and the other on geographical areas. HKAS 14 regarded one set as primary segments and the other as secondary segments.

IN12 A component of an entity that sells primarily or exclusively to other operating segments of the entity is included in the HKFRS's definition of an operating segment if the entity is managed that way. HKAS 14 limited reportable segments to those that earn a majority of their revenue from sales to external customers and therefore did not require the different stages of vertically integrated operations to be identified as separate segments.

Measurement of segment information

IN13 The HKFRS requires the amount reported for each operating segment item to be the measure reported to the chief operating decision maker for the purposes of allocating resources to the segment and assessing its performance. HKAS 14 required segment information to be prepared in conformity with the accounting policies adopted for preparing and presenting the financial statements of the consolidated group or entity.

IN14 HKAS 14 defined segment revenue, segment expense, segment result, segment assets and segment liabilities. The HKFRS does not define these terms, but requires an explanation of how segment profit or loss, segment assets and segment liabilities are measured for each reportable segment.

Disclosure

IN15 The HKFRS requires an entity to disclose the following information:

(a) factors used to identify the entity's operating segments, including the basis of organisation (for example, whether management organises the entity around differences in products and services, geographical areas, regulatory environments, or a combination of factors and whether segments have been aggregated), and

(b) types of products and services from which each reportable segment derives its revenues.

IN16 HKAS 14 required the entity to disclose specified items of information about its primary segments. The HKFRS requires an entity to disclose specified amounts about each reportable segment, if the specified amounts are included in the measure of segment profit or loss and are reviewed by or otherwise regularly provided to the chief operating decision maker.

IN17 The HKFRS requires an entity to report interest revenue separately from interest expense for each reportable segment unless a majority of the segment's revenues are from interest and the chief operating decision maker relies primarily on net interest revenue to assess the performance of the segment and to make decisions about resources to be allocated to the segment. HKAS 14 did not require disclosure of interest income and expense.

IN18 The HKFRS requires an entity, including an entity with a single reportable segment, to disclose information for the entity as a whole about its products and services, geographical areas, and major customers. This requirement applies, regardless of the entity's organisation, if the information is not included as part of the disclosures about segments. HKAS 14 required the disclosure of secondary segment information for either industry or geographical segments, to supplement the information given for the primary segments.

Hong Kong Financial Reporting Standard 8
Operating Segments

Core principle

1 **An entity shall disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.**

Scope

2 This HKFRS shall apply to:

(a) the separate or individual financial statements of an entity:

(i) whose debt or equity instruments are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets), or

(ii) that files, or is in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market; and

(b) the consolidated financial statements of a group with a parent:

(i) whose debt or equity instruments are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets), or

(ii) that files, or is in the process of filing, the consolidated financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market.

3 If an entity that is not required to apply this HKFRS chooses to disclose information about segments that does not comply with this HKFRS, it shall not describe the information as segment information.

4 If a financial report contains both the consolidated financial statements of a parent that is within the scope of this HKFRS as well as the parent's separate financial statements, segment information is required only in the consolidated financial statements.

Operating segments

5 An operating segment is a component of an entity:

(a) 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),

(b) whose 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

(c) for which discrete financial 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 revenues.

6 Not every part of an entity is necessarily an operating segment or part of an operating segment. For example, a corporate headquarters or some functional departments may not earn revenues or may earn revenues that are only incidental to the activities of the entity and would not be operating segments. For the purposes of this HKFRS, an entity's post-employment benefit plans are not operating segments.

7 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 operating segments of an entity. Often the chief operating decision maker of an entity is its chief executive officer or chief operating officer but, for example, it may be a group of executive directors or others.

8 For many entities, the three characteristics of operating segments described in paragraph 5 clearly identify its operating segments. However, an entity may produce reports in which its business activities are presented in a variety of ways. If the chief operating decision maker uses more than one set of segment information, other factors may identify a single set of components as constituting an entity's operating segments, including the nature of the business activities of each component, the existence of managers responsible for them, and information presented to the board of directors.

9 Generally, an operating segment has a segment manager who is directly accountable to and maintains regular contact with the chief operating decision maker to discuss operating activities, financial results, forecasts, or plans for the segment. The term "segment manager" identifies a function, not necessarily a manager with a specific title. The chief operating decision maker also may be the segment manager for some operating segments. A single manager may be the segment manager for more than one operating segment. If the characteristics in paragraph 5 apply to more than one set of components of an organisation but there is only one set for which segment managers are held responsible, that set of components constitutes the operating segments.

10 The characteristics in paragraph 5 may apply to two or more overlapping sets of components for which managers are held responsible. That structure is sometimes referred to as a matrix form of organisation. For example, in some entities, some managers are responsible for different product and service lines worldwide, whereas other managers are responsible for specific geographical areas. The chief operating decision maker regularly reviews the operating results of both sets of components, and financial information is available for both. In that situation, the entity shall determine which set of components constitutes the operating segments by reference to the core principle.

Reportable segments

11 **An entity shall report separately information about each operating segment that:**

(a) has been identified in accordance with paragraphs 5-10 or results from aggregating two or more of those segments in accordance with paragraph 12, and

(b) exceeds the quantitative thresholds in paragraph 13.

Paragraphs 14-19 specify other situations in which separate information about an operating segment shall be reported.

Aggregation criteria

12 Operating segments often exhibit similar long-term financial performance if they have similar economic characteristics. For example, similar long-term average gross margins for two operating segments would be expected if their economic characteristics were similar. Two or more operating segments may be aggregated into a single operating segment if aggregation is consistent with the core principle of this HKFRS, the segments have similar economic characteristics, and the segments are similar in each of the following respects:

(a) the nature of the products and services;

(b) the nature of the production processes;

(c) the type or class of customer for their products and services;

(d) the methods used to distribute their products or provide their services; and

(e) if applicable, the nature of the regulatory environment, for example, banking, insurance or public utilities.

Quantitative thresholds

13 An entity shall report separately information about an operating segment that meets any of the following quantitative thresholds:

(a) Its reported revenue, including both sales to external customers and intersegment sales or transfers, is 10 per cent or more of the combined revenue, internal and external, of all operating segments.

(b) The absolute amount of its reported profit or loss is 10 per cent or more of the greater, in absolute amount, of (i) the combined reported profit of all operating segments that did not report a loss and (ii) the combined reported loss of all operating segments that reported a loss.

(c) Its assets are 10 per cent or more of the combined assets of all operating segments.

Operating segments that do not meet any of the quantitative thresholds may be considered reportable, and separately disclosed, if management believes that information about the segment would be useful to users of the financial statements.

14 An entity may combine information about operating segments that do not meet the quantitative thresholds with information about other operating segments that do not meet the quantitative thresholds to produce a reportable segment only if the operating segments have similar economic characteristics and share a majority of the aggregation criteria listed in paragraph 12.

15 If the total external revenue reported by operating segments constitutes less than 75 per cent of the entity's revenue, additional operating segments shall be identified as reportable segments (even if they do not meet the criteria in paragraph 13) until at least 75 per cent of the entity's revenue is included in reportable segments.

16 Information about other business activities and operating segments that are not reportable shall be combined and disclosed in an "all other segments" category separately from other reconciling items in the reconciliations required by paragraph 28. The sources of the revenue included in the "all other segments" category shall be described.

17 If management judges that an operating segment identified as a reportable segment in the immediately preceding period is of continuing significance, information about that segment shall continue to be reported separately in the current period even if it no longer meets the criteria for reportability in paragraph 13.

18 If an operating segment is identified as a reportable segment in the current period in accordance with the quantitative thresholds, segment data for a prior period presented for comparative purposes shall be restated to reflect the newly reportable segment as a separate segment, even if that segment did not satisfy the criteria for reportability in paragraph 13 in the prior period, unless the necessary information is not available and the cost to develop it would be excessive.

19 There may be a practical limit to the number of reportable segments that an entity separately discloses beyond which segment information may become too detailed. Although no precise limit has been determined, as the number of segments that are reportable in accordance with paragraphs 13-18 increases above ten, the entity should consider whether a practical limit has been reached.

Disclosure

20 An entity shall disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.

21 To give effect to the principle in paragraph 20, an entity shall disclose the following for each period for which an income statement is presented:

(a) general information as described in paragraph 22;

(b) information about reported segment profit or loss, including specified revenues and expenses included in reported segment profit or loss, segment assets, segment liabilities and the basis of measurement, as described in paragraphs 23-27; and

(c) reconciliations of the totals of segment revenues, reported segment profit or loss, segment assets, segment liabilities and other material segment items to corresponding entity amounts as described in paragraph 28.

Reconciliations of balance sheet amounts for reportable segments to the entity's balance sheet amounts are required for each date at which a balance sheet is presented. Information for prior periods shall be restated as described in paragraphs 29 and 30.

General information

22 An entity shall disclose the following general information:

(a) factors used to identify the entity's reportable segments, including the basis of organisation (for example, whether management has chosen to organise the entity around differences in products and services, geographical areas, regulatory environments, or a combination of factors and whether operating segments have been aggregated), and

(b) types of products and services from which each reportable segment derives its revenues.

Information about profit or loss, assets and liabilities

23 An entity shall report a measure of profit or loss and total assets for each reportable segment. An entity shall report a measure of liabilities for each reportable segment if

such an amount is regularly provided to the chief operating decision maker. An entity shall also disclose the following about each reportable segment if the specified amounts are included in the measure of segment profit or loss reviewed by the chief operating decision maker, or are otherwise regularly provided to the chief operating decision maker, even if not included in that measure of segment profit or loss:

(a) revenues from external customers;

(b) revenues from transactions with other operating segments of the same entity;

(c) interest revenue;

(d) interest expense;

(e) depreciation and amortisation;

(f) material items of income and expense disclosed in accordance with paragraph 86 of HKAS 1 *Presentation of Financial Statements*;

(g) the entity's interest in the profit or loss of associates and joint ventures accounted for by the equity method;

(h) income tax expense or income; and

(i) material non-cash items other than depreciation and amortisation.

An entity shall report interest revenue separately from interest expense for each reportable segment unless a majority of the segment's revenues are from interest and the chief operating decision maker relies primarily on net interest revenue to assess the performance of the segment and make decisions about resources to be allocated to the segment. In that situation, an entity may report that segment's interest revenue net of its interest expense and disclose that it has done so.

24 An entity shall disclose the following about each reportable segment if the specified amounts are included in the measure of segment assets reviewed by the chief operating decision maker or are otherwise regularly provided to the chief operating decision maker, even if not included in the measure of segment assets:

(a) the amount of investment in associates and joint ventures accounted for by the equity method, and

(b) the amounts of additions to non-current assets[*] other than financial instruments, deferred tax assets, post-employment benefit assets (see HKAS 19 *Employee Benefits* paragraphs 54-58) and rights arising under insurance contracts.

Measurement

25 The amount of each segment item reported shall be the measure reported to the chief operating decision maker for the purposes of making decisions about allocating resources to the segment and assessing its performance. Adjustments and eliminations made in preparing an entity's financial statements and allocations of revenues, expenses, and gains or losses shall be included in determining reported segment profit or loss only if they are included in the measure of the segment's profit or loss that is used by the chief operating decision maker. Similarly, only those assets and liabilities that are included in the measures of the segment's assets and

[*] For assets classified according to a liquidity presentation, non-current assets are assets that include amounts expected to be recovered more than twelve months after the balance sheet date.

segment's liabilities that are used by the chief operating decision maker shall be reported for that segment. If amounts are allocated to reported segment profit or loss, assets or liabilities, those amounts shall be allocated on a reasonable basis.

26 If the chief operating decision maker uses only one measure of an operating segment's profit or loss, the segment's assets or the segment's liabilities in assessing segment performance and deciding how to allocate resources, segment profit or loss, assets and liabilities shall be reported at those measures. If the chief operating decision maker uses more than one measure of an operating segment's profit or loss, the segment's assets or the segment's liabilities, the reported measures shall be those that management believes are determined in accordance with the measurement principles most consistent with those used in measuring the corresponding amounts in the entity's financial statements.

27 An entity shall provide an explanation of the measurements of segment profit or loss, segment assets and segment liabilities for each reportable segment. At a minimum, an entity shall disclose the following:

(a) the basis of accounting for any transactions between reportable segments.

(b) the nature of any differences between the measurements of the reportable segments' profits or losses and the entity's profit or loss before income tax expense or income and discontinued operations (if not apparent from the reconciliations described in paragraph 28). Those differences could include accounting policies and policies for allocation of centrally incurred costs that are necessary for an understanding of the reported segment information.

(c) the nature of any differences between the measurements of the reportable segments' assets and the entity's assets (if not apparent from the reconciliations described in paragraph 28). Those differences could include accounting policies and policies for allocation of jointly used assets that are necessary for an understanding of the reported segment information.

(d) the nature of any differences between the measurements of the reportable segments' liabilities and the entity's liabilities (if not apparent from the reconciliations described in paragraph 28). Those differences could include accounting policies and policies for allocation of jointly utilised liabilities that are necessary for an understanding of the reported segment information.

(e) the nature of any changes from prior periods in the measurement methods used to determine reported segment profit or loss and the effect, if any, of those changes on the measure of segment profit or loss.

(f) the nature and effect of any asymmetrical allocations to reportable segments. For example, an entity might allocate depreciation expense to a segment without allocating the related depreciable assets to that segment.

Reconciliations

28 An entity shall provide reconciliations of all of the following:

(a) the total of the reportable segments' revenues to the entity's revenue.

(b) the total of the reportable segments' measures of profit or loss to the entity's profit or loss before tax expense (tax income) and discontinued operations. However, if an entity allocates to reportable segments items such as tax expense (tax income), the entity may reconcile the total of the segments' measures of profit or loss to the entity's profit or loss after those items.

(c) the total of the reportable segments' assets to the entity's assets.

(d) the total of the reportable segments' liabilities to the entity's liabilities if segment liabilities are reported in accordance with paragraph 23.

(e) the total of the reportable segments' amounts for every other material item of information disclosed to the corresponding amount for the entity.

All material reconciling items shall be separately identified and described. For example, the amount of each material adjustment needed to reconcile reportable segment profit or loss to the entity's profit or loss arising from different accounting policies shall be separately identified and described.

Restatement of previously reported information

29 If an entity changes the structure of its internal organisation in a manner that causes the composition of its reportable segments to change, the corresponding information for earlier periods, including interim periods, shall be restated unless the information is not available and the cost to develop it would be excessive. The determination of whether the information is not available and the cost to develop it would be excessive shall be made for each individual item of disclosure. Following a change in the composition of its reportable segments, an entity shall disclose whether it has restated the corresponding items of segment information for earlier periods.

30 If an entity has changed the structure of its internal organisation in a manner that causes the composition of its reportable segments to change and if segment information for earlier periods, including interim periods, is not restated to reflect the change, the entity shall disclose in the year in which the change occurs segment information for the current period on both the old basis and the new basis of segmentation, unless the necessary information is not available and the cost to develop it would be excessive.

Entity-wide disclosures

31 Paragraphs 32-34 apply to all entities subject to this HKFRS including those entities that have a single reportable segment. Some entities' business activities are not organised on the basis of differences in related products and services or differences in geographical areas of operations. Such an entity's reportable segments may report revenues from a broad range of essentially different products and services, or more than one of its reportable segments may provide essentially the same products and services. Similarly, an entity's reportable segments may hold assets in different geographical areas and report revenues from customers in different geographical areas, or more than one of its reportable segments may operate in the same geographical area. Information required by paragraphs 32-34 shall be provided only if it is not provided as part of the reportable segment information required by this HKFRS.

Information about products and services

32 An entity shall report the revenues from external customers for each product and service, or each group of similar products and services, unless the necessary information is not available and the cost to develop it would be excessive, in which case that fact shall be disclosed. The amounts of revenues reported shall be based on the financial information used to produce the entity's financial statements.

Information about geographical areas

33 An entity shall report the following geographical information, unless the necessary information is not available and the cost to develop it would be excessive:

(a) revenues from external customers (i) attributed to the entity's country of domicile and (ii) attributed to all foreign countries in total from which the entity derives revenues. If revenues from external customers attributed to an individual foreign country are material, those revenues shall be disclosed separately. An entity shall disclose the basis for attributing revenues from external customers to individual countries.

(b) non-current assets* other than financial instruments, deferred tax assets, post-employment benefit assets, and rights arising under insurance contracts (i) located in the entity's country of domicile and (ii) located in all foreign countries in total in which the entity holds assets. If assets in an individual foreign country are material, those assets shall be disclosed separately.

The amounts reported shall be based on the financial information that is used to produce the entity's financial statements. If the necessary information is not available and the cost to develop it would be excessive, that fact shall be disclosed. An entity may provide, in addition to the information required by this paragraph, subtotals of geographical information about groups of countries.

Information about major customers

34 An entity shall provide information about the extent of its reliance on its major customers. If revenues from transactions with a single external customer amount to 10 per cent or more of an entity's revenues, the entity shall disclose that fact, the total amount of revenues from each such customer, and the identity of the segment or segments reporting the revenues. The entity need not disclose the identity of a major customer or the amount of revenues that each segment reports from that customer. For the purposes of this HKFRS, a group of entities known to a reporting entity to be under common control shall be considered a single customer, and a government (national, state, provincial, territorial, local or foreign) and entities known to the reporting entity to be under the control of that government shall be considered a single customer.

Transition and effective date

35 An entity shall apply this HKFRS in its annual financial statements for periods beginning on or after 1 January 2009. Earlier application is permitted. If an entity applies this HKFRS in its financial statements for a period before 1 January 2009, it shall disclose that fact.

36 Segment information for prior years that is reported as comparative information for the initial year of application shall be restated to conform to the requirements of this HKFRS, unless the necessary information is not available and the cost to develop it would be excessive.

Withdrawal of HKAS 14

37 This HKFRS supersedes HKAS 14 *Segment Reporting*.

* For assets classified according to a liquidity presentation, non-current assets are assets that include amounts expected to be recovered more than twelve months after the balance sheet date.

Appendix A
Defined term

This appendix is an integral part of the HKFRS.

operating segment	An operating segment is a component of an entity: (a) 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), (b) whose 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 (c) for which discrete financial information is available.

Appendix B
Amendments to other HKFRSs

The amendments in this appendix shall be applied for annual periods beginning on or after 1 January 2009. If an entity applies this HKFRS for an earlier period, these amendments shall be applied for that earlier period. In the amended paragraphs, new text is underlined and deleted text is struck through.

B1 References to HKAS 14 *Segment Reporting* are amended to HKFRS 8 *Operating Segments* in the following paragraphs:

- paragraph 20 of HKAS 27 *Consolidated and Separate Financial Statements*
- paragraph 130(d)(i) of HKAS 36 *Impairment of Assets*.

B2 In HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, paragraph 41 is amended as follows:

41 An entity shall disclose the following information in the notes in the period in which a non-current asset (or disposal group) has been either classified as held for sale or sold:

...

(d) if applicable, the reportable segment in which the non-current asset (or disposal group) is presented in accordance with ~~HKAS 14 *Segment Reporting*~~ HKFRS 8 *Operating Segments*.

B3 In HKFRS 6 *Exploration for and Evaluation of Mineral Resources*, paragraph 21 is amended as follows:

21 An entity shall determine an accounting policy for allocating exploration and evaluation assets to cash-generating units or groups of cash-generating units for the purpose of assessing such assets for impairment. Each cash-generating unit or group of units to which an exploration and evaluation asset is allocated shall not be larger than ~~a segment based on either the entity's primary or secondary reporting format~~ an operating segment determined in accordance with ~~HKAS 14 *Segment Reporting*~~ HKFRS 8 *Operating Segments*.

B4 In HKAS 2 *Inventories*, paragraphs 26 and 29 are amended as follows:

26 For example, inventories used in one ~~business~~ operating segment may have a use to the entity different from the same type of inventories used in another ~~business~~ operating 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.

29 Inventories are usually written down to net realisable value item by item. In some circumstances, however, 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~~ operating segment. Service providers generally accumulate costs in respect of each service for which a separate selling price is charged. Therefore, each such service is treated as a separate item.

B5 In HKAS 7 *Cash Flow Statements*, paragraph 50 is amended as follows:

50 Additional information may be relevant to users in understanding the financial position and liquidity of an entity. Disclosure of this information, together with a commentary by management, is encouraged and may include:

...

(d) the amount of the cash flows arising from the operating, investing and financing activities of each ~~reported industry and geographical~~ reportable segment (see ~~HKAS 14 *Segment Reporting*~~ HKFRS 8 *Operating Segments*).

B6 In HKAS 19 *Employee Benefits*, the example illustrating paragraph 115 is amended as follows:

Example illustrating paragraph 115
An entity discontinues ~~a business~~ an operating segment and employees of the discontinued segment will earn no further benefits...

B7 In HKAS 33 *Earnings per Share*, paragraph 2 is replaced as follows:

2 This Standard shall apply to:

(a) the separate or individual financial statements of an entity:

(i) whose ordinary shares or potential ordinary shares are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets) or

(ii) that files, or is in the process of filing, its financial statements with a securities commission or other regulatory information for the purpose of issuing ordinary shares in a public market; and

(b) the consolidated financial statements of a group with a parent:

(i) whose ordinary shares or potential ordinary shares are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets) or

(ii) that files, or is in the process of filing, its financial statements with a securities commission or other regulatory information for the purpose of issuing ordinary shares in a public market.

B8 In HKAS 34 *Interim Financial Reporting*, paragraph 16 is amended as follows:

16 An entity shall include the following information, as a minimum, in the notes to its interim financial statements, if material and if not disclosed elsewhere in the interim financial report. The information shall normally be reported on a financial year-to-date basis. However, the entity shall also disclose any events or transactions that are material to an understanding of the current interim period:

...

(g) **the following segment ~~revenue and segment result for business segments or geographical segments, whichever is the entity's primary basis of segment reporting~~ information (disclosure of segment ~~data~~ information is required in an entity's interim financial report only if ~~HKAS 14 *Segment Reporting*~~ HKFRS 8 *Operating Segments* requires that entity to disclose segment ~~data~~ information in its annual financial statements)~~;~~:**

(i) **revenues from external customers, if included in the measure of segment profit or loss reviewed by the chief operating decision maker or otherwise regularly provided to the chief operating decision maker;**

(ii) **intersegment revenues, if included in the measure of segment profit or loss reviewed by the chief operating decision maker or otherwise regularly provided to the chief operating decision maker;**

(iii) **a measure of segment profit or loss;**

(iv) **total assets for which there has been a material change from the amount disclosed in the last annual financial statements;**

(v) **a description of differences from the last annual financial statements in the basis of segmentation or in the basis of measurement of segment profit or loss;**

(vi) **a reconciliation of the total of the reportable segments' measures of profit or loss to the entity's profit or loss before tax expense (tax income) and discontinued operations. However, if an entity allocates to reportable segments items such as tax expense (tax income), the entity may reconcile the total of the segments' measures of profit or loss to profit or loss after those items. Material reconciling items shall be separately identified and described in that reconciliation;**

...

B9 HKAS 36 *Impairment of Assets* is amended as described below.

In the Introduction, paragraph IN11 is amended as follows:

IN11 SSAP 31 required goodwill acquired in a business combination to be tested for impairment as part of impairment testing the cash-generating unit(s) to which it related. It employed a "bottom-up/top-down" approach under which the goodwill was, in effect, tested for impairment by allocating its carrying amount to each cash-generating unit or smallest group of cash-generating units to which a portion of that carrying amount could be allocated on a reasonable and consistent basis. The Standard similarly requires goodwill acquired in a business combination to be tested for impairment as part of impairment testing the cash-generating unit(s) to which it relates. However, the Standard clarifies that:

...

(b) each unit or group of units to which the goodwill is allocated should:

(i) represent the lowest level within the entity at which the goodwill is monitored for internal management purposes; and

(ii) not be larger than a<u>n operating</u> segment ~~based on either the entity's primary or the entity's secondary reporting format~~ determined in accordance with ~~HKAS 14 *Segment Reporting*~~ <u>HKFRS 8 *Operating Segments*</u>.

Paragraph 80 is amended as follows:

80 For the purpose of impairment testing, goodwill acquired in a business combination shall, from the acquisition date, be allocated to each of the acquirer's cash-generating units, or groups of cash-generating units, that is expected to benefit from the synergies of the combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units or groups of units. Each unit or group of units to which the goodwill is so allocated shall:

...

(b) not be larger than a<u>n operating</u> segment ~~based on either the entity's primary or the entity's secondary reporting format~~ determined in accordance with ~~HKAS 14 *Segment Reporting*~~ <u>HKFRS 8 *Operating Segments*</u>.

Paragraph 129 is amended as follows:

129 An entity that reports segment information in accordance with ~~HKAS 14 *Segment Reporting*~~ <u>HKFRS 8 *Operating Segments*</u> shall disclose the following for each reportable segment ~~based on an entity's primary reporting format~~:

In paragraph 130, subparagraphs (c)(ii) and (d)(ii) are amended as follows:

130 (c) (ii) if the entity reports segment information in accordance with ~~HKAS 14~~ <u>HKFRS 8</u>, the reportable segment to which the asset belongs~~, based on the entity's primary reporting format~~.

103 (d) (ii) the amount of the impairment loss recognised or reversed by class of assets and, if the entity reports segment information in accordance with ~~HKAS 14~~ <u>HKFRS 8</u>, by reportable segment ~~based on the entity's primary reporting format~~; and

HKFRS 8 BC
Issued March 2007

Basis for Conclusions on
Hong Kong Financial Reporting Standard 8

Operating Segments

Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Basis for Conclusions
HKFRS 8 *Operating Segments*

HKFRS 8 is based on IFRS 8 *Operating Segments*. In approving HKFRS 8, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IASB's Basis for Conclusions on IFRS 8. Accordingly, there are no significant differences between HKFRS 8 and IFRS 8. The IASB's Basis for Conclusions is reproduced below. The paragraph numbers of IFRS 8 referred to below generally correspond with those in HKFRS 8.

CONTENTS

APPENDICES

Basis for Conclusions on IFRS 8 *Operating Segments*

This Basis for Conclusions and its appendices accompany, but are not part of, IFRS 8.

Introduction

BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in reaching the conclusions in IFRS 8 *Operating Segments*. Individual Board members gave greater weight to some factors than to others.

BC2 In September 2002 the Board decided to add a short-term convergence project to its active agenda. The project is being conducted jointly with the United States standard-setter, the Financial Accounting Standards Board (FASB). The objective of the project is to reduce differences between IFRSs and US generally accepted accounting principles (US GAAP) that are capable of resolution in a relatively short time and can be addressed outside major projects.

BC3 As part of the project, the Board identified differences between IAS 14 *Segment Reporting* and the US standard SFAS 131 *Disclosures about Segments of an Enterprise and Related Information*, reviewed academic research findings on segment reporting, in particular relating to the implementation of SFAS 131, and had meetings with users of financial statements.

Differences between IAS 14 and SFAS 131

BC4 The requirements of SFAS 131 are based on the way that management regards an entity, focusing on information about the components of the business that management uses to make decisions about operating matters. In contrast, IAS 14 requires the disaggregation of the entity's financial statements into segments based on related products and services, and on geographical areas.

BC5 The requirements of SFAS 14 *Financial Reporting for Segments of a Business Enterprise*, the predecessor to SFAS 131, were similar to those of IAS 14. In particular, both standards required the accounting policies underlying the disaggregated information to be the same as those underlying the entity information, since segment information was regarded as a disaggregation of the entity information. The approach to segment disclosures in SFAS 14 was criticised for not providing information about segments based on the structure of an entity's internal organisation that could enhance a user's ability to predict actions or reactions of management that could significantly affect the entity's future cash flow prospects.

Academic research findings

BC6 Most of the academic research findings on segment reporting indicated that application of SFAS 131 resulted in more useful information than its predecessor, SFAS 14. According to the research, the management approach of SFAS 131:

(a) increased the number of reported segments and provided more information;

(b) enabled users to see an entity through the eyes of management;

(c) enabled an entity to provide timely segment information for external interim reporting with relatively low incremental cost;

(d) enhanced consistency with the management discussion and analysis or other annual report disclosures; and

(e) provided various measures of segment performance.

Meetings with users

BC7 The Board discussed segment reporting at several meetings with users of financial statements. Most of the users supported the management approach of SFAS 131 for the reasons mentioned in the previous paragraph. In particular, they supported an approach that would enable more segment information to be provided in interim financial reports.

BC8 Consequently the Board decided to adopt the US approach and published its proposals as an exposure draft in ED 8 *Operating Segments* in January 2006. The deadline for comments was 19 May 2006. The Board received 182 comment letters. After reviewing the responses, the Board issued IFRS 8 in November 2006.

Adoption of management approach

BC9 In the Basis for Conclusions on ED 8, the Board noted that the primary benefits of adopting the management approach in SFAS 131 are that:

(a) entities will report segments that correspond to internal management reports;

(b) entities will report segment information that will be more consistent with other parts of their annual reports;

(c) some entities will report more segments; and

(d) entities will report more segment information in interim financial reports.

In addition, the Board noted that the proposed IFRS would reduce the cost of providing disaggregated information for many entities because it uses segment information that is generated for management's use.

BC10 Most respondents to the Exposure Draft supported the adoption of the management approach. They considered the management approach appropriate, and superior to the approach of IAS 14. These respondents observed that the management approach for segment reporting allows users to review an entity's operations from the same perspective as management. They noted that although the IAS 14 approach would enhance comparability by requiring entities to report segment information that is consistent with IFRSs, the disclosures will not necessarily correspond to segment information that is reported to management and is used for making decisions.

BC11 Other respondents disagreed with the management approach. They argued that convergence should instead be achieved by changing SFAS 131 to IAS 14. In their view the latter approach is superior because it provides comparability of information across entities by defining measures of segment revenue, segment expense, segment result, segment assets and segment liabilities.

BC12 Yet other respondents agreed with the management approach for the identification of segment assets, but disagreed with the management approach for the measurement of the various segment disclosures. In particular, they doubted whether the publication of internally reported amounts would generate significant benefit for investors if those amounts differ from IFRS amounts.

BC13 The Board noted that if IFRS amounts could be prepared reliably and on a timely basis for segments identified using the management approach, that approach would provide the most useful information. However, the Board observed that IFRS amounts for segments cannot always be prepared on a sufficiently timely basis for interim reporting.

BC14 The Board also noted the requirements in the IFRS for an explanation of the measurements of segment profit or loss and segment assets and for reconciliations of the segment amounts to the amounts recognised in the entity's financial statements. The Board was satisfied that users would be able to understand and judge appropriately the basis on which the segment amounts were determined.

BC15 The Board concluded that the advantages of the management approach, in particular the ability of entities to prepare segment information on a sufficiently timely basis for inclusion in interim financial reports, outweighed any disadvantages arising from the potential for segments to be reported in accordance with non-IFRS accounting policies.

BC16 Given the Board's support for the principles of the management approach required by SFAS 131 and the objectives of the short-term convergence project, the Board decided that the simplest and most complete way to achieve convergence would be to use the text of SFAS 131 for the IFRS.

BC17 The FASB's thinking behind the management approach of SFAS 131 is presented in its Background Information and Basis for Conclusions. Because the Board has adopted that approach, the FASB's Background Information and Basis for Conclusions are reproduced in Appendix A to this Basis for Conclusions. The few differences from SFAS 131 that the Board has included in the IFRS are noted in paragraph BC60 below.

Scope of the standard

BC18 In ED 8, the Board proposed extending the scope of the IFRS to all entities that have public accountability rather than just entities whose securities are publicly traded. The Board noted that it was premature to adopt the proposed definition of public accountability that is being considered in a separate Board project on small and medium-sized entities (SMEs). However, the Board decided that the scope of the standard should be extended to include entities that hold assets in a fiduciary capacity for a broad group of outsiders. The Board concluded that the SMEs project is the most appropriate context in which to decide whether to extend the scope of the requirements on segment reporting to other entities.

BC19 Some respondents to ED 8 commented that the scope of the IFRS should not be extended until the Board has reached a conclusion on the definitions of "fiduciary capacity" and "public accountability" in the SMEs project. They argued that the terms needed clarification and definition.

BC20 The Board accepted these concerns and decided that the IFRS should not apply to entities that hold assets in a fiduciary capacity. However, the Board decided that publicly accountable entities should be within the scope of the IFRS, and that a future amendment of the scope of the IFRS should be proposed to include publicly accountable entities once the definition has been properly developed in the SMEs project. The proposed amendment will therefore be exposed at the same time as the exposure draft of the proposed IFRS for SMEs.

BC21 A number of respondents to ED 8 suggested that the scope exemption of paragraph 6 of IAS 14 should be included in the IFRS. This paragraph provided an exemption from segment reporting in the separate financial statements of the parent when a financial report contains both consolidated financial statements and the parent's separate financial statements. The Board agreed that on practical grounds such an exemption was appropriate.

BC22 In ED 8 the Board proposed that if an entity not required to apply the IFRS chooses to disclose segment information in financial statements that comply with IFRSs, that entity would be required to comply with the requirements of the IFRS. Respondents commented that this was unnecessarily restrictive. For example, they observed that requiring full compliance with the IFRS would prevent an entity outside its scope from voluntarily disclosing sales information for segments without also disclosing segment profit or loss. The Board concluded that an entity should be able to provide segment information on a voluntary basis without triggering the need to comply fully with the IFRS, so long as the disclosure is not referred to as segment information.

BC23 A respondent to ED 8 asked for clarification on whether the scope of the proposed IFRS included the consolidated financial statements of a group whose parent has no listed financial instruments, but includes a listed minority interest or a subsidiary with listed debt. The Board decided that such consolidated financial statements should not be included in the scope and that the scope should be clarified accordingly. The Board also noted that the same clarification should be made to the scope of IAS 33 *Earnings per Share*.

Aspects of the management approach

Specific measurement requirements for some items

BC24 In ED 8, the Board invited comments on whether the proposed IFRS should depart from the management approach in SFAS 131 by setting measurement requirements for specified items. Some respondents to ED 8 supported an approach that would define the measurement of the key terms such as segment revenues, segment expenses, segment results, segment assets and segment liabilities in order to enhance comparability between reporting entities. Other respondents disagreed with any departure from SFAS 131 on the grounds that defined measurements for specified items would eliminate the major benefits of the management approach.

BC25 The IFRS requires the entity to explain the measurements of segment profit or loss and segment assets and liabilities and to provide reconciliations of the total segment amounts to the amounts recognised in the entity's financial statements. The Board believes that such reconciliations will enable users to understand and judge the basis on which the segment amounts were determined. The Board also noted that to define the measurement of such amounts would be a departure from the requirements of SFAS 131 that would involve additional time and cost for entities and would be inconsistent with the management perspective on segment information.

BC26 Therefore, the Board decided not to require defined measures of segment revenues, segment expenses, segment result, segment assets and segment liabilities.

Matrix form of organisations

BC27 In ED 8 the Board proposed that when more than one set of segments could be identified, for example when entities use a matrix form of organisation, the components based on products and services should be the basis for the operating segments. Some respondents noted that matrix organisational structures are commonly used for large complex organisations and that mandating the use of components based on products and services was inconsistent with the management approach. The Board agreed with this view. Accordingly, the IFRS requires the identification of operating segments to be made by reference to the core principle of the IFRS.

Quantitative thresholds

BC28 In ED 8 the Board proposed quantitative thresholds for identifying reportable segments. Some respondents argued that such requirements represent adoption of a rule-based, rather than a principle-based, approach. In addition, some respondents commented that the inclusion of a 10 per cent threshold could create a precedent for determining materiality in other areas.

BC29 The Board considered an approach whereby any material operating segment would be required to be disclosed separately. However, the Board was concerned that there might be uncertainty about the meaning of materiality in relation to disclosure. Furthermore, such a requirement would be a significant change from the wording of SFAS 131. Thus, the Board was concerned that the change would be from an easily understandable and familiar set of words that converges with SFAS 131 to a potentially confusing principle. Accordingly, the Board decided to retain the quantitative thresholds.

Interaction of aggregation criteria and quantitative thresholds

BC30 One respondent commented that the ranking of the aggregation criteria for operating segments and the quantitative thresholds for determining reportable segments was unclear in ED 8. However, the flow chart in paragraph IG7 of the implementation guidance indicates that the aggregation criteria take precedence over the quantitative thresholds. The Board also noted that the wording in SFAS 131 was clear because the paragraph on aggregation refers to aggregation into a "single operating segment". The quantitative thresholds then determine which operating segments are reportable segments. The term "operating" has been inserted in paragraph 12 of the IFRS.

Inclusion of US guidance

BC31 The Board discussed the extent to which the IFRS should address the practical problems that have arisen from applying SFAS 131 in the US. The Board considered the FASB *Q&A 131 Segment Information: Guidance on Applying Statement 131* and Emerging Issues Task Force (EITF) 04-10 *Determining Whether to Aggregate Operating Segments that do not Meet the Quantitative Threshold*.

BC32 EITF 04-10 addresses the issue of whether to aggregate operating segments that do not meet the quantitative thresholds. It requires quantitative thresholds to be aggregated only if aggregation is consistent with the objective and core principles of SFAS 131, the segments have similar economic characteristics, and the segments share a majority of the aggregation criteria listed in paragraph 17(a)-(e) of SFAS 131. The Board agreed with the approach adopted in EITF 04-10 and concluded that the same requirement should be included in the IFRS.

BC33 FASB *Q&A 131-Segment Information: Guidance on Applying Statement 131* is an implementation guide that provides the views of the FASB staff on certain questions on SFAS 131. Because it was not issued by the FASB itself, the Board decided not to include this material in the IFRS.

Information about segment assets

BC34 Several respondents noted that, whilst a measure of segment profit or loss can be expected in every entity's internal reporting, a measure of segment assets is not always available, particularly in service industries or other industries with low utilisation of physical assets. Respondents suggested that in such circumstances a measure of segment assets should be disclosed only if those amounts were regularly provided to the chief operating decision maker.

BC35 The Board noted that requiring disclosure of a measure of segment assets only when such a measure is reviewed by the chief operating decision maker would create divergence from SFAS 131. The Board also supported a minimum disclosure of segment profit or loss and segment assets. The Board therefore concluded that measures of segment profit or loss and total segment assets should be disclosed for all segments regardless of whether those measures are reviewed by the chief operating decision maker.

Information about segment liabilities

BC36 ED 8 did not propose disclosure of segment liabilities because there is no such requirement in SFAS 131. The reasons for this are set out in paragraph 96 of the Basis for Conclusions on SFAS 131, included as Appendix A to this Basis for Conclusions.

BC37 Some respondents proposed adding a requirement for each entity to disclose information about segment liabilities, if such information is regularly provided to the chief operating decision maker. They argued that information about segment liabilities would be helpful to users. Other respondents favoured information about net segment assets rather than gross segment assets.

BC38 The Board noted that if segment liabilities are considered in assessing the performance of, and allocating resources to, the segments of an entity, such disclosure would be consistent with the management approach. The Board also noted support for this disclosure from some commentators, particularly users of financial statements. Accordingly the Board decided to require disclosure of a measure of segment liabilities if those amounts are regularly provided to the chief operating decision maker notwithstanding that such a requirement would create divergence from SFAS 131.

Level of reconciliations

BC39 ED 8 proposed that an entity should provide reconciliations of total reportable segment amounts for specified items to amounts the entity recognised in accordance with IFRSs. It did not propose such reconciliations for individual reportable segments.

BC40 Several respondents expressed concern about the level of detail provided by the proposed reconciliations. They argued that if the IFRS allows segment information to be measured on the basis of management information, it should require reconciliations for individual reportable segments between the segment amounts and the equivalent amounts measured in accordance with an entity's IFRS accounting policies. They added that reconciling only total reportable segment amounts to amounts presented in the financial statements does not provide useful information.

BC41 Other respondents supported the proposed reconciliations on the grounds that more detailed reconciliations would not be more understandable to users and might be confusing. They believed that the additional costs to reporting entities were not justified.

BC42 The Board noted that a requirement to provide reconciliations at the individual reportable segment level would effectively lead to two complete segment reports–one according to internal measures and the other according to IFRSs. The Board concluded that the cost of providing two sets of segment information would outweigh the benefits.

Lack of a competitive harm exemption

BC43 The Board discussed whether entities should be exempt from aspects of the IFRS if disclosure could cause competitive damage or erosion of shareholder value. The Board considered an alternative approach whereby entities could be required to provide reasons for non-disclosure on a "comply or explain" basis.

BC44 The Board concluded that a "competitive harm" exemption would be inappropriate because it would provide a means for broad non-compliance with the IFRS. The Board noted that entities would be unlikely to suffer competitive harm from the required disclosures since most competitors have sources of detailed information about an entity other than its financial statements.

BC45 Respondents also commented that the requirements of the IFRS would place small listed companies at a disadvantage to non-listed companies, which are outside the scope of the IFRS. The Board noted that the relative advantage/disadvantage of an entity being publicly listed is not a matter for the Board to consider.

Adoption of the term 'impracticable'

BC46 Some respondents to ED 8 expressed concern that entities were to be allowed not to give entity-wide disclosures about products and services and geographical areas if "…the necessary information is not available and the cost to develop it would be excessive." They argued that the test to be applied for non-disclosure should be that of impracticability as defined in IAS 1 *Presentation of Financial Statements*.

BC47 The Board noted that the wording in ED 8 ensures convergence with SFAS 131. Using the term "impracticable" as defined in IAS 1 would change the requirement and create divergence from SFAS 131. Therefore, the Board decided to retain the wording of ED 8.

Entity-wide disclosures

Geographical information

BC48 The IFRS requires an entity to disclose geographical information about non-current assets, excluding specified items. The Board considered comments made by some respondents who advocated country-by-country disclosure, others who requested specific items of geographical information to be disclosed, and some who expressed reservations with the proposed requirement relating to disclosure of country of domicile.

BC49 A coalition of over 300 organisations from more than 50 countries known as the Publish What You Pay campaign requested that the scope of the IFRS should be extended to require additional disclosure on a country-by-country basis. The objective of such additional disclosure would be to promote greater transparency in the management of amounts paid by the oil, gas and mining industries to governments in developing or transitional countries that are resource-rich. The view of these campaigners was that publication of specific payments made by those companies to governments is in the interest of all users of financial statements.

BC50 Because the IFRS is being developed in a short-term convergence project to converge with SFAS 131, the Board decided that issues raised by the Publish What You Pay campaign relating to country-by-country disclosures should not be addressed in the IFRS. The Board was of the view that such issues merit further discussion with bodies that are currently engaged in similar issues, for example the United Nations, International Public Sector Accounting Standards Board, International Monetary Fund, World Bank, regional development banks and Financial Stability Forum.

Exemption from entity-wide disclosures

BC51 Several respondents suggested different geographical disclosures from those proposed in ED 8. For example, some preferred disclosures by geographical areas rather than by individual country. Others favoured geographical disclosure of profit or loss as well as non-current assets. Several respondents expressed the view that disclosure of total assets would be more relevant than non-current assets. Some took the view that disclosures should be made of both current and non-current assets.

Other respondents recommended that financial assets should be disclosed as well as non-current assets. Some respondents expressed the view that disclosure of non-current assets should not be required if those amounts are not reviewed by the chief operating decision maker.

BC52 In developing ED 8, the Board decided to adopt the requirements in SFAS 131. Paragraphs 104-107 of the Basis for Conclusions on SFAS 131 provide the rationale for the geographical disclosures required.

BC53 None of the suggested alternative disclosures was broadly supported by the user responses. The Board noted that entities that wish to give additional information are free to do so. The Board therefore concluded that the disclosure requirement taken from SFAS 131 should not be changed.

Country of domicile

BC54 Some respondents asserted that disclosures relating to the country of domicile were inappropriate for many entities. They expressed the view that such information would be relevant when a large proportion of an entity's business is carried out in its country of domicile. They noted, however, that in many circumstances the country of domicile represents a small proportion of the entity's business and in these cases the information required would not be relevant. In addition, they argued that SFAS 131 had been designed for entities in the US, for whom the "country of domicile" is in itself a significant geographical area. These respondents suggested that disclosures should instead be required about the country of principal activities.

BC55 The IFRS requires disclosures for any country that is individually material. The Board noted that identifying the country of principal activities may be difficult and subjective. Accordingly, the Board decided not to require entities to identify the country of principal activities.

Subtotal for tangible non-current assets

BC56 Paragraphs 14 and 15 of the Basis for Conclusions on ED 8 highlighted a potential difference from SFAS 131. SFAS 131 requires disclosure of "long-lived assets" excluding intangible assets, whereas ED 8 proposed disclosure of "non-current assets" including intangible assets. The Board reconsidered whether, in the interest of convergence, the IFRS should require disclosure of the subtotal of tangible non-current assets.

BC57 The Board concluded that a separate disclosure of a subtotal of tangible non-current assets was unnecessary on the grounds that the incremental benefit does not justify such disclosure. However, the Board noted that entities that wish to provide that information are free to do so.

Information about major customers

BC58 ED 8 proposed that, in respect of the disclosures about major customers, a group of entities known to be under common control should be treated as a single customer. Some respondents noted that this could be difficult when entities are state-controlled. The Board noted that it was considering proposals to amend IAS 24 *Related Party Disclosures* with regard to state-controlled entities, and a consequential amendment to the IFRS on reporting segments might result from those proposals. In the meantime, the Board decided to require in the IFRS that a government (whether national, state, provincial, territorial, local or foreign) and entities known to the reporting entity to be controlled by that government should be treated as a single customer. This makes the requirements relating to government-controlled entities the same as those relating to privately controlled entities.

Interim financial information

BC59 The Board decided that the changes to IAS 34 *Interim Financial Reporting* proposed in ED 8 should be amended to clarify that interim disclosure of information on segment profit or loss items is required only if the specified amounts are included in the measure of segment profit or loss reviewed by the chief operating decision maker. The Board reached this conclusion because it noted that such disclosure is consistent with the management approach.

Differences from SFAS 131

BC60 In developing the IFRS, the Board included the following differences from SFAS 131:

(a) The FASB *Guidance on Applying Statement 131* indicates that the FASB staff believe that "long-lived assets", as that phrase is used in paragraph 38 of SFAS 131, implies hard assets that cannot be readily removed, which would appear to exclude intangibles. Non-current assets in the IFRS include intangibles (see paragraphs BC56 and BC57).

(b) SFAS 131 does not require disclosure of a measure of segment liabilities. The IFRS requires disclosure of segment liabilities if such a measure is regularly provided to the chief operating decision maker (see paragraphs BC36-BC38).

(c) SFAS 131 requires an entity with a matrix form of organisation to determine operating segments based on products and services. The IFRS requires such an entity to determine operating segments by reference to the core principle of the IFRS (see paragraph BC27).

Transitional provisions

BC61 Under its transitional provisions, SFAS 131 was not required to be applied to interim financial statements in the initial year of its application. However, in the second year of application, comparative information relating to interim periods in the initial year of application was required. The Basis for Conclusions on SFAS 131 explained that the reason for these transitional requirements was that some of the information that is required to be reported for interim periods is based on information reported in the most recent annual financial statements. Interim segment information would not be as meaningful without a full set of annual segment information to use as a comparison and to provide an understanding of the basis on which it is provided.

BC62 The Board did not agree with the transitional provision for interim financial statements in SFAS 131. The Board noted that the IFRS is not effective until 2009, giving entities adequate time to prepare. Furthermore, the Board was aware that some entities adopting IFRSs for the first time may wish to present comparative information in accordance with the IFRS rather than IAS 14.

Dissenting opinions on IFRS 8

Dissent of Gilbert Gélard and James J Leisenring

DO1 Messrs Gélard and Leisenring dissent from the issue of the IFRS because it does not require a defined measure of segment profit or loss to be disclosed and does not require the measure of profit or loss reported to be consistent with the attribution of assets to reportable segments.

DO2 By not defining segment profit or loss, the IFRS allows the reporting of any measure of segment profit or loss as long as that measure is reviewed by the chief operating decision maker. Items of revenue and expense directly attributable to a segment need not be included in the reported profit or loss of that segment, and allocation of items not directly attributable to any given segment is not required. Messrs Gélard and Leisenring believe that the IFRS should require amounts directly incurred by or directly attributable to a segment to be included in that segment's profit or loss, and measurement of a segment's profit or loss to be consistent with the attribution of assets to the segment.

DO3 Messrs Gélard and Leisenring support the disclosure of information to enable users of financial statements to evaluate the activities of an entity and the economic environment in which it operates. However, they believe that the IFRS will not meet this objective, even with the required disclosures and reconciliation to the entity's annual financial statements, because it does not define segment profit or loss and does not require consistent attribution of assets and profit or loss to segments.

DO4 Messrs Gélard and Leisenring support the management approach for defining reportable segments and support requiring disclosure of selected segment information in interim financial reports. They believe, however, that the definitions of segment revenue, expense, result, assets and liabilities in paragraph 16 of IAS 14 *Segment Reporting* should be retained in the IFRS and applied to segments identified by the management approach. They believe that proper external reporting of segment information should not permit the use of non-GAAP measures because they might mislead users.

DO5 Messrs Gélard and Leisenring also believe that the changes from IAS 14 are not justified by the need for convergence with US GAAP. IAS 14 is a disclosure standard and therefore does not affect the reconciliation of IFRS amounts to US GAAP, though additional disclosure from what is required now by IAS 14 might be needed to comply with US GAAP.

Appendix A

Background information and basis for conclusions of the US Financial Accounting Standards Board on SFAS 131

CONTENTS

Background information and basis for conclusions of the US Financial Accounting Standards Board on SFAS 131

Introduction

41. This appendix summarises considerations that were deemed significant by Board members in reaching the conclusions in this Statement. It includes reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

Background Information

42. FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise*, was issued in 1976. That Statement required that business enterprises report segment information on two bases: by industry and by geographic area. It also required disclosure of information about export sales and major customers.

43. The Board concluded at the time it issued Statement 14 that information about components of an enterprise, the products and services that it offers, its foreign operations, and its major customers is useful for understanding and making decisions about the enterprise as a whole. Financial statement users observe that the evaluation of the prospects for future cash flows is the central element of investment and lending decisions. The evaluation of prospects requires assessment of the uncertainty that surrounds both the timing and the amount of the expected cash flows to the enterprise, which in turn affect potential cash flows to the investor or creditor. Users also observe that uncertainty results in part from factors related to the products and services an enterprise offers and the geographic areas in which it operates.

44. In its 1993 position paper, *Financial Reporting in the 1990s and Beyond*, the Association for Investment Management and Research (AIMR) said:

> [Segment data] is vital, essential, fundamental, indispensable, and integral to the investment analysis process. Analysts need to know and understand how the various components of a multifaceted enterprise behave economically. One weak member of the group is analogous to a section of blight on a piece of fruit; it has the potential to spread rot over the entirety. Even in the absence of weakness, different segments will generate dissimilar streams of cash flows to which are attached disparate risks and which bring about unique values. Thus, without disaggregation, there is no sensible way to predict the overall amounts, timing, or risks of a complete enterprise's future cash flows. There is little dispute over the analytic usefulness of disaggregated financial data. [pages 59 and 60]

45. Over the years, financial analysts consistently requested that financial statement data be disaggregated to a much greater degree than it is in current practice. Many analysts said that they found Statement 14 helpful but inadequate. In its 1993 position paper, the AIMR emphasized that:

> There is no disagreement among AIMR members that segment information is totally vital to their work. There also is general agreement among them that the current segment reporting standard, Financial Accounting Standard No. 14, is inadequate. Recent work by a subcommittee of the [Financial Accounting Policy Committee] has confirmed that a substantial majority of analysts seek and, when it is available, use quarterly segment data. [page 5]

46. The Canadian Institute of Chartered Accountants (CICA) published a Research Study, *Financial Reporting for Segments*, in August 1992. An FASB Research Report, *Reporting Disaggregated Information*, was published in February 1993. In March 1993, the FASB and the Accounting Standards Board (AcSB) of the CICA agreed to pursue their projects jointly.

47. In May 1993, the FASB and the AcSB jointly issued an Invitation to Comment, *Reporting Disaggregated Information by Business Enterprises*. That Invitation to Comment identified certain issues related to disclosure of information about segments, solicited comments on those issues, and asked readers to identify additional issues. The boards received 129 comment letters from U.S. and Canadian respondents.

48. In late 1993, the FASB and the AcSB formed the Disaggregated Disclosures Advisory Group to advise and otherwise support the two boards in their efforts to improve disaggregated disclosures. The members of the group included financial statement issuers, auditors, financial analysts, and academics from both the United States and Canada. In January 1994, the FASB and the AcSB began discussing changes to Statement 14 and *CICA Handbook* Section 1700, "Segmented Information." The two boards met with and otherwise actively solicited the views of analysts and preparers of financial statements about possible improvements to the current segment reporting requirements. FASB and AcSB members and staff also discussed disaggregated disclosures at meetings of several groups of analysts, including the AIMR's Financial Accounting Policy Committee.

49. In 1991, the AICPA formed the Special Committee on Financial Reporting (the Special Committee) to make recommendations to improve the relevance and usefulness of business reporting. The Special Committee, which comprised financial statement auditors and preparers, established focus groups of credit analysts and equity analysts to assist in formulating its recommendations. The Special Committee issued its report, *Improving Business Reporting–A Customer Focus*, in 1994. That report listed improvements in disclosures of business segment information as its first recommendation and included the following commentary:

> ... for users analyzing a company involved in diverse businesses, financial information about business segments often is as important as information about the company as a whole. Users suggest that standard setters assign the highest priority to improving segment reporting because of its importance to their work and the perceived problems with current reporting of segment information. [page 68]

50. The report of the Special Committee listed the following as among the most important improvements needed:

(a) Disclosure of segment information in interim financial reports

(b) Greater number of segments for some enterprises

(c) More information about segments

(d) Segmentation that corresponds to internal management reports

(e) Consistency of segment information with other parts of an annual report.

Similar recommendations had been made in each of the last 20 years in evaluations of corporate reporting conducted by the AIMR.

51. The two boards reached tentative conclusions about an approach to segment reporting that was substantially different from the approach in Statement 14 and Section 1700. Key characteristics of the new approach were that (a) information would be provided about segments of the enterprise that corresponded to the structure of the enterprise's internal organization, that is, about the divisions, departments, subsidiaries, or other internal units that the chief operating decision maker uses to make operating decisions and to assess an enterprise's performance, (b) specific amounts would be allocated to segments only if they were allocated in reports used by the chief operating decision maker for evaluation of segment performance, and (c) accounting policies used to produce the disaggregated information would be the same as those used in the reports used by the chief operating decision maker in allocating resources and assessing segment performance.

52. In February 1995, the staffs of the FASB and the CICA distributed a paper, "Tentative Conclusions on Financial Reporting for Segments" (Tentative Conclusions), to selected securities analysts, the FASB Task Force on Consolidations and Related Matters, the Disaggregated Disclosures Advisory Group, the FASB's Emerging Issues Task Force, the Financial Accounting Standards Advisory Council, the AcSB's list of Associates,[1] and members of representative organizations that regularly work with the boards. The paper also was announced in FASB and CICA publications and was sent to anyone who requested a copy. Board and staff members discussed the Tentative Conclusions with various analyst and preparer groups. Approximately 80 comment letters were received from U.S. and Canadian respondents.

53. In January 1996, the FASB and the AcSB issued virtually identical Exposure Drafts, *Reporting Disaggregated Information about a Business Enterprise*. The FASB received 221 comment letters and the AcSB received 73 comment letters in response to the Exposure Drafts. A field test of the proposals was conducted in March 1996. A public meeting was held in Toronto in October 1996 to discuss results and concerns with field test participants. Other interested parties attended a public meeting in Norwalk in October 1996 to discuss their concerns about the proposals in the Exposure Drafts. The FASB decided that it could reach an informed decision on the project without holding a public hearing.

54. The FASB and the AcSB exchanged information during the course of redeliberating the proposals in their respective Exposure Drafts. AcSB members and CICA staff attended FASB meetings, and FASB members and staff attended AcSB meetings in late 1996 and in 1997 to discuss the issues raised by respondents. Both boards reached agreement on all of the substantive issues to achieve virtually identical standards for segment reporting in the United States and Canada. Members of the Segment Disclosures Advisory Group (formerly the Disaggregated Disclosures Advisory Group) discussed a draft of the standards section in March 1997.

55. The International Accounting Standards Committee (IASC) issued an Exposure Draft of a proposed International Accounting Standard that would replace International Accounting Standard IAS 14, *Reporting Financial Information by Segment*, in December 1995. Although many of its provisions are similar to those of the FASB and AcSB Exposure Drafts, the IASC's proposal is based on different objectives and is different from those Exposure Drafts. A member of the IASC Segments Steering Committee participated in FASB meetings during the redeliberations of the Exposure Draft, and members of the FASB participated in meetings of the IASC Segments Steering Committee. Many of the respondents to the Exposure Drafts encouraged the FASB and the AcSB to work closely with the IASC to achieve similar standards for segment reporting. The IASC expects to issue a standard on segment reporting later in 1997. Although there likely will be differences between the IASC's requirements for segment reporting and those of this Statement, the boards expect that it will be possible to prepare one set of segment information that complies with both the IASC requirements and those of this Statement.

56. This Statement addresses the following key issues:

    (a) What is the appropriate basis for defining segments?

    (b) What accounting principles and allocations should be used?

    (c) What specific items of information should be reported?

    (d) Should segment information be reported in condensed financial statements for interim periods?

[1] Associates are individuals and organizations with a particular interest in financial reporting issues that have volunteered to provide an outside reaction to AcSB positions at an early stage in the AcSB's deliberations.

Defining Operating Segments of an Enterprise

57. The Board concluded that the *industry approach* to segment disclosures in Statement 14 was not providing the information required by financial statement users and that disclosure of disaggregated information should be based on operating segments. This Statement defines an operating segment as a component of an enterprise (a) that engages in business activities from which it may earn revenues and incur expenses, (b) whose operating results are regularly reviewed by the enterprise's chief operating decision maker to make decisions about resources to be allocated to the segment and to assess its performance, and (c) for which discrete financial information is available.

58. The AIMR's 1993 position paper and the report of the AICPA Special Committee criticized Statement 14's industry segment approach to reporting segment information. The AIMR's position paper included the following:

> FAS 14 requires disclosure of line-of-business information classified by "industry segment." Its definition of segment is necessarily imprecise, recognizing that there are numerous practical problems in applying that definition to different business entities operating under disparate circumstances. That weakness in FAS 14 has been exploited by many enterprises to suit their own financial reporting purposes. As a result, we have seen one of the ten largest firms in the country report all of its operations as being in a single, very broadly defined industry segment. [page 60]

The report of the Special Committee said that "[financial statement users] believe that many companies define industry segments too broadly for business reporting and thus report on too few industry segments" (page 69).

59. The report of the AICPA Special Committee also said that "…the primary means to improving industry segment reporting should be to align business reporting with internal reporting" (page 69), and the AIMR's 1993 position paper recommended that:

> ... priority should be given to the production and dissemination of financial data that reflects and reports sensibly the operations of specific enterprises. If we could obtain reports showing the details of how an individual business firm is organized and managed, we would assume more responsibility for making meaningful comparisons of those data to the unlike data of other firms that conduct their business differently. [pages 60 and 61]

Almost all of the users and many other constituents who responded to the Exposure Draft or who met with Board and staff members agreed that defining segments based on the structure of an enterprise's internal organization would result in improved information. They said that not only would enterprises be likely to report more detailed information but knowledge of the structure of an enterprise's internal organization is valuable in itself because it highlights the risks and opportunities that management believes are important.

60. Segments based on the structure of an enterprise's internal organization have at least three other significant advantages. First, an ability to see an enterprise "through the eyes of management" enhances a user's ability to predict actions or reactions of management that can significantly affect the enterprise's prospects for future cash flows. Second, because information about those segments is generated for management's use, the incremental cost of providing information for external reporting should be relatively low. Third, practice has demonstrated that the term *industry* is subjective. Segments based on an existing internal structure should be less subjective.

61. The AIMR and other users have commented that segment information is more useful if it is consistent with explanatory information provided elsewhere in the annual report. They note that the business review section and the chairman's letter in an annual report frequently discuss the enterprise's operations on a basis different from that of

the segment information in the notes to the financial statements and the management's discussion and analysis section, which is required by SEC rules to correspond to the segment information provided to comply with Statement 14. That appears to occur if the enterprise is not managed in a way that corresponds to the way it defines segments under the requirements of Statement 14. Segmentation based on the structure of an enterprise's internal organization should facilitate consistent discussion of segment financial results throughout an enterprise's annual report.

62. Some respondents to the Exposure Draft opposed the Board's approach for several reasons. Segments based on the structure of an enterprise's internal organization may not be comparable between enterprises that engage in similar activities and may not be comparable from year to year for an individual enterprise. In addition, an enterprise may not be organized based on products and services or geographic areas, and thus the enterprise's segments may not be susceptible to analysis using macroeconomic models. Finally, some asserted that because enterprises are organized strategically, the information that would be reported may be competitively harmful to the reporting enterprise.

63. The Board acknowledges that comparability of accounting information is important. The summary of principal conclusions in FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, says: "Comparability between enterprises and consistency in the application of methods over time increases the informational value of comparisons of relative economic opportunities or performance. The significance of information, especially quantitative information, depends to a great extent on the user's ability to relate it to some benchmark." However, Concepts Statement 2 also notes a danger:

> Improving comparability may destroy or weaken relevance or reliability if, to secure comparability between two measures, one of them has to be obtained by a method yielding less relevant or less reliable information. Historically, extreme examples of this have been provided in some European countries in which the use of standardized charts of accounts has been made mandatory in the interest of interfirm comparability but at the expense of relevance and often reliability as well. That kind of uniformity may even adversely affect comparability of information if it conceals real differences between enterprises. [paragraph 116]

64. The Board was concerned that segments defined using the approach in Statement 14 may appear to be more comparable between enterprises than they actually are. Statement 14 included the following:

> Information prepared in conformity with [Statement 14] may be of limited usefulness for comparing an industry segment of one enterprise with a similar industry segment of another enterprise (i.e., for interenterprise comparison). Interenterprise comparison of industry segments would require a fairly detailed prescription of the basis or bases of disaggregation to be followed by all enterprises, as well as specification of the basis of accounting for intersegment transfers and methods of allocating costs common to two or more segments. [paragraph 76]

65. Statement 14 explained why the Board chose not to develop a detailed prescription of the bases of disaggregation:

> ... differences among enterprises in the nature of their operations and in the extent to which components of the enterprise share common facilities, equipment, materials and supplies, or labor force make unworkable the prescription of highly detailed rules and procedures that must be followed by all enterprises. Moreover, ... differences in the accounting systems of business enterprises are a practical constraint on the degree of specificity with which standards of financial accounting and reporting for disaggregated information can be established. [paragraph 74]

Those same considerations persuaded the Board not to adopt more specific requirements in this Statement. Both relevance and comparability will not be achievable in all cases, and relevance should be the overriding concern.

66. The AICPA Special Committee, some respondents to the Exposure Draft, and other constituents recommended that the Board require that an enterprise use an alternative method of segmentation for external reporting if its internal organization is not based on differences in products and services or geography. Some specifically recommended adoption of the proposal in the IASC Exposure Draft that was commonly referred to as a "safety net." The IASC Exposure Draft approach to identifying primary and secondary operating segments calls for review of management's organization of segments, but both primary and secondary segments are required to be defined either on the basis of related products and services or on the basis of geography. That is, regardless of management's organization, segments must be grouped either by related products and services or by geographic areas, and one set must be presented as primary segments and the other as secondary segments.

67. The Board recognizes that an enterprise may not be divided into components with similar products and services or geographic areas for internal purposes and that some users of financial statements have expressed a desire for information organized on those bases. However, instead of an alternative method of segmentation, which would call for multiple sets of segment information in many circumstances, the Board chose to require disclosure of additional information about products and services and about geographic areas of operations for the enterprise as a whole if the basic segment disclosures do not provide it.

68. One reason for not prescribing segmentation along bases of only related products and services or geography is that it is difficult to define clearly the circumstances in which an alternative method that differs from the management approach would be applied consistently. An enterprise with a relatively narrow product line may not consider two products to be similar, while an enterprise with a broad product line may consider those same two products to be similar. For example, a highly diversified enterprise may consider all consumer products to be similar if it has other businesses such as financial services and road construction. However, an enterprise that sells only consumer products might consider razor blades to be different from toasters.

69. A second reason for rejecting that approach is that an alternative method of segmentation would increase the cost to some enterprises to prepare the information. A management approach to defining segments allows enterprises to present the information that they use internally and facilitates consistent descriptions of the components of an enterprise from one part of the annual report to another. An enterprise could be organized by its products and services, geography, a mixture of both products and services and geography, or other bases, such as customer type, and the segment information required by this Statement would be consistent with that method of organization. Furthermore, the enterprise-wide disclosures about products and services will provide information about the total revenues from related products and services, and the enterprise-wide disclosures about geography will provide information about the revenues and assets of an enterprise both inside and outside its home country. If material, individual foreign country information also is required.

70. The Board recognizes that some enterprises organize their segments on more than one basis. Other enterprises may produce reports in which their activities are presented in a variety of ways. In those situations, reportable segments are to be determined based on a review of other factors to identify the enterprise's operating segments, including the nature of the activities of each component, the existence of managers responsible for them, and the information provided to the board of directors. In many enterprises, only one set of data is provided to the board of directors. That set of data generally is indicative of how management views the enterprise's activities.

Reportable Segments

71. The Board included a notion of reportable segments, a subset of operating segments,

in this Statement by defining aggregation criteria and quantitative thresholds for determining which operating segments should be reported separately in the financial statements.

72. A so-called pure management approach to segment reporting might require that an enterprise report all of the information that is reviewed by the chief operating decision maker to make decisions about resource allocations and to assess the performance of the enterprise. However, that level of detail may not be useful to readers of external financial statements, and it also may be cumbersome for an enterprise to present. Therefore, this Statement uses a modified management approach that includes both aggregation criteria and quantitative thresholds for determining reportable operating segments. However, an enterprise need not aggregate similar segments, and it may present segments that fall below the quantitative thresholds.

Aggregation of Similar Operating Segments

73. The Board believes that separate reporting of segment information will not add significantly to an investor's understanding of an enterprise if its operating segments have characteristics so similar that they can be expected to have essentially the same future prospects. The Board concluded that although information about each segment may be available, in those circumstances the benefit would be insufficient to justify its disclosure. For example, a retail chain may have 10 stores that individually meet the definition of an operating segment, but each store may be essentially the same as the others.

74. Most respondents commented on the aggregation criteria in the Exposure Draft. Many said that the criteria were unreasonably strict, to the extent that nearly identical segments might not qualify for aggregation. Some respondents linked their concerns about competitive harm and too many segments directly to the aggregation criteria, indicating that a relaxation of the criteria would significantly reduce those concerns. To better convey its intent, the Board revised the wording of the aggregation criteria and the introduction to them. However, the Board rejected recommendations that the criteria be indicators rather than tests and that the guidance require only the expectation of similar long-term performance of segments to justify aggregation because those changes might result in a level of aggregation that would cause a loss of potentially valuable information. For the same reason, the Board also rejected suggestions that segments need be similar in only a majority of the characteristics in paragraph 17 to justify aggregation. The Board recognizes that determining when two segments are sufficiently similar to justify aggregating them is difficult and subjective. However, the Board notes that one of the reasons that the information provided under Statement 14 did not satisfy financial statement users' needs is that segments with different characteristics in important areas were at times aggregated.

Quantitative Thresholds

75. In developing the Exposure Draft, the Board had concluded that quantitative criteria might interfere with the determination of operating segments and, if anything, might unnecessarily reduce the number of segments disclosed. Respondents to the Exposure Draft and others urged the Board to include quantitative criteria for determining which segments to report because they said that some enterprises would be required to report too many segments unless specific quantitative guidelines allowed them to omit small segments. Some respondents said that the Exposure Draft would have required disclosure of as many as 25 operating segments, which was not a result anticipated by the Board in its deliberations preceding the Exposure Draft. Others said that enterprises would report information that was too highly aggregated unless quantitative guidelines prevented it. The Board decided that the addition of quantitative thresholds would be a practical way to address respondents' concerns about competitive harm and proliferation of segments without fundamentally changing the management approach to segment definition.

76. Similar to the requirements in Statement 14, the Board decided to require that any operating segment that constitutes 10 percent or more of reported revenues, assets, or profit or loss be reported separately and that reportable segments account for at least 75 percent of an enterprise's external revenues. The Board decided to retain that guidance for the quantitative thresholds because it can be objectively applied and because preparers and users of financial statements already understand it.

77. Inclusion of quantitative thresholds similar to those in Statement 14 necessitates guidance on how to report operating segments that do not meet the thresholds. The Board concluded that enterprises should be permitted to aggregate information about operating segments that do not meet the thresholds with information about other operating segments that do not meet the thresholds if a majority of the aggregation criteria in paragraph 17 are met. That is a more liberal aggregation provision than that for individually material operating segments, but it prohibits aggregation of segments that are dissimilar.

78. Paragraph 125 of Concepts Statement 2 states that "... magnitude by itself, without regard to the nature of the item and the circumstances in which the judgment has to be made, will not generally be a sufficient basis for a materiality judgment." That guidance applies to segment information. An understanding of the material segments of an enterprise is important for understanding the enterprise as a whole, and individual items of segment information are important for understanding the segments. Thus, an item of segment information that, if omitted, would change a user's decision about that segment so significantly that it would change the user's decision about the enterprise as a whole is material even though an item of a similar magnitude might not be considered material if it were omitted from the consolidated financial statements. Therefore, enterprises are encouraged to report information about segments that do not meet the quantitative thresholds if management believes that it is material. Those who are familiar with the particular circumstances of each enterprise must decide what constitutes *material*.

Vertically Integrated Enterprises

79. The Board concluded that the definition of an operating segment should include components of an enterprise that sell primarily or exclusively to other operating segments of the enterprise if the enterprise is managed that way. Information about the components engaged in each stage of production is particularly important for understanding vertically integrated enterprises in certain businesses, for example, oil and gas enterprises. Different activities within the enterprise may have significantly different prospects for future cash flows, and users of financial statements have asserted that they need to know results of each operation.

80. Some respondents to the Exposure Draft opposed the requirement to report vertically integrated segments separately. They said that the segment results may not be comparable between enterprises and that transfer prices are not sufficiently reliable for external reporting purposes. The Board considered an approach that would have required separate reporting of vertically integrated segments only if transfer prices were based on quoted market prices and if there was no basis for combining the selling segment and the buying segment. However, that would have been a significant departure from the management approach to defining segments. The Board also was concerned that the criteria would be unworkable. Therefore, the Board decided to retain the Exposure Draft's provisions for vertically integrated segments.

Accounting Principles and Allocations

81. The Board decided that the information to be reported about each segment should be measured on the same basis as the information used by the chief operating decision maker for purposes of allocating resources to segments and assessing segments' performance. That is a management approach to measuring segment information as proposed in the Exposure Draft. The Board does not think that a separate measure of

segment profit or loss or assets should have to be developed solely for the purpose of disclosing segment information. For example, an enterprise that accounts for inventory using a specialized valuation method for internal purposes should not be required to restate inventory amounts for each segment, and an enterprise that accounts for pension expense only on a consolidated basis should not be required to allocate pension expense to each operating segment.

82. The report of the AICPA Special Committee said that the Board "should allow companies to report a statistic on the same basis it is reported for internal purposes, if the statistic is reported internally. The usefulness of information prepared only for [external] reporting is questionable. Users want to understand management's perspective on the company and the implications of key statistics." It also said that "key statistics to be reported [should] be limited to statistics a company has available..." (page 72).

83. Respondents to the Exposure Draft had mixed reactions to its measurement guidance. Very few suggested that the Board require allocations solely for external reporting purposes. Most agreed that allocations are inherently arbitrary and may not be meaningful if they are not used for management purposes. No respondents suggested that intersegment transfers should be reported on any basis other than that used internally. However, some respondents recommended that information about each segment be provided based on the accounting principles used in the enterprise's general-purpose financial statements. Some observed that unadjusted information from internal sources would not necessarily comply with generally accepted accounting principles and, for that reason, might be difficult for users to understand. Other respondents argued that comparability between enterprises would be improved if the segment information were provided on the basis of generally accepted accounting principles. Finally, a few questioned the verifiability of the information.

84. The Board decided not to require that segment information be provided in accordance with the same generally accepted accounting principles used to prepare the consolidated financial statements for several reasons. Preparing segment information in accordance with the generally accepted accounting principles used at the consolidated level would be difficult because some generally accepted accounting principles are not intended to apply at a segment level. Examples include allocation of the cost of an acquisition to individual assets and liabilities of a subsidiary using the purchase method of accounting, accounting for the cost of enterprise-wide employee benefit plans, accounting for income taxes in an enterprise that files a consolidated income tax return, and accounting for inventory on a last-in, first-out basis if the pools include items in more than one segment. In addition, there are no generally accepted accounting principles for allocating joint costs, jointly used assets, or jointly incurred liabilities to segments or for pricing intersegment transfers. As a consequence, it generally is not feasible to present segment profitability in accordance with generally accepted accounting principles.

85. The Board recognizes that segment information is subject to certain limitations and that some of that information may not be susceptible to the same degree of verifiability as some other financial information. However, verifiability is not the only important qualitative characteristic of accounting information. Verifiability is a component of reliability, which is one of two characteristics that contribute to the usefulness of accounting information. The other is relevance, which is equally important. Concepts Statement 2 states:

> Although financial information must be both relevant and reliable to be useful, information may possess both characteristics to varying degrees. It may be possible to trade relevance for reliability or vice versa, though not to the point of dispensing with one of them altogether. ... trade-offs between characteristics may be necessary or beneficial.
>
> In a particular situation, the importance attached to relevance in relation to the importance of other decision specific qualities of accounting information (for example,

> reliability) will be different for different information users, and their willingness to trade one quality for another will also differ. [paragraphs 42 and 45]

86. It is apparent that users are willing to trade a degree of reliability in segment information for more relevant information. The AIMR's 1993 position paper states:

> Analysts need financial statements structured so as to be consistent with how the business is organized and managed. That means that two different companies in the same industry may have to report segment data differently because they are structured differently themselves. [page 20]

But, as previously noted, the position paper says that, under those circumstances, analysts "would assume more responsibility for making meaningful comparisons of those data to the unlike data of other firms that conduct their business differently" (page 61).

87. The Board believes that the information required by this Statement meets the objective of reliability of which both representational faithfulness and verifiability are components. An auditor can determine whether the information reported in the notes to the financial statements came from the required source by reviewing management reports or minutes from meetings of the board of directors. The information is not required to be provided on a specified basis, but the enterprise is required to explain the basis on which it is provided and to reconcile the segment information to consolidated enterprise totals. Adequate explanation and an appropriate reconciliation will enable a user to understand the information and its limitations in the context of the enterprise's financial statements. The auditor can test both the explanation of segment amounts and the reconciliations to consolidated totals. Furthermore, because management uses that information in its decision-making processes, that information is likely to be highly reliable. The information provided to comply with Statement 14 was more difficult to verify in many situations and was less reliable. Because it was prepared solely for external reporting purposes, it required allocations that may have been arbitrary, and it was based on accounting principles that may have been difficult to apply at the segment level.

88. Paragraph 29 requires amounts allocated to a segment to be allocated on a reasonable basis. However, the Board believes that the potential increased reliability that might have been achieved by requiring allocation of consolidated amounts is illusory because expenses incurred at the consolidated level could be allocated to segments in a variety of ways that could be considered "reasonable." For example, an enterprise could use either the number of employees in each segment or the segment's total salary expense in relation to the consolidated amounts as a basis for allocating pension expense to segments. Those two approaches to allocation could result in significantly different measures of segment profit or loss. However, both the number of employees and the total salary expense might be reasonable bases on which to allocate total pension expense. In contrast, it would not seem reasonable for an enterprise to allocate pension expense to a segment that had no employees eligible for the pension plan. Because of the potential for misleading information that may result from such allocations, the Board decided that it is appropriate for this Statement to require that amounts allocated to a segment be allocated on a reasonable basis.

89. The Board also considered explicitly requiring that revenues and expenses directly incurred by or directly attributable to an operating segment be reported by that segment. However, it decided that, in some cases, whether an item of revenue or expense is attributable to an operating segment is a matter of judgment. Further, such an explicit requirement would be an additional modification of the management approach to measurement. While the Board decided not to include an explicit requirement, it believes that many items of revenue or expense clearly relate to a particular segment and that it would be unlikely that the information used by management would omit those items.

90. To assist users of financial statements in understanding segment disclosures, this Statement requires that enterprises provide sufficient explanation of the basis on which the information was prepared. That disclosure must include any differences in the basis of measurement between the consolidated amounts and the segment amounts. It also must indicate whether allocations of items were made symmetrically. An enterprise may allocate an expense to a segment without allocating the related asset; however, disclosure of that fact is required. Enterprises also are required to reconcile to the consolidated totals in the enterprise's financial statements the totals of reportable segment assets, segment revenues, segment profit or loss, and any other significant segment information that is disclosed.

91. In addition, the advantages of reporting unadjusted management information are significant. That practice is consistent with defining segments based on the structure of the enterprise's internal organization. It imposes little incremental cost on the enterprise and requires little incremental time to prepare. Thus, the enterprise can more easily report segment information in condensed financial statements for interim periods and can report more information about each segment in annual financial statements. Information used by management also highlights for a user of financial statements the risks and opportunities that management considers important.

Information to Be Disclosed about Segments

92. The items of information about each reportable operating segment that must be disclosed as described in paragraphs 25-31 represent a balance between the needs of users of financial statements who may want a complete set of financial statements for each segment and the costs to preparers who may prefer not to disclose any segment information. Statement 14 required disclosure of internal and external revenues; profit or loss; depreciation, depletion, and amortization expense; and unusual items as defined in APB Opinion No. 30, *Reporting the Results of Operations-Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, for each segment. Statement 14 also required disclosure of total assets, equity in the net income of investees accounted for by the equity method, the amount of investment in equity method investees, and total expenditures for additions to long-lived assets. Some respondents to the Exposure Draft objected to disclosing any information that was not required by Statement 14, while others recommended disclosure of additional items that are not required by this Statement. This Statement calls for the following additional disclosures only if the items are included in the measure of segment profit or loss that is reviewed by the chief operating decision maker: significant noncash items, interest revenue, interest expense, and income tax expense.

93. Some respondents to the Exposure Draft expressed concern that the proposals would increase the sheer volume of information compared to what was required to be reported under Statement 14. The Board considers that concern to be overstated for several reasons. Although this Statement requires disclosure of more information about an individual operating segment than Statement 14 required for an industry segment, this Statement requires disclosure of information about only one type of segment–reportable operating segments–while Statement 14 required information about two types of segments–industry segments and geographic segments. Moreover, Statement 14 required that many enterprises create information solely for external reporting, while almost all of the segment information that this Statement requires is already available in management reports. The Board recognizes, however, that some enterprises may find it necessary to create the enterprise-wide information about products and services, geographic areas, and major customers required by paragraphs 36-39.

94. The Board decided to require disclosure of significant noncash items included in the measure of segment profit or loss and information about total expenditures for additions to long-lived segment assets (other than financial instruments, long-term customer relationships of a financial institution, mortgage and other servicing rights,

deferred policy acquisition costs, and deferred tax assets) if that information is reported internally because it improves financial statement users' abilities to estimate cash-generating potential and cash requirements of operating segments. As an alternative, the Board considered requiring disclosure of operating cash flow for each operating segment. However, many respondents said that disclosing operating cash flow in accordance with FASB Statement No. 95, *Statement of Cash Flows*, would require that they gather and process information solely for external reporting purposes. They said that management often evaluates cash generated or required by segments in ways other than by calculating operating cash flow in accordance with Statement 95. For that reason, the Board decided not to require disclosure of cash flow by segment.

95. Disclosure of interest revenue and interest expense included in reported segment profit or loss is intended to provide information about the financing activities of a segment. The Exposure Draft proposed that an enterprise disclose gross interest revenue and gross interest expense for all segments in which reported profit or loss includes those items. Some respondents said that financial services segments generally are managed based on net interest revenue, or the "spread," and that management looks only to that data in its decision-making process. Therefore those segments should be required to disclose only the net amount and not both gross interest revenue and expense. Those respondents noted that requiring disclosure of both gross amounts would be analogous to requiring nonfinancial services segments to disclose both sales and cost of sales. The Board decided that segments that derive a majority of revenue from interest should be permitted to disclose net interest revenue instead of gross interest revenue and gross interest expense if management finds that amount to be more relevant in managing the segment. Information about interest is most important if a single segment comprises a mix of financial and nonfinancial operations. If a segment is primarily a financial operation, interest revenue probably constitutes most of segment revenues and interest expense will constitute most of the difference between reported segment revenues and reported segment profit or loss. If the segment has no financial operations or only immaterial financial operations, no information about interest is required.

96. The Board decided not to require the disclosure of segment liabilities. The Exposure Draft proposed that an enterprise disclose segment liabilities because the Board believed that liabilities are an important disclosure for understanding the financing activities of a segment. The Board also noted that the requirement in FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*, to disclose assets, liabilities, and profit or loss about previously unconsolidated subsidiaries was continued from APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, pending completion of the project on disaggregated disclosures. However, in commenting on the disclosures that should be required by this Statement, many respondents said that liabilities are incurred centrally and that enterprises often do not allocate those amounts to segments. The Board concluded that the value of information about segment liabilities in assessing the performance of the segments of an enterprise was limited.

97. The Board decided not to require disclosure of research and development expense included in the measure of segment profit or loss. The Exposure Draft would have required that disclosure to provide financial statement users with information about the operating segments in which an enterprise is focusing its product development efforts. Disclosure of research and development expense was requested by a number of financial statement users and was specifically requested in both the report of the AICPA's Special Committee and the AIMR's 1993 position paper. However, respondents said that disclosing research and development expense by segment may result in competitive harm by providing competitors with early insight into the strategic plans of an enterprise. Other respondents observed that research and development is only one of a number of items that indicate where an enterprise is focusing its efforts and that it is much more significant in some enterprises than in others. For example, costs of employee training and advertising were cited as items that often are more important to some enterprises than research and development, calling into question

the relevance of disclosing only research and development expense. Additionally, many respondents said that research and development expense often is incurred centrally and not allocated to segments. The Board therefore decided not to require the disclosure of research and development expense by segment.

Interim Period Information

98. This Statement requires disclosure of limited segment information in condensed financial statements that are included in quarterly reports to shareholders, as was proposed in the Exposure Draft. Statement 14 did not apply to those condensed financial statements because of the expense and the time required for producing segment information under Statement 14. A few respondents to the Exposure Draft said that reporting segment information in interim financial statements would be unnecessarily burdensome. However, users contended that, to be timely, segment information is needed more often than annually and that the difficulties of preparing it on an interim basis could be overcome by an approach like the one in this Statement. Managers of many enterprises agree and have voluntarily provided segment information for interim periods.

99. The Board decided that the condensed financial statements in interim reports issued to shareholders should include disclosure of segment revenues from external customers, intersegment revenues, a measure of segment profit or loss, material changes in segment assets, differences in the basis of segmentation or the way segment profit or loss was measured in the previous annual period, and a reconciliation to the enterprise's total profit or loss. That decision is a compromise between the needs of users who want the same segment information for interim periods as that required in annual financial statements and the costs to preparers who must report the information. Users will have some key information on a timely basis. Enterprises should not incur significant incremental costs to provide the information because it is based on information that is used internally and therefore already available.

Restatement of Previously Reported Information

100. The Board decided to require restatement of previously reported segment information following a change in the composition of an enterprise's segments unless it is impracticable to do so. Changes in the composition of segments interrupt trends, and trend analysis is important to users of financial statements. Some financial statement issuers have said that their policy is to restate one or more prior years for internal trend analysis. Many reorganizations result in discrete profit centers' being reassigned from one segment to another and lead to relatively simple restatements. However, if an enterprise undergoes a fundamental reorganization, restatement may be very difficult and expensive.

The Board concluded that in those situations restatement may be impracticable and, therefore, should not be required. However, if an enterprise does not restate its segment information, the enterprise is required to provide current-period segment information on both the old and new bases of segmentation in the year in which the change occurs unless it is impracticable to do so.

Enterprise-Wide Disclosures

101. Paragraphs 36-39 require disclosure of information about an enterprise's products and services, geographic areas, and major customers, regardless of the enterprise's organization. The required disclosures need be provided only if they are not included as part of the disclosures about segments. The Exposure Draft proposed requiring additional disclosures about products and services and geographic areas *by segment*. Many respondents said that that proposal would have resulted in disclosure of excessive amounts of information. Some enterprises providing a variety of products and services throughout many countries, for example, would have been required to

present a large quantity of information that would have been time-consuming to prepare and of questionable benefit to most financial statement users. The Board decided that additional disclosures provided on an enterprise-wide basis rather than on a segment basis would be appropriate and not unduly burdensome. The Board also agreed that those enterprise-wide disclosures are appropriate for all enterprises including those that have a single operating segment if the enterprise offers a range of products and services, derives revenues from customers in more than one country, or both.

102. Based on reviews of published information about public enterprises, discussions with constituents, and a field test of the Exposure Draft, the Board believes that most enterprises are organized by products and services or by geography and will report one or both of those types of information in their reportable operating segment disclosures. However, some enterprises will be required by paragraphs 36-39 to report additional information because the enterprise-wide disclosures are required for all enterprises, even those that have a single reportable segment.

Information about Products and Services

103. This Statement requires that enterprises report revenues from external customers for each product and service or each group of similar products and services for the enterprise as a whole. Analysts said that an analysis of trends in revenues from products and services is important in assessing both past performance and prospects for future growth. Those trends can be compared to benchmarks such as industry statistics or information reported by competitors. Information about the assets that are used to produce specific products and deliver specific services also might be useful. However, in many enterprises, assets are not dedicated to specific products and services and reporting assets by products and services would require arbitrary allocations.

Information about Geographic Areas

104. This Statement requires disclosure of information about both revenues and assets by geographic area. Analysts said that information about revenues from customers in different geographic areas assists them in understanding concentrations of risks due to negative changes in economic conditions and prospects for growth due to positive economic changes. They said that information about assets located in different areas assists them in understanding concentrations of risks (for example, political risks such as expropriation).

105. Statement 14 requires disclosure of geographic information by geographic region, whereas this Statement requires disclosure of individually material countries as well as information for the enterprise’s country of domicile and all foreign countries in the aggregate. This Statement’s approach has two significant benefits. First, it will reduce the burden on preparers of financial statements because most enterprises are likely to have material operations in only a few countries or perhaps only in their country of domicile. Second, and more important, it will provide information that is more useful in assessing the impact of concentrations of risk. Information disclosed by country is more useful because it is easier to interpret. Countries in contiguous areas often experience different rates of growth and other differences in economic conditions. Under the requirements of Statement 14, enterprises often reported information about broad geographic areas that included groupings such as Europe, Africa, and the Middle East. Analysts and others have questioned the usefulness of that type of broad disclosure.

106. Respondents to the Exposure Draft questioned how revenues should be allocated to individual countries. For example, guidance was requested for situations in which products are shipped to one location but the customer resides in another location. The Board decided to provide flexibility concerning the basis on which enterprises attribute revenues to individual countries rather than requiring that revenues be attributed to

countries according to the location of customers. The Board also decided to require that enterprises disclose the basis they have adopted for attributing revenues to countries to permit financial statement users to understand the geographic information provided.

107. As a result of its decision to require geographic information on an enterprise-wide basis, the Board decided not to require disclosure of capital expenditures on certain long-lived assets by geographic area. Such information on an enterprise-wide basis is not necessarily helpful in forecasting future cash flows of operating segments.

Information about Major Customers

108. The Board decided to retain the requirement in Statement 14, as amended by FASB Statement No. 30, *Disclosure of Information about Major Customers*, to report information about major customers because major customers of an enterprise represent a significant concentration of risk. The 10 percent threshold is arbitrary; however, it has been accepted practice since Statement 14 was issued, and few have suggested changing it.

Competitive Harm

109. A number of respondents to the Exposure Draft noted the potential for competitive harm as a result of disclosing segment information in accordance with this Statement. The Board considered adopting special provisions to reduce the potential for competitive harm from certain segment information but decided against it. In the Invitation to Comment, the Tentative Conclusions, and the Exposure Draft, the Board asked constituents for specific illustrations of competitive harm that has resulted from disclosing segment information. Some respondents said that public enterprises may be at a disadvantage to nonpublic enterprises or foreign competitors that do not have to disclose segment information. Other respondents suggested that information about narrowly defined segments may put an enterprise at a disadvantage in price negotiations with customers or in competitive bid situations.

110. Some respondents said that if a competitive disadvantage exists, it is a consequence of an obligation that enterprises have accepted to gain greater access to capital markets, which gives them certain advantages over nonpublic enterprises and many foreign enterprises. Other respondents said that enterprises are not likely to suffer competitive harm because most competitors have other sources of more detailed information about an enterprise than that disclosed in the financial statements. In addition, the information that is required to be disclosed about an operating segment is no more detailed or specific than the information typically provided by a smaller enterprise with a single operation.

111. The Board was sympathetic to specific concerns raised by certain constituents; however, it decided that a competitive-harm exemption was inappropriate because it would provide a means for broad noncompliance with this Statement. Some form of relief for single-product or single-service segments was explored; however, there are many enterprises that produce a single product or a single service that are required to issue general-purpose financial statements. Those statements would include the same information that would be reported by single-product or single-service segments of an enterprise. The Board concluded that it was not necessary to provide an exemption for single-product or single-service segments because enterprises that produce a single product or service that are required to issue general-purpose financial statements have that same exposure to competitive harm. The Board noted that concerns about competitive harm were addressed to the extent feasible by four changes made during redeliberations: (a) modifying the aggregation criteria, (b) adding quantitative materiality thresholds for identifying reportable segments, (c) eliminating the requirements to disclose research and development expense and liabilities by segment, and (d) changing the second-level disclosure requirements about products and services and geography from a segment basis to an

enterprise-wide basis.

Cost-Benefit Considerations

112. One of the precepts of the Board's mission is to promulgate standards only if the expected benefits of the resulting information exceed the perceived costs. The Board strives to determine that a proposed standard will fill a significant need and that the costs incurred to satisfy that need, as compared with other alternatives, are justified in relation to the overall benefits of the resulting information. The Board concluded that the benefits that will result from this Statement will exceed the related costs.

113. The Board believes that the primary benefits of this Statement are that enterprises will report segment information in interim financial reports, some enterprises will report a greater number of segments, most enterprises will report more items of information about each segment, enterprises will report segments that correspond to internal management reports, and enterprises will report segment information that will be more consistent with other parts of their annual reports.

114. This Statement will reduce the cost of providing disaggregated information for many enterprises. Statement 14 required that enterprises define segments by both industry and by geographical area, ways that often did not match the way that information was used internally. Even if the reported segments aligned with the internal organisation, the information required was often created solely for external reporting because Statement 14 required certain allocations of costs, prohibited other cost allocations, and required allocations of assets to segments. This Statement requires that information about operating segments be provided on the same basis that it is used internally. The Board believes that most of the enterprise-wide disclosures in this Statement about products and services, geography, and major customers typically are provided in current financial statements or can be prepared with minimal incremental cost.

Applicability to Nonpublic Enterprises and Not-for-Profit Organizations

115. The Board decided to continue to exempt nonpublic enterprises from the requirement to report segment information. Few users of nonpublic enterprises' financial statements have requested that the Board require that those enterprises provide segment information.

116. At the time the Board began considering improvements to disclosures about segment information, FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, had not been issued and there were no effective standards for consolidated financial statements of not-for-profit organizations. Most not-for-profit organizations provided financial information for each of their funds, which is a form of disaggregated information. The situation in Canada was similar. Thus, when the two boards agreed to pursue a joint project, they decided to limit the scope to public business enterprises.

117. The Board provided a limited form of disaggregated information in paragraph 26 of Statement 117, which requires disclosure of expense by functional classification. However, the Board acknowledges that the application of that Statement may increase the need for disaggregated information about not-for-profit organizations. A final Statement expected to result from the FASB Exposure Draft, *Consolidated Financial Statements: Policy and Procedures*, also may increase that need by requiring aggregation of information about more entities in the financial statements of not-for-profit organizations.

118. The general approach of providing information based on the structure of an enterprise's internal organization may be appropriate for not-for-profit organizations. However, the Board decided not to add not-for-profit organizations to the scope of this

Statement. Users of financial statements of not-for-profit organizations have not urged the Board to include those organizations, perhaps because they have not yet seen the effects of Statement 117 and the Exposure Draft on consolidations. Furthermore, the term *not-for-profit organizations* applies to a wide variety of entities, some of which are similar to business enterprises and some of which are very different. There are likely to be unique characteristics of some of those entities or special user needs that require special provisions, which the Board has not studied. In addition, the AcSB has recently adopted standards for reporting by not-for-profit organizations that are different from Statement 117. In the interest of completing this joint project in a timely manner, the Board decided not to undertake the research and deliberations that would be necessary to adapt the requirements of this Statement to not-for-profit organizations at this time. Few respondents to the Exposure Draft disagreed with the Board's position.

Effective Date and Transition

119. The Board concluded that this Statement should be effective for financial statements issued for fiscal years beginning after December 15, 1997. In developing the Exposure Draft, the Board had decided on an effective date of December 15, 1996. The Board believed that that time frame was reasonable because almost all of the information that this Statement requires is generated by systems already in place within an enterprise and a final Statement was expected to be issued before the end of 1996. However, respondents said that some enterprises may need more time to comply with the requirements of this Statement than would have been provided under the Exposure Draft.

120. The Board also decided not to require that segment information be reported in financial statements for interim periods in the initial year of application. Some of the information that is required to be reported for interim periods is based on information that would have been reported in the most recent annual financial statements. Without a full set of segment information to use as a comparison and to provide an understanding of the basis on which it is provided, interim information would not be as meaningful.

Appendix B

Amendments to Basis for Conclusions on other IFRSs (included in the Basis for Conclusions on the corresponding HKFRSs)

This appendix contains amendments to the Basis for Conclusions on other IFRSs that are necessary in order to note the replacement of IAS 14 by IFRS 8.

BCA1 In the Basis for Conclusions on IFRS 1 *First-time Adoption of International Financial Reporting Standards*, paragraph BC4 is footnoted as follows:

> In 2006 IAS 14 was replaced by IFRS 8 *Operating Segments*.

BCA2 In the Basis for Conclusions on IFRS 6 *Exploration for and Evaluation of Mineral Resources*, paragraph BC46 is footnoted as follows:

> In 2006 IAS 14 was replaced by IFRS 8 *Operating Segments*, which does not require the identification of primary and secondary segments. See paragraph BC150A of the Basis for Conclusions on IAS 36 *Impairment of Assets*.

BCA3 In the Basis for Conclusions on IFRS 7 *Financial Instruments: Disclosures*, paragraph BC47 is footnoted as follows:

> In 2006 IAS 14 was replaced by IFRS 8 *Operating Segments*.

BCA4 In the Basis for Conclusions on IAS 27 *Consolidated and Separate Financial Statements*, paragraph BC21 is footnoted as follows:

> In 2006 IAS 14 *Segment Reporting* was replaced by IFRS 8 *Operating Segments*.

BCA5 The Basis for Conclusions on IAS 36 *Impairment of Assets* is amended as described below.

Paragraph BC144 is footnoted as follows:

> In 2006 IAS 14 was replaced by IFRS 8 *Operating Segments*. IFRS 8 does not require disclosure of primary and secondary segment information. See paragraph BC150A.

In the footnote to paragraph BC147, the following is added at the end:

> IAS 14 was replaced by IFRS 8 in 2006. See paragraph BC150A.

Paragraph BC150A is added after paragraph BC150, as follows:

BC150A In 2006 IFRS 8 replaced IAS 14 and changed the basis for identifying segments. Under IAS 14, two sets of segments were identified–one based on related products and services, and the other on geographical areas. Under IFRS 8, operating segments are identified on the basis of internal reports that are regularly reviewed by the entity's chief operating decision maker in order to allocate resources to the segment and assess its performance. The objective of the change was to improve the disclosure of segment information, not to change the requirements of IAS 36 relating to the allocation of goodwill for impairment testing. The previous wording of the requirement in IAS 36 that each unit or group of units to which goodwill is allocated shall "not be larger than a segment based on either the entity's primary or the entity's secondary reporting format determined in accordance with IAS 14" has been amended by IFRS 8 to "not be larger than an

> operating segment determined in accordance with IFRS 8". The arguments set out above in support of the original requirement based on segments determined in accordance with IAS 14 support the revised requirements based on segments determined in accordance with the requirements in IFRS 8.

The second sentence of paragraph BC166(b) is footnoted as follows:

> In 2006 IAS 14 was replaced by IFRS 8 *Operating Segments*, which does not require disclosure of primary and secondary segment information. See paragraph BC150A.

HKFRS 8 IG
Issued March 2007

Guidance on Implementing
Hong Kong Financial Reporting Standard 8

Operating Segments

Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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Guidance on implementing HKFRS 8 *Operating Segments*

This guidance accompanies, but is not part of, HKFRS 8.

Introduction

IG1 This implementation guidance provides examples that illustrate the disclosures required by HKFRS 8 and a diagram to assist in identifying reportable segments. The formats in the illustrations are not requirements. The Board encourages a format that provides the information in the most understandable manner in the specific circumstances. The following illustrations are for a single hypothetical entity referred to as Diversified Company.

Descriptive information about an entity's reportable segments

IG2 The following illustrates the disclosure of descriptive information about an entity's reportable segments (the paragraph references are to the relevant requirements in the HKFRS).

Description of the types of products and services from which each reportable segment derives its revenues (paragraph 22(b))

Diversified Company has five reportable segments: car parts, motor vessels, software, electronics and finance. The car parts segment produces replacement parts for sale to car parts retailers. The motor vessels segment produces small motor vessels to serve the offshore oil industry and similar businesses. The software segment produces application software for sale to computer manufacturers and retailers. The electronics segment produces integrated circuits and related products for sale to computer manufacturers. The finance segment is responsible for portions of the company's financial operations including financing customer purchases of products from other segments and property lending operations.

Measurement of operating segment profit or loss, assets and liabilities (paragraph 27)

The accounting policies of the operating segments are the same as those described in the summary of significant accounting policies except that pension expense for each operating segment is recognised and measured on the basis of cash payments to the pension plan. Diversified Company evaluates performance on the basis of profit or loss from operations before tax expense not including non-recurring gains and losses and foreign exchange gains and losses.

Diversified Company accounts for intersegment sales and transfers as if the sales or transfers were to third parties, ie at current market prices.

Factors that management used to identify the entity's reportable segments (paragraph 22(a))

Diversified Company's reportable segments are strategic business units that offer different products and services. They are managed separately because each business requires different technology and marketing strategies. Most of the businesses were acquired as individual units, and the management at the time of the acquisition was retained.

Information about reportable segment profit or loss, assets and liabilities

IG3 The following table illustrates a suggested format for disclosing information about reportable segment profit or loss, assets and liabilities (paragraphs 23 and 24). The same type of information is required for each year for which an income statement is presented. Diversified Company does not allocate tax expense (tax income) or non-recurring gains and losses to reportable segments. In addition, not all reportable segments have material non-cash items other than depreciation and amortisation in profit or loss. The amounts in this illustration, denominated as "currency units (CU)", are assumed to be the amounts in reports used by the chief operating decision maker.

	Car parts	Motor vessels	Software	Electronics	Finance	All other	Totals
	CU	CU	CU	CU	CU	CU	CU
Revenues from external customers	3,000	5,000	9,500	12,000	5,000	1,000[(a)]	35,500
Intersegment revenues	-	-	3,000	1,500	-	-	4,500
Interest revenue	450	800	1,000	1,500	-	-	3,750
Interest expense	350	600	700	1,100	-	-	2,750
Net interest revenue [(b)]	-	-	-	-	1,000	-	1,000
Depreciation and amortisation	200	100	50	1,500	1,100	-	2,950
Reportable segment profit	200	70	900	2,300	500	100	4,070
Other material non-cash items:							
Impairment of assets	-	200	-	-	-	-	200
Reportable segment assets	2,000	5,000	3,000	12,000	57,000	2,000	81,000
Expenditures for reportable segment non-current assets	300	700	500	800	600	-	2,900
Reportable segment liabilities	1,050	3,000	1,800	8,000	30,000	-	43,850

(a) Revenues from segments below the quantitative thresholds are attributable to four operating segments of Diversified Company. Those segments include a small property business, an electronics equipment rental business, a software consulting practice and a warehouse leasing operation. None of those segments has ever met any of the quantitative thresholds for determining reportable segments.

(b) The finance segment derives a majority of its revenue from interest. Management primarily relies on net interest revenue, not the gross revenue and expense amounts, in managing that segment. Therefore, as permitted by paragraph 23, only the net amount is disclosed.

Reconciliations of reportable segment revenues, profit or loss, assets and liabilities

IG4 The following illustrate reconciliations of reportable segment revenues, profit or loss, assets and liabilities to the entity's corresponding amounts (paragraph 28(a)-(d)). Reconciliations also are required to be shown for every other material item of information disclosed (paragraph 28(e)). The entity's financial statements are assumed not to include discontinued operations. As discussed in paragraph IG2, the entity recognises and measures pension expense of its reportable segments on the basis of cash payments to the pension plan, and it does not allocate certain items to its reportable segments.

Revenues	CU
Total revenues for reportable segments	39,000
Other revenues	1,000
Elimination of intersegment revenues	(4,500)
Entity's revenues	35,500

Profit or loss	CU
Total profit or loss for reportable segments	3,970
Other profit or loss	100
Elimination of intersegment profits	(500)
Unallocated amounts:	
Litigation settlement received	500
Other corporate expenses	(750)
Adjustment to pension expense in consolidation	(250)
Income before income tax expense	3,070

Assets	CU
Total assets for reportable segments	79,000
Other assets	2,000
Elimination of receivable from corporate headquarters	(1,000)
Other unallocated amounts	1,500
Entity's assets	81,500

Liabilities	CU
Total liabilities for reportable segments	43,850
Unallocated defined benefit pension liabilities	25,000
Entity's liabilities	68,850

Other material items	Reportable segment totals CU	Adjustments CU	Entity totals CU
Interest revenue	3,750	75	3,825
Interest expense	2,750	(50)	2,700
Net interest revenue (finance segment only)	1,000	-	1,000
Expenditures for assets	2,900	1,000	3,900
Depreciation and amortisation	2,950	-	2,950
Impairment of assets	200	-	200

The reconciling item to adjust expenditures for assets is the amount incurred for the corporate headquarters building, which is not included in segment information. None of the other adjustments are material.

Geographical information

IG5 The following illustrates the geographical information required by paragraph 33. (Because Diversified Company's reportable segments are based on differences in products and services, no additional disclosures of revenue information about products and services are required (paragraph 32).)

Geographical information	**Revenues**[(a)]	**Non-current assets**
	CU	CU
United States	19,000	11,000
Canada	4,200	-
China	3,400	6,500
Japan	2,900	3,500
Other countries	6,000	3,000
Total	35,500	24,000

(a) Revenues are attributed to countries on the basis of the customer's location.

Information about major customers

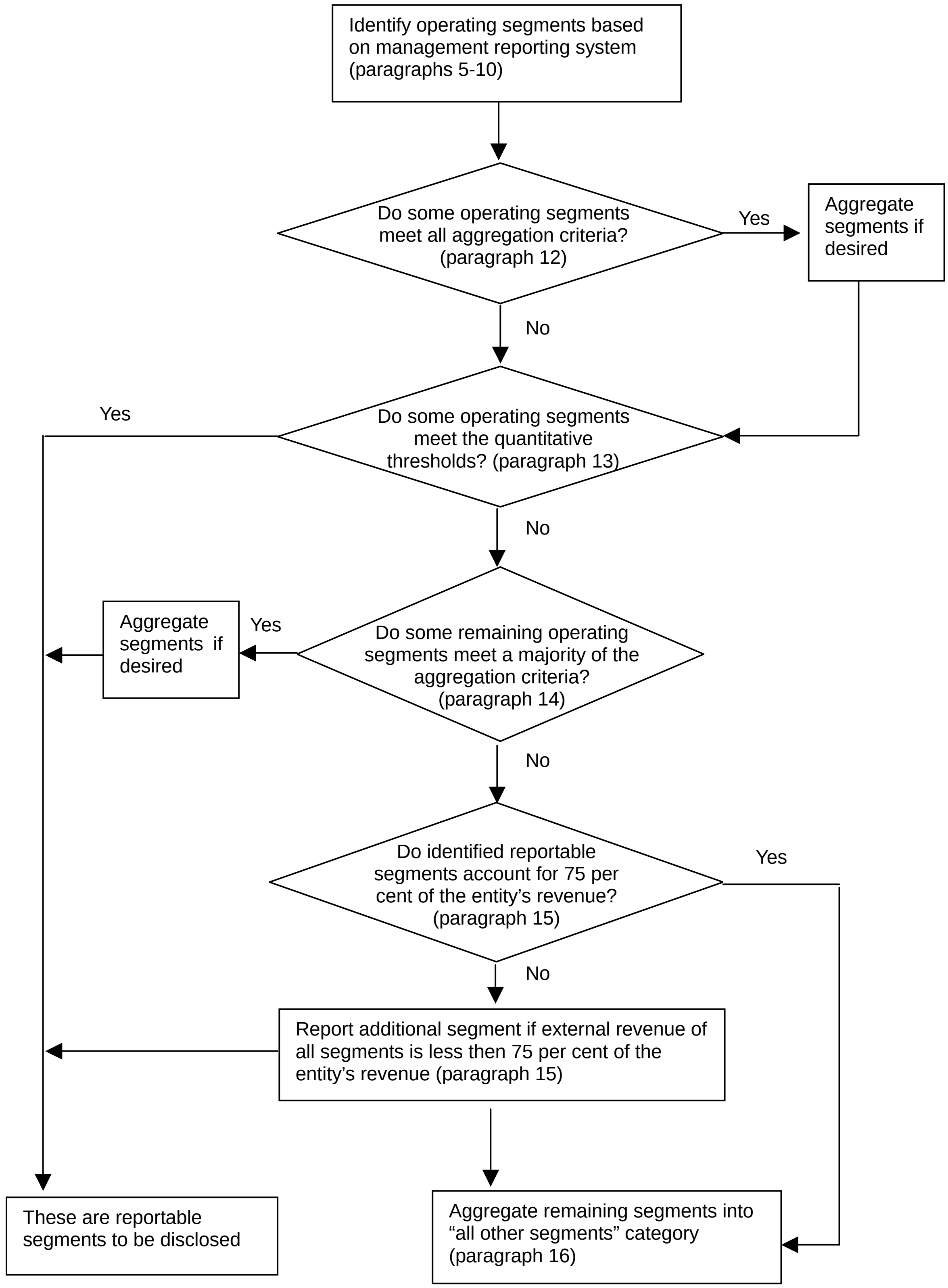
IG6 The following illustrates the information about major customers required by paragraph 34. Neither the identity of the customer nor the amount of revenues for each operating segment is required.

Revenues from one customer of Diversified Company's software and electronics segments represent approximately CU5,000 of the Company's total revenues.

Diagram to assist in identifying reportable segments

IG7 The following diagram illustrates how to apply the main provisions for identifying reportable segments as defined in the HKFRS. The diagram is a visual supplement to the HKFRS. It should not be interpreted as altering or adding to any requirements of the HKFRS nor should it be regarded as a substitute for the requirements.

Diagram for identifying reportable segments



Appendix
Amendments to other Implementation Guidance

This appendix contains amendments to guidance on other HKFRSs that are necessary in order to ensure consistency with HKFRS 8. In the amended paragraphs, new text is underlined and deleted text is struck through.

IGA1 In the Guidance on Implementing HKFRS 4 *Insurance Contracts*, paragraph IG43 is amended as follows:

IG43 Under ~~HKAS 14 *Segment Reporting*~~ HKFRS 8 *Operating Segments*, the identification of reportable segments reflects ~~differences in the risks and returns of an entity's products and services~~ the way in which management allocates resources and assesses performance. ~~HKAS 14 takes the position that the segments identified in an organisational and management structure and internal financial reporting system normally provide an appropriate segmentation for financial reporting.~~ An insurer might adopt a similar approach to identify broad classes of insurance contracts for disclosure purposes, although it might be appropriate to disaggregate disclosures down to the next level. For example, if an insurer identifies life insurance as a reportable segment for ~~HKAS 14~~ HKFRS 8, it might be appropriate to report separate information about, say, life insurance, annuities in the accumulation phase and annuities in the payout phase.

IGA2 In the Illustrative Examples accompanying HKAS 36 *Impairment of Assets*, paragraph IE80 is amended as follows:

IE80 Entity M is a multinational manufacturing firm that uses geographical segments ~~as its primary format~~ for reporting segment information. M's three reportable segments ~~based on that format~~ are Europe, North America and Asia. Goodwill has been allocated for impairment testing purposes to three individual cash–generating units–two in Europe (units A and B) and one in North America (unit C)–and to one group of cash-generating units (comprising operation XYZ) in Asia. Units A, B and C and operation XYZ each represent the lowest level within M at which the goodwill is monitored for internal management purposes.

HK(IFRIC)-Int 12
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Effective for annual periods
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HK(IFRIC) Interpretation 12

Service Concession Arrangements

Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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Hong Kong (IFRIC) Interpretation 12 *Service Concession Arrangements* (HK(IFRIC)-Int 12) is set out in paragraphs 1-30 and Appendices A and B. HK(IFRIC)-Int 12 is accompanied by Information Notes, Illustrative Examples and a Basis for Conclusions. The scope and authority of Interpretations are set out in the *Preface to Hong Kong Financial Reporting Standards*.

Hong Kong (IFRIC) Interpretation 12
Service Concession Arrangements

References

- *Framework for the Preparation and Presentation of Financial Statements*
- HKFRS 1 *First-time Adoption of International Financial Reporting Standards*
- HKFRS 7 *Financial Instruments: Disclosures*
- HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*
- HKAS 11 *Construction Contracts*
- HKAS 16 *Property, Plant and Equipment*
- HKAS 17 *Leases*
- HKAS 18 *Revenue*
- HKAS 20 *Government Grants*
- HKAS 23 *Borrowing Costs*
- HKAS 32 *Financial Instruments: Presentation*
- HKAS 36 *Impairment of Assets*
- HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*
- HKAS 38 *Intangible Assets*
- HKAS 39 *Financial Instruments: Recognition and Measurement*
- HK(IFRIC)-Int 4 *Determining whether an Arrangement contains a Lease*
- HK(SIC)-Int 29 *Disclosure–Service Concession Arrangements*

Background

1 In many countries, infrastructure for public services–such as roads, bridges, tunnels, prisons, hospitals, airports, water distribution facilities, energy supply and telecommunication networks–has traditionally been constructed, operated and maintained by the public sector and financed through public budget appropriation.

2 In some countries, governments have introduced contractual service arrangements to attract private sector participation in the development, financing, operation and maintenance of such infrastructure. The infrastructure may already exist, or may be constructed during the period of the service arrangement. An arrangement within the scope of this Interpretation typically involves a private sector entity (an operator) constructing the infrastructure used to provide the public service or upgrading it (for example, by increasing its capacity) and operating and maintaining that infrastructure for a specified period of time. The operator is paid for its services over the period of the arrangement. The arrangement is governed by a contract that sets out performance standards, mechanisms for adjusting prices, and arrangements for arbitrating disputes. Such an arrangement is often described as a “build-operate-transfer”, a “rehabilitate-operate-transfer” or a “public-to-private” service concession arrangement.

3 A feature of these service arrangements is the public service nature of the obligation undertaken by the operator. Public policy is for the services related to the infrastructure to be provided to the public, irrespective of the identity of the party that operates the services. The service arrangement contractually obliges the operator to provide the services to the public on behalf of the public sector entity. Other common features are:

(a) the party that grants the service arrangement (the grantor) is a public sector entity, including a governmental body, or a private sector entity to which the responsibility for the service has been devolved.

(b) the operator is responsible for at least some of the management of the infrastructure and related services and does not merely act as an agent on behalf of the grantor.

(c) the contract sets the initial prices to be levied by the operator and regulates price revisions over the period of the service arrangement.

(d) the operator is obliged to hand over the infrastructure to the grantor in a specified condition at the end of the period of the arrangement, for little or no incremental consideration, irrespective of which party initially financed it.

Scope

4 This Interpretation gives guidance on the accounting by operators for public-to-private service concession arrangements.

5 This Interpretation applies to public-to-private service concession arrangements if:

(a) the grantor controls or regulates what services the operator must provide with the infrastructure, to whom it must provide them, and at what price; and

(b) the grantor controls–through ownership, beneficial entitlement or otherwise–any significant residual interest in the infrastructure at the end of the term of the arrangement.

6 Infrastructure used in a public-to-private service concession arrangement for its entire useful life (whole of life assets) is within the scope of this Interpretation if the conditions in paragraph 5(a) are met. Paragraphs AG1–AG8 provide guidance on determining whether, and to what extent, public-to-private service concession arrangements are within the scope of this Interpretation.

7 This Interpretation applies to both:

(a) infrastructure that the operator constructs or acquires from a third party for the purpose of the service arrangement; and

(b) existing infrastructure to which the grantor gives the operator access for the purpose of the service arrangement.

8 This Interpretation does not specify the accounting for infrastructure that was held and recognised as property, plant and equipment by the operator before entering the service arrangement. The derecognition requirements of HKFRSs (set out in HKAS 16) apply to such infrastructure.

9 This Interpretation does not specify the accounting by grantors.

Issues

10 This Interpretation sets out general principles on recognising and measuring the obligations and related rights in service concession arrangements. Requirements for disclosing information about service concession arrangements are in HK(SIC)-Int 29 *Service Concession Arrangements: Disclosures*. The issues addressed in this Interpretation are:

(a) treatment of the operator's rights over the infrastructure;

(b) recognition and measurement of arrangement consideration;

(c) construction or upgrade services;

(d) operation services;

(e) borrowing costs;

(f) subsequent accounting treatment of a financial asset and an intangible asset; and

(g) items provided to the operator by the grantor.

Conclusions

Treatment of the operator's rights over the infrastructure

11 Infrastructure within the scope of this Interpretation shall not be recognised as property, plant and equipment of the operator because the contractual service arrangement does not convey the right to control the use of the public service infrastructure to the operator. The operator has access to operate the infrastructure to provide the public service on behalf of the grantor in accordance with the terms specified in the contract.

Recognition and measurement of arrangement consideration

12 Under the terms of contractual arrangements within the scope of this Interpretation, the operator acts as a service provider. The operator constructs or upgrades infrastructure (construction or upgrade services) used to provide a public service and operates and maintains that infrastructure (operation services) for a specified period of time.

13 The operator shall recognise and measure revenue in accordance with HKASs 11 and 18 for the services it performs. If the operator performs more than one service (ie construction or upgrade services and operation services) under a single contract or arrangement, consideration received or receivable shall be allocated by reference to the relative fair values of the services delivered, when the amounts are separately identifiable.

The nature of the consideration determines its subsequent accounting treatment. The subsequent accounting for consideration received as a financial asset and as an intangible asset is detailed in paragraphs 23-26 below.

Construction or upgrade services

14 The operator shall account for revenue and costs relating to construction or upgrade services in accordance with HKAS 11.

Consideration given by the grantor to the operator

15 If the operator provides construction or upgrade services the consideration received or receivable by the operator shall be recognised at its fair value. The consideration may be rights to:

(a) a financial asset, or

(b) an intangible asset.

16 The operator shall recognise a financial asset to the extent that it has an unconditional contractual right to receive cash or another financial asset from or at the direction of the grantor for the construction services; the grantor has little, if any, discretion to avoid payment, usually because the agreement is enforceable by law. The operator has an unconditional right to receive cash if the grantor contractually guarantees to pay the operator (a) specified or determinable amounts or (b) the shortfall, if any, between amounts received from users of the public service and specified or determinable amounts, even if payment is contingent on the operator ensuring that the infrastructure meets specified quality or efficiency requirements.

17 The operator shall recognise an intangible asset to the extent that it receives a right (a licence) to charge users of the public service. A right to charge users of the public service is not an unconditional right to receive cash because the amounts are contingent on the extent that the public uses the service.

18 If the operator is paid for the construction services partly by a financial asset and partly by an intangible asset it is necessary to account separately for each component of the operator's consideration. The consideration received or receivable for both components shall be recognised initially at the fair value of the consideration received or receivable.

19 The nature of the consideration given by the grantor to the operator shall be determined by reference to the contract terms and, when it exists, relevant contract law.

Operation services

20 The operator shall account for revenue and costs relating to operation services in accordance with HKAS 18.

Contractual obligations to restore the infrastructure to a specified level of serviceability

21 The operator may have contractual obligations it must fulfil as a condition of its licence (a) to maintain the infrastructure to a specified level of serviceability or (b) to restore the infrastructure to a specified condition before it is handed over to the grantor at the end of the service arrangement. These contractual obligations to maintain or restore infrastructure, except for any upgrade element (see paragraph 14), shall be recognised and measured in accordance with HKAS 37, ie at the best estimate of the expenditure that would be required to settle the present obligation at the balance sheet date.

Borrowing costs incurred by the operator

22 In accordance with HKAS 23, borrowing costs attributable to the arrangement shall be recognised as an expense in the period in which they are incurred unless the operator has a contractual right to receive an intangible asset (a right to charge users of the public service). In this case borrowing costs attributable to the arrangement may be capitalised during the construction phase of the arrangement in accordance with the allowed alternative treatment under that Standard.

Financial asset

23 HKASs 32 and 39 and HKFRS 7 apply to the financial asset recognised under paragraphs 16 and 18.

24 The amount due from or at the direction of the grantor is accounted for in accordance with HKAS 39 as:

(a) a loan or receivable;

(b) an available-for-sale financial asset; or

(c) if so designated upon initial recognition, a financial asset at fair value through profit or loss, if the conditions for that classification are met.

25 If the amount due from the grantor is accounted for either as a loan or receivable or as an available-for-sale financial asset, HKAS 39 requires interest calculated using the effective interest method to be recognised in profit or loss.

Intangible asset

26 HKAS 38 applies to the intangible asset recognised in accordance with paragraphs 17 and 18. Paragraphs 45-47 of HKAS 38 provide guidance on measuring intangible assets acquired in exchange for a non-monetary asset or assets or a combination of monetary and non-monetary assets.

Items provided to the operator by the grantor

27 In accordance with paragraph 11, infrastructure items to which the operator is given access by the grantor for the purposes of the service arrangement are not recognised as property, plant and equipment of the operator. The grantor may also provide other items to the operator that the operator can keep or deal with as it wishes. If such assets form part of the consideration payable by the grantor for the services, they are not government grants as defined in HKAS 20. They are recognised as assets of the operator, measured at fair value on initial recognition. The operator shall recognise a liability in respect of unfulfilled obligations it has assumed in exchange for the assets.

Effective date

28 An entity shall apply this Interpretation for annual periods beginning on or after 1 January 2008. Earlier application is permitted. If an entity applies this Interpretation for a period beginning before 1 January 2008, it shall disclose that fact.

Transition

29 Subject to paragraph 30, changes in accounting policies are accounted for in accordance with HKAS 8, ie retrospectively.

30 If, for any particular service arrangement, it is impracticable for an operator to apply this Interpretation retrospectively at the start of the earliest period presented, it shall:

(a) recognise financial assets and intangible assets that existed at the start of the earliest period presented;

(b) use the previous carrying amounts of those financial and intangible assets (however previously classified) as their carrying amounts as at that date; and

(c) test financial and intangible assets recognised at that date for impairment, unless this is not practicable, in which case the amounts shall be tested for impairment as at the start of the current period.

Appendix A
Application Guidance

This appendix is an integral part of the Interpretation.

Scope (paragraph 5)

AG1 Paragraph 5 of this Interpretation specifies that infrastructure is within the scope of the Interpretation when the following conditions apply:

(a) the grantor controls or regulates what services the operator must provide with the infrastructure, to whom it must provide them, and at what price; and

(b) the grantor controls–through ownership, beneficial entitlement or otherwise–any significant residual interest in the infrastructure at the end of the term of the arrangement.

AG2 The control or regulation referred to in condition (a) could be by contract or otherwise (such as through a regulator), and includes circumstances in which the grantor buys all of the output as well as those in which some or all of the output is bought by other users. In applying this condition, the grantor and any related parties shall be considered together. If the grantor is a public sector entity, the public sector as a whole, together with any regulators acting in the public interest, shall be regarded as related to the grantor for the purposes of this Interpretation.

AG3 For the purpose of condition (a), the grantor does not need to have complete control of the price: it is sufficient for the price to be regulated by the grantor, contract or regulator, for example by a capping mechanism. However, the condition shall be applied to the substance of the agreement. Non-substantive features, such as a cap that will apply only in remote circumstances, shall be ignored. Conversely, if for example, a contract purports to give the operator freedom to set prices, but any excess profit is returned to the grantor, the operator's return is capped and the price element of the control test is met.

AG4 For the purpose of condition (b), the grantor's control over any significant residual interest should both restrict the operator's practical ability to sell or pledge the infrastructure and give the grantor a continuing right of use throughout the period of the arrangement. The residual interest in the infrastructure is the estimated current value of the infrastructure as if it were already of the age and in the condition expected at the end of the period of the arrangement.

AG5 Control should be distinguished from management. If the grantor retains both the degree of control described in paragraph 5(a) and any significant residual interest in the infrastructure, the operator is only managing the infrastructure on the grantor's behalf–even though, in many cases, it may have wide managerial discretion.

AG6 Conditions (a) and (b) together identify when the infrastructure, including any replacements required (see paragraph 21), is controlled by the grantor for the whole of its economic life. For example, if the operator has to replace part of an item of infrastructure during the period of the arrangement (eg the top layer of a road or the roof of a building), the item of infrastructure shall be considered as a whole. Thus condition (b) is met for the whole of the infrastructure, including the part that is replaced, if the grantor controls any significant residual interest in the final replacement of that part.

AG7 Sometimes the use of infrastructure is partly regulated in the manner described in paragraph 5(a) and partly unregulated. However, these arrangements take a variety of forms:

(a) any infrastructure that is physically separable and capable of being operated independently and meets the definition of a cash-generating unit as defined in HKAS 36 shall be analysed separately if it is used wholly for unregulated purposes. For example, this might apply to a private wing of a hospital, where the remainder of the hospital is used by the grantor to treat public patients.

(b) when purely ancillary activities (such as a hospital shop) are unregulated, the control tests shall be applied as if those services did not exist, because in cases in which the grantor controls the services in the manner described in paragraph 5, the existence of ancillary activities does not detract from the grantor's control of the infrastructure.

AG8 The operator may have a right to use the separable infrastructure described in paragraph AG7(a), or the facilities used to provide ancillary unregulated services described in paragraph AG7(b). In either case, there may in substance be a lease from the grantor to the operator; if so, it shall be accounted for in accordance with HKAS 17.

Appendix B
Amendments to HKFRS 1 and to other Interpretations

The amendments in this appendix shall be applied for annual periods beginning on or after 1 January 2008. If an entity applies this Interpretation for an earlier period, these amendments shall be applied for that earlier period.

B1 HKFRS 1 *First-time Adoption of Hong Kong Financial Reporting Standards* is amended as described below. New text is underlined and deleted text struck through.

Paragraph 9 is amended as follows:

9 The transitional provisions in other HKFRSs apply to changes in accounting policies made by an entity that already uses HKFRSs; they do not apply to a *first-time adopter's* transition to HKFRSs, except as specified in paragraphs 25D, <u>25H</u>, 34A and 34B.

In paragraph 12(a), the reference to paragraphs 13-25G is changed to 13-25H.

In paragraph 13, subparagraphs (k) and (l) are amended, and subparagraph (m) is inserted, as follows:

(k) leases (paragraph 25F); ~~and~~

(l) fair value measurement of financial assets or financial liabilities at initial recognition (paragraph 25G~~).~~<u>; and</u>

<u>(m)</u> <u>a financial asset or an intangible asset accounted for in accordance with HK(IFRIC)-Int 12 *Service Concession Arrangements* (paragraph 25H).</u>

After paragraph 25G, a new heading and paragraph 25H are inserted as follows:

Service concession arrangements

25H A first-time adopter may apply the transitional provisions in HK(IFRIC)-Int 12 *Service Concession Arrangements*.

B2 HK(IFRIC)-Int 4 *Determining whether an Arrangement Contains a Lease* is amended as described below.

Paragraph 4 is amended as follows (new text is underlined):

4 This Interpretation does not apply to arrangements that:

<u>(a)</u> are, or contain, leases excluded from the scope of HKAS 17<u>; or</u>

<u>(b)</u> <u>are public-to-private service concession arrangements within the scope of HK(IFRIC)-Int 12 *Service Concession Arrangements*.</u>

In the Basis for Conclusions, after paragraph BC14 a new paragraph BC14A is inserted as follows:

BC14A The IFRIC considered whether the scope of the Interpretation might overlap with IFRIC 12, which was developed from draft Interpretations D12-D14. In particular it noted the views expressed by some respondents to the proposals that the contractual terms of some public-to-private service concession arrangements would be regarded as leases under IFRIC 4 and would also be regarded as meeting the scope criterion of D12-D14. The IFRIC did not regard the choice between accounting treatments as appropriate because it could lead to different accounting treatments for contracts that have similar economic effects. The IFRIC therefore amended IFRIC 4 to specify that if a public-to-private service concession arrangement met the scope requirements of IFRIC 12 it would not be within the scope of IFRIC 4.

B3 HK(SIC)-Int 29 *Disclosure–Service Concession Arrangements* is amended as described below (in amended paragraphs new text is underlined).

Its title is amended to *Service Concession Arrangements: Disclosures*.

In paragraphs 1-6 references to “Concession Operator” are changed to “operator”, and references to “Concession Provider” are changed to “grantor”.

In paragraph 6, subparagraph (d) is amended, and subparagraph (e) is inserted, as follows:

(d) changes in the arrangement occurring during the period~~.~~; and

(e) how the service arrangement has been classified.

After paragraph 6 a new paragraph 6A is inserted, as follows:

6A An operator shall disclose the amount of revenue and profits or losses recognised in the period on exchanging construction services for a financial asset or an intangible asset.

In the HK(SIC)’s Basis for Conclusions, a rubric is added above paragraph 8 as follows:

[The original text has been marked up to reflect the issue of HK(IFRIC)-Int 12 in 2007;]

and the last sentence of paragraph 9 is changed as follows:

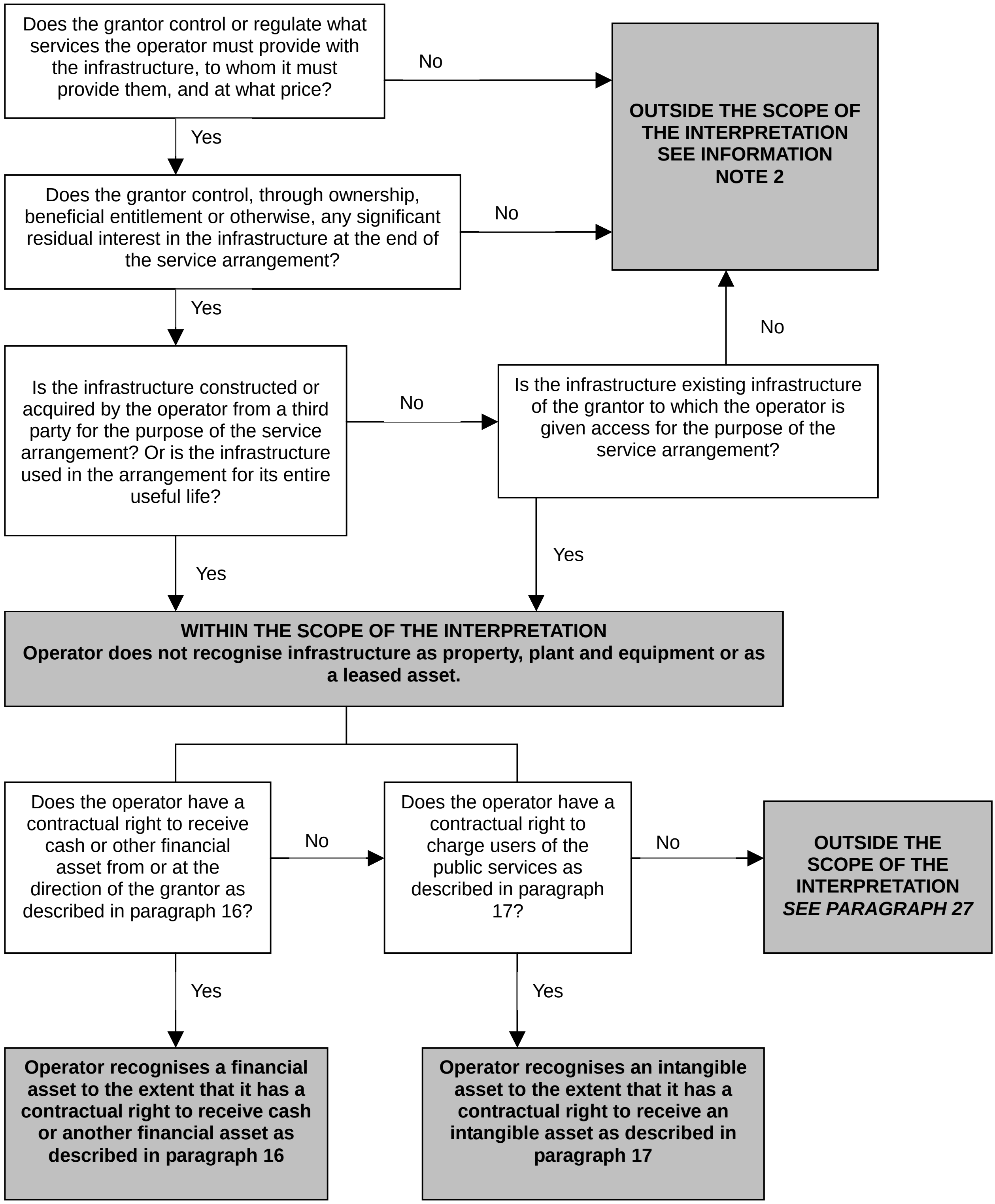
⋯ delivering that asset to the ~~Concession Provider~~ grantor at the end of the concession period.

Information note 1

Accounting framework for public-to-private service arrangements

This note accompanies, but is not part of, HK(IFRIC)-Int 12.

The diagram below summarises the accounting for service arrangements established by HK(IFRIC)-Int 12.



Information note 2

References to HKFRSs that apply to typical types of public-to-private arrangements

This note accompanies, but is not part of, HK(IFRIC)-Int 12.

The table sets out the typical types of arrangements for private sector participation in the provision of public sector services and provides references to HKFRSs that apply to those arrangements. The list of arrangements types is not exhaustive. The purpose of the table is to highlight the continuum of arrangements. It is not the Institute's intention to convey the impression that bright lines exist between the accounting requirements for public-to-private arrangements.

Category	**Lessee**	**Service provider**			**Owner**	
Typical arrangement types	Lease (eg Operator leases asset from grantor)	Service and/or maintenance contract (specific tasks eg debt collection)	Rehabilitate-operate-transfer	Build-Operate-transfer	Build-Own-operate	100% Divestment/ Privatisation/ Corporation
Asset ownership	Grantor				Operator	
Capital investment	Grantor		Operator			
Demand risk	Shared	Grantor	Operator and/or Grantor		Operator	
Typical duration	8–20 years	1–5 years	25-30 years			Indefinite (or may be limited by licence)
Residual interest	Grantor				Operator	
Relevant HKFRSs	HKAS 17	HKAS 18	HK(IFRIC)-Int 12		HKAS 16	

Illustrative Examples

These examples accompany, but are not part of, HK(IFRIC)-Int 12.

Example 1: The grantor gives the operator a financial asset

Arrangement terms

IE1 The terms of the arrangement require an operator to construct a road–completing construction within two years–and maintain and operate the road to a specified standard for eight years (ie years 3-10). The terms of the arrangement also require the operator to resurface the road at the end of year 8–the resurfacing activity is revenue-generating. At the end of year 10, the arrangement will end. The operator estimates that the costs it will incur to fulfil its obligations will be:

Table 1.1 ***Contract costs***

	Year	CU*
Construction services	1	500
	2	500
Operation services (per year)	3-10	10
Road resurfacing	8	100

* in this example, monetary amounts are denominated in “currency units” (CU).

IE2 The terms of the arrangement require the grantor to pay the operator 200 currency units (CU200) per year in years 3-10 for making the road available to the public.

IE3 For the purpose of this illustration, it is assumed that all cash flows take place at the end of the year.

Contract revenue

IE4 The operator recognises contract revenue and costs in accordance with HKAS 11 *Construction Contracts* and HKAS 18 *Revenue*. The costs of each activity–construction, operation and resurfacing–are recognised as expenses by reference to the stage of completion of that activity. Contract revenue–the fair value of the amount due from the grantor for the activity undertaken–is recognised at the same time. Under the terms of the arrangement the operator is obliged to resurface the road at the end of year 8. In year 8 the operator will be reimbursed by the grantor for resurfacing the road. The obligation to resurface the road is measured at zero in the balance sheet and the revenue and expense are not recognised in the income statement until the resurfacing work is performed.

IE5 The total consideration (CU200 in each of years 3 – 8) reflects the fair values for each of the services, which are:

Table 1.2 ***Fair values of the consideration received or receivable***

	Fair value		
Construction services	Forecast cost	+	5%
Operation services	“ “	+	20%
Road resurfacing	“ “	+	10%
Effective interest rate	6.18% per year		

IE6 In year 1, for example, construction costs of CU500, construction revenue of CU525 (cost plus 5 per cent), and hence construction profit of CU25 are recognised in the income statement.

Financial asset

IE7 The amounts due from the grantor meet the definition of a receivable in HKAS 39 *Financial Instruments: Recognition and Measurement*. The receivable is measured initially at fair value. It is subsequently measured at amortised cost, ie the amount initially recognised plus the cumulative interest on that amount calculated using the effective interest method minus repayments.

IE8 If the cash flows and fair values remain the same as those forecast, the effective interest rate is 6.18 per cent per year and the receivable recognised at the end of years 1-3 will be:

Table 1.3 ***Measurement of receivable***

	CU
Amount due for construction in year 1	525
Receivable at end of year 1*	**525**
Effective interest in year 2 on receivable at the end of year 1 (6.18% x CU525)	32
Amount due for construction in year 2	525
Receivable at end of year 2	**1,082**
Effective interest in year 3 on receivable at the end of year 2 (6.18% x CU1,082)	67
Amount due for operation in year 3 (CU10 x (1+20%))	12
Cash receipts in year 3	(200)
Receivable at end of year 3	**961**

* No effective interest arises in year 1 because the cash flows are assumed to take place at the end of the year.

Overview of cash flows, income statement and balance sheet

IE9 For the purpose of this illustration, it is assumed that the operator finances the arrangement wholly with debt and retained profits. It pays interest at 6.7 per cent per year on outstanding debt. If the cash flows and fair values remain the same as those forecast, the operator's cash flows, income statement and balance sheet over the duration of the arrangement will be:

Table 1.4 ***Cash flows*** *(currency units)*

Year	1	2	3	4	5	6	7	8	9	10	Total
Receipts	-	-	200	200	200	200	200	200	200	200	1,600
Contract costs*	(500)	(500)	(10)	(10)	(10)	(10)	(10)	(110)	(10)	(10)	(1,180)
Borrowing costs†	-	(34)	(69)	(61)	(53)	(43)	(33)	(23)	(19)	(7)	(342)
Net inflow/ (outflow)	(500)	(534)	121	129	137	147	157	67	171	183	78

* Table 1.1

† Debt at start of year (table 1.6) x 6.7%

Table 1.5 ***Income statement*** *(currency units)*

Year	1	2	3	4	5	6	7	8	9	10	Total
Revenue	525	525	12	12	12	12	12	122	12	12	1,256
Contract costs	(500)	(500)	(10)	(10)	(10)	(10)	(10)	(110)	(10)	(10)	(1,180)
Finance income*	-	32	67	59	51	43	34	25	22	11	344
Borrowing costs†	-	(34)	(69)	(61)	(53)	(43)	(33)	(23)	(19)	(7)	(342)
Net profit	25	23	-	-	-	2	3	14	5	6	78

* Amount due from grantor at start of year (table 1.6) x 6.18%

† Cash/(debt) (table 1.6) x 6.7%

Table 1.6 ***Balance sheet*** *(currency units)*

End of Year	1	2	3	4	5	6	7	8	9	10
Amount due from grantor*	525	1,082	961	832	695	550	396	343	177	-
Cash/(debt)†	(500)	(1,034)	(913)	(784)	(647)	(500)	(343)	(276)	(105)	78
Net assets	25	48	48	48	48	50	53	67	72	78

* Amount due from grantor at start of year, plus revenue and finance income earned in year (table 1.5), less receipts in year (table 1.4).

† Debt at start of year plus net cash flow in year (table 1.4).

IE10 This example deals with only one of many possible types of arrangements. Its purpose is to illustrate the accounting treatment for some features that are commonly found in practice. To make the illustration as clear as possible, it has been assumed that the arrangement period is only ten years and that the operator's annual receipts are constant over that period. In practice, arrangement periods may be much longer and annual revenues may increase with time. In such circumstances, the changes in net profit from year to year could be greater.

Example 2: The grantor gives the operator an intangible asset (a licence to charge users)

Arrangement terms

IE11 The terms of a service arrangement require an operator to construct a road–completing construction within two years–and maintain and operate the road to a specified standard for eight years (ie years 3-10). The terms of the arrangement also require the operator to resurface the road when the original surface has deteriorated below a specified condition. The operator estimates that it will have to undertake the resurfacing at the end of year 8. At the end of year 10, the service arrangement will end. The operator estimates that the costs it will incur to fulfil its obligations will be:

Table 2.1 ***Contract costs***

	Year	CU*
Construction services	1	500
	2	500
Operation services (per year)	3-10	10
Road resurfacing	8	100

* in this example, monetary amounts are denominated in "currency units" (CU).

IE12 The terms of the arrangement allow the operator to collect tolls from drivers using the road. The operator forecasts that vehicle numbers will remain constant over the duration of the contract and that it will receive tolls of 200 currency units (CU200) in each of years 3-10.

IE13 For the purpose of this illustration, it is assumed that all cash flows take place at the end of the year.

Intangible asset

IE14 The operator provides construction services to the grantor in exchange for an intangible asset, ie a right to collect tolls from road users in years 3-10. In accordance with HKAS 38 *Intangible Assets*, the operator recognises the intangible asset at cost, ie the fair value of consideration transferred to acquire the asset, which is the fair value of the consideration received or receivable for the construction services delivered.

IE15 During the construction phase of the arrangement the operator's asset (representing its accumulating right to be paid for providing construction services) is classified as an intangible asset (licence to charge users of the infrastructure). The operator estimates the fair value of its consideration received to be equal to the forecast construction costs plus 5 per cent margin. It is also assumed that the operator adopts the allowed alternative treatment in HKAS 23 *Borrowing Costs* and therefore capitalises the borrowing costs, estimated at 6.7 per cent, during the construction phase of the arrangement:

Table 2.2 ***Initial measurement of intangible asset***

	CU*
Construction services in year 1 (CU500 x (1 + 5%))	525
Capitalisation of borrowing costs (table 2.4)	34
Construction services in year 2 (CU500 x (1 + 5%))	525
Intangible asset at end of year 2	1,084

IE16 In accordance with HKAS 38, the intangible asset is amortised over the period in which it is expected to be available for use by the operator, ie years 3-10. The depreciable amount of the intangible asset (CU1,084) is allocated using a straight-line method. The annual amortisation charge is therefore CU1,084 divided by 8 years, ie CU135 per year.

Construction costs and revenue

IE17 The operator recognises the revenue and costs in accordance with HKAS 11 *Construction Contracts*, ie by reference to the stage of completion of the construction. It measures contract revenue at the fair value of the consideration received or receivable. Thus in each of years 1 and 2 it recognises in its income statement construction costs of CU500, construction revenue of CU525 (cost plus 5 per cent) and, hence, construction profit of CU25.

Toll revenue

IE18 The road users pay for the public services at the same time as they receive them, ie when they use the road. The operator therefore recognises toll revenue when it collects the tolls.

Resurfacing obligations

IE19 The operator's resurfacing obligation arises as a consequence of use of the road during the operating phase. It is recognised and measured in accordance with HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, ie at the best estimate of the expenditure required to settle the present obligation at the balance sheet date.

IE20 For the purpose of this illustration, it is assumed that the terms of the operator's contractual obligation are such that the best estimate of the expenditure required to settle the obligation at any date is proportional to the number of vehicles that have used the road by that date and increases by CU17 (discounted to a current value) each year. The operator discounts the provision to its present value in accordance with HKAS 37. The income statement charge each period is:

Table 2.3 *Resurfacing obligation* *(currency units)*

Year	3	4	5	6	7	8	Total
Obligation arising in year (CU17 discounted at 6%)	12	13	14	15	16	17	87
Increase in earlier years' provision arising from passage of time	0	1	1	2	4	5	13
Total expense recognised in income statement	12	14	15	17	20	22	100

Overview of cash flows, income statement and balance sheet

IE21 For the purposes of this illustration, it is assumed that the operator finances the arrangement wholly with debt and retained profits. It pays interest at 6.7 per cent per year on outstanding debt. If the cash flows and fair values remain the same as those forecast, the operator's cash flows, income statement and balance sheet over the duration of the arrangement will be:

Table 2.4 ***Cash flows*** *(currency units)*

Year	1	2	3	4	5	6	7	8	9	10	Total
Receipts	-	-	200	200	200	200	200	200	200	200	1,600
Contract costs*	(500)	(500)	(10)	(10)	(10)	(10)	(10)	(110)	(10)	(10)	(1,180)
Borrowing costs†	-	(34)	(69)	(61)	(53)	(43)	(33)	(23)	(19)	(7)	(342)
Net inflow/ (outflow)	(500)	(534)	121	129	137	147	157	67	171	183	78

* Table 2.1

† Debt at start of year (table 2.6) x 6.7%

Table 2.5 ***Income statement*** *(currency units)*

Year	1	2	3	4	5	6	7	8	9	10	Total
Revenue	525	525	200	200	200	200	200	200	200	200	2,650
Amortisation	-	-	(135)	(135)	(136)	(136)	(136)	(136)	(135)	(135)	(1,084)
Resurfacing expense	-	-	(12)	(14)	(15)	(17)	(20)	(22)	-	-	(100)
Other contract costs*	(500)	(500)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(1,080)
Borrowing costs†	-	-	(69)	(61)	(53)	(43)	(33)	(23)	(19)	(7)	(308)
Net profit	25	25	(26)	(20)	(14)	(6)	1	9	36	48	78

* Borrowing costs are captialised during the construction phase

† Table 2.4

Table 2.6 ***Balance sheet*** *(currency units)*

End of year	1	2	3	4	5	6	7	8	9	10
Intangible asset	525	1,084	949	814	678	542	406	270	135	-
Cash/(debt)*	(500)	(1,034)	(913)	(784)	(647)	(500)	(343)	(276)	(105)	78
Resurfacing obligation	-	-	(12)	(26)	(41)	(58)	(78)	-	-	-
Net assets	25	50	24	4	(10)	(16)	(15)	(6)	30	78

* Debt at start of year plus net cash flow in year (table 2.4).

IE22 This example deals with only one of many possible types of arrangements. Its purpose is to illustrate the accounting treatment for some features that are commonly found in practice. To make the illustration as clear as possible, it has been assumed that the arrangement period is only ten years and that the operator's annual receipts are constant over that period. In practice, arrangement periods may be much longer and annual revenues may increase with time. In such circumstances, the changes in net profit from year to year could be greater.

Example 3: The grantor gives the operator a financial asset and an intangible asset

Arrangement terms

IE23 The terms of a service arrangement require an operator to construct a road–completing construction within two years–and to operate the road and maintain it to a specified standard for eight years (ie years 3-10). The terms of the arrangement also require the operator to resurface the road when the original surface has deteriorated below a specified condition. The operator estimates that it will have to undertake the resurfacing at the end of year 8. At the end of year 10, the arrangement will end. The operator estimates that the costs it will incur to fulfil its obligations will be:

Table 3.1 *Contract costs*

	Year	CU*
Construction services	1	500
	2	500
Operation services (per year)	3-10	10
Road resurfacing	8	100

* in this example, monetary amounts are denominated in “currency units” (CU).

IE24 The operator estimates the consideration in respect of construction services to be cost plus 5 per cent.

IE25 The terms of the arrangement allow the operator to collect tolls from drivers using the road. In addition, the grantor guarantees the operator a minimum amount of CU700 and interest at a specified rate of 6.18% to reflect the timing of cash receipts. The operator forecasts that vehicle numbers will remain constant over the duration of the contract and that it will receive tolls of CU200 in each of years 3-10.

IE26 For the purpose of this illustration, it is assumed that all cash flows take place at the end of the year.

Dividing the arrangement

IE27 The contractual right to receive cash from the grantor for the services and the right to charge users for the public services should be regarded as two separate assets under HKFRSs. Therefore in this arrangement it is necessary to divide the operator’s consideration into two components–a financial asset component based on the guaranteed amount and an intangible asset for the remainder.

Table 3.2 ***Dividing the operator's consideration***

Year	Total	Financial asset	Intangible asset
Construction services in year 1 (CU500 × (1 + 5%))	525	350	175
Construction services in year 2 (CU500 × (1 + 5%))	525	350	175
Total construction services	1,050	700	350
	100%	*67%**	*33%*
Finance income, at specified rate of 6.18% on receivable (see table 3.3)	22	22	-
Borrowing costs capitalised (interest paid in year 1 and 2 x 33%) see table 3.7	11	-	11
Total fair value of the operator's consideration	1,083	722	361

* Amount guaranteed by the grantor as a proportion of the construction services

Financial asset

IE28 The amount due from or at the direction of the grantor in exchange for the construction services meets the definition of a receivable in HKAS 39 *Financial Instruments: Recognition and Measurement*. The receivable is measured initially at fair value. It is subsequently measured at amortised cost, ie the amount initially recognised plus the cumulative interest on that amount minus repayments.

IE29 On this basis the receivable recognised at the end of years 2 and 3 will be:

Table 3.3 ***Measurement of receivable***

	CU
Construction services in year 1 allocated to the financial asset	350
Receivable at end of year 1	350
Construction services in year 2 allocated to the financial asset	350
Interest in year 2 on receivable at end of year 1 (6.18% x CU350)	22
Receivable at end of year 2	722
Interest in year 3 on receivable at end of year 2 (6.18% x CU722)	45
Cash receipts in year 3 (see table 3.5)	(117)
Receivable at end of year 3	650

Intangible asset

IE30 In accordance with HKAS 38 *Intangible Assets*, the operator recognises the intangible asset at cost, ie the fair value of the consideration received or receivable.

IE31 During the construction phase of the arrangement the operator's asset (representing its accumulating right to be paid for providing construction services) is classified as a right to receive a licence to charge users of the infrastructure. The operator estimates the fair value of its consideration received or receivable as equal to the forecast construction costs plus 5 per cent. It is also assumed that the operator adopts the allowed alternative treatment in HKAS 23 *Borrowing Costs* and therefore capitalises the borrowing costs, estimated at 6.7 per cent, during the construction phase:

Table 3.4 ***Initial measurement of intangible asset***

	CU
Construction services in year 1 (CU500 x (1 + 5%) x 33%)	175
Borrowing costs (interest paid in year 1 and 2 x 33%) see table 3.7	11
Construction services in year 2 (CU500 x (1 + 5%) x 33%)	175
Intangible asset at the end of year 2	361

IE32 In accordance with HKAS 38, the intangible asset is amortised over the period in which it is expected to be available for use by the operator, ie years 3-10. The depreciable amount of the intangible asset (CU361 including borrowing costs) is allocated using a straight-line method. The annual amortisation charge is therefore CU361 divided by 8 years, ie CU45 per year.

Contract revenue and costs

IE33 The operator provides construction services to the grantor in exchange for a financial asset and an intangible asset. Under both the financial asset model and intangible asset model, the operator recognises contract revenue and costs in accordance with HKAS 11 *Construction Contracts*, ie by reference to the stage of completion of the construction. It measures contract revenue at the fair value of the consideration receivable. Thus in each of years 1 and 2 it recognises in its income statement construction costs of CU500 and construction revenue of CU525 (cost plus 5 per cent).

Toll revenue

IE34 The road users pay for the public services at the same time as they receive them, ie when they use the road. Under the terms of this arrangement the cash flows are allocated to the financial asset and intangible asset in proportion, so the operator allocates the receipts from tolls between repayment of the financial asset and revenue earned from the intangible asset:

Table 3.5 ***Allocation of toll receipts***

Year	CU
Guaranteed receipt from grantor	700
Finance income (see table 3.8)	237
Total	937
Cash allocated to realisation of the financial asset per year (CU937 / 8 years)	**117**
Receipts attributable to intangible asset (CU200 x 8 years - CU937)	663
Annual receipt from intangible asset (CU663 / 8 years)	**83**

Resurfacing obligations

IE35 The operator's resurfacing obligation arises as a consequence of use of the road during the operation phase. It is recognised and measured in accordance with HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, ie at the best estimate of the expenditure required to settle the present obligation at the balance sheet date.

IE36 For the purpose of this illustration, it is assumed that the terms of the operator's contractual obligation are such that the best estimate of the expenditure required to settle the obligation at any date is proportional to the number of vehicles that have used the road by that date and increases by CU17 each year. The operator discounts the provision to its present value in accordance with HKAS 37. The income statement charge each period is:

Table 3.6 *Resurfacing obligation* *(currency units)*

Year	3	4	5	6	7	8	Total
Obligation arising in year (CU17 discounted at 6%)	12	13	14	15	16	17	87
Increase in earlier years' provision arising from passage of time	0	1	1	2	4	5	13
Total expense recognised in income statement	12	14	15	17	20	22	100

Overview of cash flows, income statement and balance sheet

IE37 For the purposes of this illustration, it is assumed that the operator finances the arrangement wholly with debt and retained profits. It pays interest at 6.7 per cent per year on outstanding debt. If the cash flows and fair values remain the same as those forecast, the operator's cash flows, income statement and balance sheet over the duration of the arrangement will be:

Table 3.7 *Cash flows* *(currency units)*

Year	1	2	3	4	5	6	7	8	9	10	Total
Receipts	-	-	200	200	200	200	200	200	200	200	1,600
Contract costs*	(500)	(500)	(10)	(10)	(10)	(10)	(10)	(110)	(10)	(10)	(1,180)
Borrowing costs†	-	(34)	(69)	(61)	(53)	(43)	(33)	(23)	(19)	(7)	(342)
Net inflow/ (outflow)	(500)	(534)	121	129	137	147	157	67	171	183	78

* Table 3.1
† Debt at start of year (table 3.9) x 6.7%

Table 3.8 *Income statement* *(currency units)*

Year	1	2	3	4	5	6	7	8	9	10	Total
Revenue on construction	525	525	-	-	-	-	-	-	-	-	1,050
Revenue from intangible asset	-	-	83	83	83	83	83	83	83	83	663
Finance income*	-	22	45	40	35	30	25	19	13	7	237
Amortisation	-	-	(45)	(45)	(45)	(45)	(45)	(45)	(45)	(46)	(361)
Resurfacing expense	-	-	(12)	(14)	(15)	(17)	(20)	(22)	-	-	(100)
Construction costs	(500)	(500)									(1,000)
Other contract costs†			(10)	(10)	(10)	(10)	(10)	(10)	(10)	(10)	(80)
Borrowing costs (table 3.7)‡	-	(23)	(69)	(61)	(53)	(43)	(33)	(23)	(19)	(7)	(331)
Net profit	25	24	(8)	(7)	(5)	(2)	0	2	22	27	78

* Interest on receivable
† Table 3.1
‡ In year 2, borrowing costs are stated net of amount capitalised in the intangible (see table 3.4)

Table 3.9 ***Balance sheet*** *(currency units)*

End of year	1	2	3	4	5	6	7	8	9	10
Receivable	350	722	650	573	491	404	312	214	110	-
Intangible asset	175	361	316	271	226	181	136	91	46	-
Cash/(debt)*	(500)	(1,034)	(913)	(784)	(647)	(500)	(343)	(276)	(105)	78
Resurfacing obligation	-	-	(12)	(26)	(41)	(58)	(78)	-	-	-
Net assets	25	49	41	34	29	27	27	29	51	78

* Debt at start of year plus net cash flow in year (table 3.7).

IE38 This example deals with only one of many possible types of arrangements. Its purpose is to illustrate the accounting treatment for some features that are commonly found in practice. To make the illustration as clear as possible, it has been assumed that the arrangement period is only ten years and that the operator's annual receipts are constant over that period. In practice, arrangement periods may be much longer and annual revenues may increase with time. In such circumstances, the changes in net profit from year to year could be greater.

Basis for Conclusions on HK(IFRIC)-Int 12

This Basis for Conclusions accompanies, but is not part of HK(IFRIC)-Int 12.

HK(IFRIC)-Int 12 is based on IFRIC Interpretation 12 *Service Concession Arrangements*. In approving HK(IFRIC)-Int 12, Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IFRIC's Basis for Conclusions on IFRIC Interpretation 12. Accordingly, there are no significant differences between HK(IFRIC)-Int 12 and IFRIC Interpretation 12. The IFRIC's Basis for Conclusions is reproduced below. The paragraph numbers of IFRIC Interpretation 12 referred to below generally correspond with those in HK(IFRIC)-Int 12.

Introduction

BC1 This Basis for Conclusions summarises the IFRIC's considerations in reaching its consensus. Individual IFRIC members gave greater weight to some factors than to others.

Background (paragraphs 1-3)

BC2 SIC-29 *Service Concession Arrangements: Disclosures* (formerly *Disclosure–Service Concession Arrangements*) contains disclosure requirements in respect of public-to-private service arrangements, but does not specify how they should be accounted for.

BC3 There was widespread concern about the lack of such guidance. In particular, operators wished to know how to account for infrastructure that they either constructed or acquired for the purpose of a public-to-private service concession arrangement, or were given access to for the purpose of providing the public service. They also wanted to know how to account for other rights and obligations arising from these types of arrangements.

BC4 In response to this concern, the International Accounting Standards Board asked a working group comprising representatives of the standard-setters of Australia, France, Spain and the United Kingdom (four of the countries that had expressed such concern) to carry out initial research on the subject. The working group recommended that the IFRIC should seek to clarify how certain aspects of existing accounting standards were to be applied.

BC5 In March 2005 the IFRIC published for public comment three draft Interpretations: D12 *Service Concession Arrangements–Determining the Accounting Model*, D13 *Service Concession Arrangements–The Financial Asset Model* and D14 *Service Concession Arrangements–The Intangible Asset Model*. In response to the proposals 77 comment letters were received. In addition, in order to understand better the practical issues that would have arisen on implementing the proposed Interpretations, IASB staff met various interested parties, including preparers, auditors and regulators.

BC6 Most respondents to D12-D14 supported the IFRIC's proposal to develop an Interpretation. However, nearly all respondents expressed concern with fundamental aspects of the proposals, some urging that the project be passed to the Board to develop a comprehensive standard.

BC7 In its redeliberation of the proposals the IFRIC acknowledged that the project was a large undertaking but concluded that it should continue its work because, given the limited scope of the project, it was by then better placed than the Board to deal with the issues in a timely way.

Terminology

BC8 SIC-29 used the terms "Concession Provider" and "Concession Operator" to describe, respectively, the grantor and operator of the service arrangement. Some commentators, and some members of the IFRIC, found these terms confusingly similar. The IFRIC decided to adopt the terms "grantor" and "operator", and amended SIC-29 accordingly.

Scope (paragraphs 4-9)

BC9 The IFRIC observed that public-to-private service arrangements take a variety of forms. The continued involvement of both grantor and operator over the term of the arrangement, accompanied by heavy upfront investment, raises questions over what assets and liabilities should be recognised by the operator.

BC10 The working group recommended that the scope of the IFRIC's project should be restricted to public-to-private service concession arrangements.

BC11 In developing the proposals the IFRIC decided to address only arrangements in which the grantor (a) controlled or regulated the services provided by the operator, and (b) controlled any significant residual interest in the infrastructure at the end of the term of the arrangement. It also decided to specify the accounting treatment only for infrastructure that the operator constructed or acquired from a third party, or to which it was given access by the grantor, for the purpose of the arrangement. The IFRIC concluded that these conditions were likely to be met in most of the public-to-private arrangements for which guidance had been sought.

BC12 Commentators on the draft Interpretations argued that the proposals ignored many arrangements that were found in practice, in particular, when the infrastructure was leased to the operator or, conversely, when it was held as the property, plant and equipment of the operator before the start of the service arrangement.

BC13 In considering these comments, the IFRIC decided that the scope of the project should not be expanded because it already included the arrangements most in need of interpretative guidance and expansion would have significantly delayed the Interpretation. The scope of the project was considered at length during the initial stage, as indicated above. The IFRIC confirmed its view that the proposed Interpretation should address the issues set out in paragraph 10. Nonetheless, during its redeliberation the IFRIC considered the range of typical arrangements for private sector participation in the provision of public services, including some that were outside the scope of the proposed Interpretation. The IFRIC decided that the Interpretation could provide references to relevant standards that apply to arrangements outside the scope of the Interpretation without giving guidance on their application. If experience showed that such guidance was needed, a separate project could be undertaken at a later date. Information Note 2 contains a table of references to relevant standards for the types of arrangements considered by the IFRIC.

Private-to-private arrangements

BC14 Some respondents to the draft Interpretations suggested that the scope of the proposed Interpretation should be extended to include private-to-private service arrangements. The IFRIC noted that addressing the accounting for such arrangements was not the primary purpose of the project because the IFRIC had been asked to provide guidance for public-to-private arrangements that meet the requirements set out in paragraph 5 and have the characteristics described in paragraph 3. The IFRIC noted that application by analogy would be appropriate under the hierarchy set out in paragraphs 7-12 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

Grantor accounting

BC15 The Interpretation does not specify the accounting by grantors, because the IFRIC's objective and priority were to establish guidance for operators. Some commentators asked the IFRIC to establish guidance for the accounting by grantors. The IFRIC discussed these comments but reaffirmed its view. It noted that in many cases the grantor is a government body, and that IFRSs are not designed to apply to not-for-profit activities in the private sector, public sector or government, though entities with such activities may find them appropriate (see *Preface to IFRSs* paragraph 9).

Existing assets of the operator

BC16 The Interpretation does not specify the treatment of existing assets of the operator because the IFRIC decided that it was unnecessary to address the derecognition requirements of existing standards.

BC17 Some respondents asked the IFRIC to provide guidance on the accounting for existing assets of the operator, stating that the scope exclusion would create uncertainty about the treatment of these assets.

BC18 In its redeliberations the IFRIC noted that one objective of the Interpretation is to address whether the operator should recognise as its property, plant and equipment the infrastructure it constructs or to which it is given access. The accounting issue to be addressed for existing assets of the operator is one of derecognition, which is already addressed in IFRSs (IAS 16 *Property, Plant and Equipment*). In the light of the comments received from respondents, the IFRIC decided to clarify that certain public-to-private service arrangements may convey to the grantor a right to use existing assets of the operator, in which case the operator would apply the derecognition requirements of IFRSs to determine whether it should derecognise its existing assets.

The significant residual interest criterion

BC19 Paragraph 5(b) of D12 proposed that for a service arrangement to be within its scope the residual interest in the infrastructure handed over to the grantor at the end of the arrangement must be significant. Respondents argued, and the IFRIC agreed, that the significant residual interest criterion would limit the usefulness of the guidance because a service arrangement for the entire physical life of the infrastructure would be excluded from the scope of the guidance. That result was not the IFRIC's intention. In its redeliberation of the proposals, the IFRIC decided that it would not retain the proposal that the residual interest in the infrastructure handed over to the grantor at the end of the arrangement must be significant. As a consequence, "whole of life" infrastructure (ie where the infrastructure is used in a public-to-private service arrangement for the entirety of its useful life) is within the scope of the Interpretation.

Treatment of the operator's rights over the infrastructure (paragraph 11)

BC20 The IFRIC considered the nature of the rights conveyed to the operator in a service concession arrangement. It first examined whether the infrastructure used to provide public services could be classified as property, plant and equipment of the operator under IAS 16. It started from the principle that infrastructure used to provide public services should be recognised as property, plant and equipment of the party that controls its use. This principle determines which party should recognise the property, plant and equipment as its own. The reference to control stems from the *Framework*:

(a) an asset is defined by the *Framework* as "a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity."

(b) the *Framework* notes that many assets are associated with legal rights, including the right of ownership. It goes on to clarify that the right of ownership is not essential.

(c) rights are often unbundled. For example, they may be divided proportionately (undivided interests in land) or by specified cash flows (principal and interest on a bond) or over time (a lease).

BC21 The IFRIC concluded that treatment of infrastructure that the operator constructs or acquires or to which the grantor gives the operator access for the purpose of the service arrangement should be determined by whether it is controlled by the grantor in the manner described in paragraph 5. If it is so controlled (as will be the case for all arrangements within the scope of the Interpretation), then, regardless of which party has legal title to it during the arrangement, the infrastructure should not be recognised as property, plant and equipment of the operator because the operator does not control the use of the public service infrastructure.

BC22 In reaching this conclusion the IFRIC observed that it is control of the right to use an asset that determines recognition under IAS 16 and the creation of a lease under IAS 17 *Leases*. IAS 16 defines property, plant and equipment as tangible items that "are held for use in the production or supply of goods or services, for rental to others or for administrative purposes …". It requires items within this definition to be recognised as property, plant and equipment unless another standard requires or permits a different approach. As an example of a different approach, it highlights the requirement in IAS 17 for recognition of leased property, plant and equipment to be evaluated on the basis of the transfer of risks and rewards. That standard defines a lease as "an agreement whereby the lessor conveys to the lessee in return for a series of payments the right to use an asset" and it sets out the requirements for classification of leases. IFRIC 4 *Determining whether an Arrangement contains a Lease* interprets the meaning of right to use an asset as "the arrangement conveys the right to control the use of the underlying asset."

BC23 Accordingly, it is only if an arrangement conveys the right to control the use of the underlying asset that reference is made to IAS 17 to determine how such a lease should be classified. A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.

BC24 The IFRIC considered whether arrangements within the scope of IFRIC 12 convey "the right to control the use of the underlying asset" (the public service infrastructure) to the operator. The IFRIC decided that, if an arrangement met the conditions in paragraph 5, the operator would not have the right to control the use of the underlying asset and should therefore not recognise the infrastructure as a leased asset.

BC25 In arrangements within the scope of the Interpretation the operator acts as a service provider. The operator constructs or upgrades infrastructure used to provide a public service. Under the terms of the contract the operator has access to operate the infrastructure to provide the public service on the grantor's behalf. The asset recognised by the operator is the consideration it receives in exchange for its services, not the public service infrastructure that it constructs or upgrades.

BC26 Respondents to the draft Interpretations disagreed that recognition should be determined solely on the basis of control of use without any assessment of the extent to which the operator or the grantor bears the risks and rewards of ownership. They questioned how the proposed approach could be reconciled to IAS 17, in which the leased asset is recognised by the party that bears substantially all the risks and rewards incidental to ownership.

BC27 During its redeliberation the IFRIC affirmed its decision that if an arrangement met the control conditions in paragraph 5 of the Interpretation the operator would not have the right to control the use of the underlying asset (public service infrastructure) and should therefore not recognise the infrastructure as its property, plant and equipment under IAS 16 or the creation of a lease under IAS 17. The contractual service arrangement between the grantor and operator would not convey the right to use the infrastructure to the operator. The IFRIC concluded that this treatment is also consistent with IAS 18

Revenue because, for arrangements within the scope of the Interpretation, the second condition of paragraph 14 of IAS 18 is not satisfied. The grantor retains continuing managerial involvement to the degree usually associated with ownership and control over the infrastructure as described in paragraph 5.

BC28 In service concession arrangements rights are usually conveyed for a limited period, which is similar to a lease. However, for arrangements within the scope of the Interpretation, the operator's right is different from that of a lessee: the grantor retains control over the use to which the infrastructure is put, by controlling or regulating what services the operator must provide, to whom it must provide them, and at what price, as described in paragraph 5(a). The grantor also retains control over any significant residual interest in the infrastructure throughout the period of the arrangement. Unlike a lessee, the operator does not have a right of use of the underlying asset: rather it has access to operate the infrastructure to provide the public service on behalf of the grantor in accordance with the terms specified in the contract.

BC29 The IFRIC considered whether the scope of the Interpretation might overlap with IFRIC 4. In particular, it noted the views expressed by some respondents that the contractual terms of certain service arrangements would be regarded as leases under IFRIC 4 and would also be regarded as meeting the scope criterion set out in paragraph 5 of IFRIC 12. The IFRIC did not regard the choice between accounting treatments as appropriate because it could lead to different accounting treatments for contracts that have similar economic effects. In the light of comments received the IFRIC amended the scope of IFRIC 4 to specify that if a service arrangement met the scope requirements of IFRIC 12 it would not be within the scope of IFRIC 4.

Recognition and measurement of arrangement consideration (paragraphs 12 and 13)

BC30 The accounting requirements for construction and service contracts are addressed in IAS 11 *Construction Contracts* and IAS 18. They require revenue to be recognised by reference to the stage of completion of the contract activity. IAS 18 states the general principle that revenue is measured at the fair value of the consideration received or receivable. However, the IFRIC observed that the fair value of the construction services delivered may in practice be the most appropriate method of establishing the fair value of the consideration received or receivable for the construction services. This will be the case in service concession arrangements, because the consideration attributable to the construction activity often has to be apportioned from a total sum receivable on the contract as a whole and, if it consists of an intangible asset, may also be subject to uncertainty in measurement.

BC31 The IFRIC noted that IAS 18 requires its recognition criteria to be applied separately to identifiable components of a single transaction in order to reflect the substance of the transaction. For example, when the selling price of a product includes an identifiable amount for subsequent servicing, that amount is deferred and is recognised as revenue over the period during which the service is performed. The IFRIC concluded that this requirement was relevant to service arrangements within the scope of the Interpretation. Arrangements within the scope of the Interpretation involve an operator providing more than one service, ie construction or upgrade services, and operation services. Although the contract for each service is generally negotiated as a single contract, its terms call for separate phases or elements because each separate phase or element has its own distinct skills, requirements and risks. The IFRIC noted that, in these circumstances, IAS 18 paragraphs 4 and 13 require the contract to be separated into two separate phases or elements, a construction element within the scope of IAS 11 and an operations element within the scope of IAS 18. Thus the operator might report different profit margins on each phase or element. The IFRIC noted that the amount for each service would be identifiable because such services were often provided as a single service. The IFRIC also noted that the combining and segmenting criteria of IAS 11 applied only to the construction element of the arrangement.

BC32 In some circumstances, the grantor makes a non-cash payment for the construction services, ie it gives the operator an intangible asset (a right to charge users of the public service) in exchange for the operator providing construction services. The operator then uses the intangible asset to generate further revenues from users of the public service.

BC33 Paragraph 12 of IAS 18 states:

> When goods are sold or services are rendered in exchange for dissimilar goods or services, the exchange is regarded as a transaction which generates revenue. The revenue is measured at the fair value of the goods or services received, adjusted by the amount of any cash or cash equivalents transferred. When the fair value of the goods or services received cannot be measured reliably, the revenue is measured at the fair value of the goods or services given up, adjusted by the amount of any cash or cash equivalents transferred.

BC34 The IFRIC noted that total revenue does not equal total cash inflows. The reason for this outcome is that, when the operator receives an intangible asset in exchange for its construction services, there are two sets of inflows and outflows rather than one. In the first set, the construction services are exchanged for the intangible asset in a barter transaction with the grantor. In the second set, the intangible asset received from the grantor is used up to generate cash flows from users of the public service. This result is not unique to service arrangements within the scope of the Interpretation. Any situation in which an entity provides goods or services in exchange for another dissimilar asset that is subsequently used to generate cash revenues would lead to a similar result.

BC35 Some IFRIC members were uncomfortable with such a result, and would have preferred a method of accounting under which total revenues were limited to the cash inflows. However, they accepted that it is consistent with the treatment accorded to a barter transaction, ie an exchange of dissimilar goods or services.

Consideration given by the grantor to the operator (paragraphs 14 – 19)

BC36 The IFRIC observed that the contractual rights that the operator receives in exchange for providing construction services can take a variety of forms. They are not necessarily rights to receive cash or other financial assets.

BC37 The draft Interpretations proposed that the nature of the operator's asset depended on who had the primary responsibility to pay the operator for the services. The operator should recognise a financial asset when the grantor had the primary responsibility to pay the operator for the services. The operator should recognise an intangible asset in all other cases.

BC38 Respondents to the draft Interpretations argued that determining which accounting model to apply by looking at who has the primary responsibility to pay the operator for the services, irrespective of who bears demand risk (ie ability and willingness of users to pay for the service), would result in an accounting treatment that did not reflect the economic substance of the arrangement. Respondents were concerned that the proposal would require operators with essentially identical cash flow streams to adopt different accounting models. This would impair users' understanding of entities involved in providing public-to-private service concession arrangements. Several gave the example of a shadow toll road and a toll road, where the economics (demand risk) of the arrangements would be similar, pointing out that under the proposals the two arrangements would be accounted for differently. In the light of comments received on the proposals, the IFRIC decided to clarify (see paragraphs 15-19) the extent to which an operator should recognise a financial asset and an intangible asset.

BC39 Responses to the draft Interpretations provided only limited information about the impact of the proposals. To obtain additional information, IASB staff arranged for discussions with preparers, auditors and regulators. The consensus of those consulted was that the identity of the payee has no effect on the risks to the operator's cash flow stream. The operator typically relies on the terms of the service arrangement contract to determine the risks to its cash flow stream. The operator's cash flows may be guaranteed by the grantor, in which case the grantor bears demand risk, or the operator's cash flows may be conditional on usage levels, in which case the operator bears demand risk.

BC40 The IFRIC noted that the operator's cash flows are guaranteed when (a) the grantor agrees to pay the operator specified or determinable amounts whether or not the public service is used (sometimes known as take-or-pay arrangements) or (b) the grantor grants a right to the operator to charge users of the public service and the grantor guarantees the operator's cash flows by way of a shortfall guarantee described in paragraph 16. The operator's cash flows are conditional on usage when it has no such guarantee but must obtain its revenue either directly from users of the public service or from the grantor in proportion to public usage of the service (road tolls or shadow tolls for example).

A financial asset (operator's cash flows are guaranteed by the grantor)

BC41 Paragraph 11 of IAS 32 *Financial Instruments: Presentation* defines a financial asset to include "a contractual right to receive cash or another financial asset from another entity". Paragraph 13 of that standard clarifies that "contractual" refers to "an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law."

BC42 The IFRIC decided that a financial asset should be recognised to the extent that the operator has an unconditional present right to receive cash from or at the direction of the grantor for the construction services; and the grantor has little, if any, discretion to avoid payment, usually because the agreement is enforceable by law. The operator has a contractual right to receive cash for the construction services if the grantor contractually guarantees the operator's cash flows, in the manner described in paragraph 16. The IFRIC noted that the operator has an unconditional right to receive cash to the extent that the grantor bears the risk (demand risk) that the cash flows generated by the users of the public service will not be sufficient to recover the operator's investment.

BC43 The IFRIC noted that:

(a) An agreement to pay for the shortfall, if any, between amounts received from users of the service and specified or determinable amounts does not meet the definition of a financial guarantee in paragraph 9 of IAS 39 *Financial Instruments: Recognition and Measurement* because the operator has an unconditional contractual right to receive cash from the grantor. Furthermore, the amendments made to IAS 39 in August 2005 by *Financial Guarantee Contracts* do not address the treatment of financial guarantee contracts by the holder. The objective of the amendments was to ensure that issuers of financial guarantee contracts recognise a liability for the obligations the guarantor has undertaken in issuing that guarantee.

(b) Users or the grantor may pay the contractual amount receivable directly to the operator. The method of payment is a matter of form only. In both cases the operator has a present, unconditional, contractual right to receive the specified or determinable cash flows from or at the direction of the grantor. The nature of the operator's asset is not altered solely because the contractual amount receivable may be paid directly by users of the public service. The IFRIC observed that accounting for these contractual cash flows in accordance with IASs 32 and 39 faithfully reflects the economics of the arrangements, which is to provide finance to the grantor for the construction of the infrastructure.

Operator's cash flows are contingent on the operator meeting specified quality or efficiency requirements

BC44 The IFRIC concluded that the definition of a financial asset is met even if the contractual right to receive cash is contingent on the operator meeting specified quality or efficiency requirements or targets. Before the grantor is required to pay the operator for its construction services, the operator may have to ensure that the infrastructure is capable of generating the public services specified by the grantor or that the infrastructure is up to or exceeds operating standards or efficiency targets specified by the grantor to ensure a specified level of service and capacity can be delivered. In this respect the operator's position is the same as that of any other entity in which payment for goods or services is contingent on subsequent performance of the goods or service sold.

BC45 Therefore IFRIC 12 treats the consideration given by the grantor to the operator as giving rise to a financial asset irrespective of whether the contractual amounts receivable are contingent on the operator meeting levels of performance or efficiency targets.

An intangible asset (operator's cash flows are conditional on usage)

BC46 IAS 38 *Intangible Assets* defines an intangible asset as "an identifiable non-monetary asset without physical substance". It mentions licences as examples of intangible assets. It describes an asset as being identifiable when it arises from contractual rights.

BC47 The IFRIC concluded that the right of an operator to charge users of the public service meets the definition of an intangible asset, and therefore should be accounted for in accordance with IAS 38. In these circumstances the operator's revenue is conditional on usage and it bears the risk (demand risk) that the cash flows generated by users of the public service will not be sufficient to recover its investment.

BC48 In the absence of contractual arrangements designed to ensure that the operator receives a minimum amount (see paragraphs BC53 and BC54), the operator has no contractual right to receive cash even if receipt of the cash is highly probable. Rather, the operator has an opportunity to charge those who use the public service in the future. The operator bears the demand risk and hence its commercial return is contingent on users using the public service. The operator's asset is a licence, which would be classified as an intangible asset within the scope of IAS 38. And, as clarified in paragraph AG10 of the application guidance in IAS 32:

> Physical assets (such as inventories, property, plant and equipment), leased assets and intangible assets (such as patents and trademarks) are not financial assets. Control of such physical and intangible assets creates an opportunity to generate an inflow of cash or another financial asset, but it does not give rise to a present right to receive cash or another financial asset.

BC49 The IFRIC considered whether a right to charge users unsupported by any shortfall guarantee from the grantor could be regarded as an indirect right to receive cash arising from the contract with the grantor. It concluded that although the operator's asset might have characteristics that are similar to those of a financial asset, it would not meet the definition of a financial asset in IAS 32: the operator would not at the balance sheet date have a contractual right to receive cash from another entity. That other entity (ie the user) would still have the ability to avoid any obligation. The grantor would be passing to the operator an opportunity to charge users in future, not a present right to receive cash.

Contractual arrangements that eliminate substantially all variability in the operator's return

BC50 The IFRIC considered whether agreements incorporating contractual arrangements designed to eliminate substantially all variability in the operator's return would meet the definition of a financial asset, for example:

(a) the price charged by the operator would be varied by regulation designed to ensure that the operator received a substantially fixed return; or

(b) the operator would be permitted to collect revenues from users or the grantor until it achieved a specified return on its investment, at which point the arrangement would come to an end.

BC51 The IFRIC noted that, as a result of such contractual arrangements, the operator's return would be low risk. Only if usage were extremely low would the contractual mechanisms fail to give the operator the specified return. The likelihood of usage being that low could be remote. Commercially, the operator's return would be regarded as fixed, giving its asset many of the characteristics of a financial asset.

BC52 However, the IFRIC concluded that the fact that the operator's asset was low risk did not influence its classification. IAS 32 does not define financial assets by reference to the amount of risk in the return–it defines them solely by reference to the existence or absence of an unconditional contractual right to receive cash. There are other examples of licences that offer the holders of the rights predictable, low risk returns, but such licences are not regarded as giving the holder a contractual right to cash. And there are other industries in which price regulation is designed to provide the operators with substantially fixed returns–but the rights of operators in these other industries are not classified as financial assets as a result. The operator's asset is a variable term licence, which would be classified as an intangible asset within the scope of IAS 38.

A financial asset and an intangible asset

BC53 The IFRIC concluded that if the operator is paid for its construction services partly by a financial asset and partly by an intangible asset it is necessary to account separately for each component of the operator's consideration. The IFRIC included the requirement to account separately for each component (sometimes known as a bifurcated arrangement) of the operator's consideration in response to a concern raised on the draft Interpretations. The concern was that, in some arrangements, both parties to the contract share the risk (demand risk) that the cash flows generated by users of the public service will not be sufficient to recover the operator's investment. In order to achieve the desired sharing of risk, the parties often agree to arrangements under which the grantor pays the operator for its services partly by a financial asset and partly by granting a right to charge users of the public service (an intangible asset). The IFRIC concluded that in these circumstances it would be necessary to divide the operator's consideration into a financial asset component for any guaranteed amount of cash or other financial asset and an intangible asset for the remainder.

BC54 The IFRIC concluded that the nature of consideration given by the grantor to the operator is determined by reference to the contract terms and when it exists, relevant contract law. The IFRIC noted public-to-private service agreements are rarely if ever the same; technical requirements vary by sector and country. Furthermore, the terms of the contractual agreement may also depend on the specific features of the overall legal framework of the particular country. Public-to-private service contract laws, where they exist, may contain terms that do not have to be repeated in individual contracts.

Contractual obligations to restore the infrastructure to a specified level of serviceability (paragraph 21)

BC55 The IFRIC noted that IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* prohibits an entity from providing for the replacement of parts of its own property, plant and equipment. IAS 16 requires such costs to be recognised in the carrying amount of an item of property, plant and equipment if the recognition criteria in paragraph 7 are met. Each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item is depreciated separately. The IFRIC concluded that this prohibition would not apply to arrangements within the scope of the Interpretation because the operator does not recognise the infrastructure as its own property, plant and equipment. The operator has an unavoidable obligation that it owes to a third party, the grantor, in respect of the infrastructure. The operator should recognise its obligations in accordance with IAS 37.

BC56 The IFRIC considered whether the Interpretation should contain guidance on the timing of recognition of the obligations. It noted that the precise terms and circumstances of the obligations would vary from contract to contract. It concluded that the requirements and guidance in IAS 37 were sufficiently clear to enable an operator to identify the period(s) in which different obligations should be recognised.

Borrowing costs (paragraph 22)

BC57 IAS 23 *Borrowing Costs* permits borrowing costs to be capitalised as part of the cost of a qualifying asset to the extent that they are directly attributable to its acquisition, construction or production until the asset is ready for its intended use or sale. That Standard defines a qualifying asset as “an asset that necessarily takes a substantial period of time to get ready for its intended use or sale”.

BC58 For arrangements within the scope of the Interpretation, the IFRIC decided that an intangible asset (ie the grantor gives the operator a right to charge users of the public service in return for construction services) meets the definition of a qualifying asset of the operator because generally the licence would not be ready for use until the infrastructure was constructed or upgraded. A financial asset (ie the grantor gives the operator a contractual right to receive cash or other financial asset in return for construction services) does not meet the definition of a qualifying asset of the operator. The IFRIC observed that interest is generally accreted on the carrying value of financial assets.

BC59 The IFRIC noted that financing arrangements may result in an operator obtaining borrowed funds and incurring associated borrowing costs before some or all of the funds are used for expenditure relating to construction or operation services. In such circumstances the funds are often temporarily invested. Any investment income earned on such funds is recognised in accordance with IAS 39, unless the operator adopts the allowed alternative treatment, in which case investment income earned during the construction phase of the arrangement is accounted for in accordance with paragraph 16 of IAS 23.

Financial asset (paragraphs 23 – 25)

BC60 Paragraph 9 of IAS 39 identifies and defines four categories of financial asset: (i) those held at fair value through profit or loss; (ii) held-to-maturity investments; (iii) loans and receivables; and (iv) available-for-sale financial assets.

BC61 Paragraph 24 of IFRIC 12 assumes that public-to-private service arrangement financial assets will not be categorised as held-to-maturity investments. Paragraph 9 of IAS 39 states that a financial asset may not be classified as a held-to-maturity investment if it meets the definition of a loan or receivable. An asset that meets the definition of a held-to-maturity investment will meet the definition of a loan or receivable unless:

(a) it is quoted in an active market; or

(b) the holder may not recover substantially all of its initial investment, other than because of credit deterioration.

It is not envisaged that a public-to-private service arrangement financial asset will be quoted in an active market. Hence the circumstances of (a) will not arise. In the circumstances of (b), the asset must be classified as available for sale (if not designated upon initial recognition as at fair value through profit or loss).

BC62 The IFRIC considered whether the contract would include an embedded derivative if the amount to be received by the operator could vary with the quality of subsequent services to be provided by the operator or performance or efficiency targets to be achieved by the operator. The IFRIC concluded that it would not, because the definition of a derivative in IAS 39 requires, among other things, that the variable is not specific to a party to the contract. The consequence is that the contract's provision for variations in payments does not meet the definition of a derivative and, accordingly, the requirements of IAS 39 in relation to embedded derivatives do not apply. The IFRIC observed that if the amount to be received by the operator is conditional on the infrastructure meeting quality or performance or efficiency targets as described in paragraph BC44, this would not prevent the amount from being classified as a financial asset. The IFRIC also concluded that during the construction phase of the arrangement the operator's asset (representing its accumulating right to be paid for providing construction services) should be classified as a financial asset when it represents cash or another financial asset due from or at the direction of the grantor.

Intangible asset (paragraph 26)

BC63 The Interpretation requires the operator to account for its intangible asset in accordance with IAS 38. Among other requirements, IAS 38 requires an intangible asset with a finite useful economic life to be amortised over that life. Paragraph 97 states that "the amortisation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity."

BC64 The IFRIC considered whether it would be appropriate for intangible assets under paragraph 26 to be amortised using an "interest" method of amortisation, ie one that takes account of the time value of money in addition to the consumption of the intangible asset, treating the asset more like a monetary than a non-monetary asset. However, the IFRIC concluded that there was nothing unique about these intangible assets that would justify use of a method of depreciation different from that used for other intangible assets. The IFRIC noted that paragraph 98 of IAS 38 provides for a number of amortisation methods for intangible assets with finite useful lives. These methods include the straight-line method, the diminishing balance method and the unit of production method. The method used is selected on the basis of the expected pattern of consumption of the expected future economic benefits embodied in the asset and is applied consistently from period to period, unless there is a change in the expected pattern of consumption of those future economic benefits.

BC65 The IFRIC noted that interest methods of amortisation are not permitted under IAS 38. Therefore, IFRIC 12 does not provide exceptions to permit use of interest methods of amortisation.

BC66 The IFRIC considered when the operator should first recognise the intangible asset. The IFRIC concluded that the intangible asset (the licence) received in exchange for construction services should be recognised in accordance with general principles applicable to contracts for the exchange of assets or services.

BC67 The IFRIC noted that it is current practice not to recognise executory contracts to the extent that they are unperformed by both parties (unless the contract is onerous). IAS 37 describes executory contracts as "contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent". Paragraph 91 of the *Framework* states:

> In practice, obligations under contracts that are equally proportionately unperformed (for example, liabilities for inventory ordered but not yet received) are generally not recognised as liabilities in the financial statements.

BC68 Therefore, the IFRIC concluded that contracts within the scope of the Interpretation should not be recognised to the extent that they are executory. The IFRIC noted that service concession arrangements within the scope of the Interpretation are generally executory when the contracts are signed. The IFRIC also concluded that during the construction phase of the arrangement the operator's asset (representing its accumulating right to be paid for providing construction services) should be classified as an intangible asset to the extent that it represents a right to receive a right (licence) to charge users of the public service (an intangible asset).

Items provided to the operator by the grantor (paragraph 27)

BC69 For service arrangements within the scope of the Interpretation, pre-existing infrastructure items made available to the operator by the grantor for the purpose of the service arrangement are not recognised as property, plant and equipment of the operator.

BC70 However, different considerations apply to other assets provided to the operator by the grantor if the operator can keep or deal with the assets as it wishes. Such assets become assets of the operator and so should be accounted for in accordance with general recognition and measurement principles, as should the obligations undertaken in exchange for them.

BC71 The IFRIC considered whether such assets would represent government grants, as defined in paragraph 3 of IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*:

> Government grants are assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the entity.

The IFRIC concluded that if such assets were part of the overall consideration payable by the grantor on an arms' length basis for the operator's services, they would not constitute "assistance". Therefore, they would not meet the definition of government grants in IAS 20 and that standard would not apply.

Transition (paragraphs 29 and 30)

BC72 IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* states that an entity shall account for a change in accounting policy resulting from initial application of an Interpretation in accordance with any specific transitional provisions in that Interpretation. In the absence of any specific transitional provisions, the general requirements of IAS 8 apply. The general requirement in IAS 8 is that the changes should be accounted for retrospectively, except to the extent that retrospective application would be impracticable.

BC73 The IFRIC noted that there are two aspects to retrospective determination: reclassification and remeasurement. The IFRIC took the view that it will usually be practicable to determine retrospectively the appropriate classification of all amounts previously included in an operator's balance sheet, but that retrospective remeasurement of service arrangement assets might not always be practicable.

BC74 The IFRIC noted that, when retrospective restatement is not practicable, IAS 8 requires prospective application from the earliest practicable date, which could be the start of the current period. Under prospective application, the operator could be applying different accounting models to similar transactions, which the IFRIC decided would be inappropriate. The IFRIC regarded it as important that the correct accounting model should be consistently applied.

BC75 The Interpretation reflects these conclusions.

Amendments to IFRS 1

BC76 The amendments to IFRS 1 *First-time Adoption of International Financial Reporting Standards* are necessary to ensure that the transitional arrangements are available to both existing users and first-time adopters of IFRSs. The IFRIC believes that the requirements will ensure that the balance sheet will exclude any items that would not qualify for recognition as assets and liabilities under IFRSs.

Summary of changes from the draft Interpretations

BC77 The main changes from the IFRIC's proposals are as follows:

(a) The proposals were issued in three separate draft Interpretations, D12 *Service Concession Arrangements–Determining the Accounting Model*, D13 *Service Concession Arrangements–The Financial Asset Model* and D14 *Service Concession Arrangements–The Intangible Asset Model*. In finalising IFRIC 12, the IFRIC combined the three draft Interpretations.

(b) By contrast with IFRIC 12 the draft Interpretations did not explain the reasons for the scope limitations and the reasons for the control approach adopted by the IFRIC in paragraph 5. The IFRIC added Information Note 2 to IFRIC 12 to provide references to standards that apply to arrangements outside the scope of the Interpretation.

(c) The scope of the proposals did not include "whole of life infrastructure" (ie infrastructure used in a public-to-private service arrangement for its entire useful life). IFRIC 12 includes "whole of life infrastructure" within its scope.

(d) Under the approach proposed, an entity determined the appropriate accounting model by reference to whether the grantor or the user had primary responsibility to pay the operator for the services provided. IFRIC 12 requires an entity to recognise a financial asset to the extent that the operator has an unconditional contractual right to receive cash from or at the direction of the grantor. The operator should recognise an intangible asset to the extent that it receives a right to charge users of the public service.

(e) By contrast with IFRIC 12, the draft Interpretations implied that the nature of asset recognised (a financial asset or an intangible asset) by the operator as consideration for providing construction services determined the accounting for the operation phase of the arrangement.

(f) Under the approach proposed in the draft Interpretations, an entity could capitalise borrowing costs under the allowed alternative treatment in IAS 23. IFRIC 12 requires borrowing costs to be recognised as an expense in the period in which they are incurred unless the operator has a contractual right to receive an intangible asset (a right to charge users of the public service), in which case borrowing costs attributable to the arrangement may be capitalised in accordance with the allowed alternative treatment under IAS 23.

(g) In finalising IFRIC 12, the IFRIC decided to amend IFRIC 4.