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GOVERNMENT NOTICES • GOEWERMENTSKENNISGEWINGS

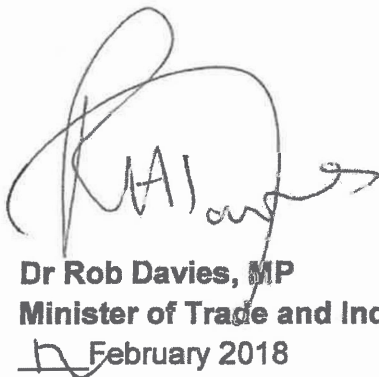
DEPARTMENT OF TRADE AND INDUSTRY

NO. 232 **16 MARCH 2018**

COMPANIES ACT, 2008 (Act 71 of 2008)

FINANCIAL REPORTING PRONOUNCEMENT 1
SUBSTANTIVELY ENACTED TAX RATES AND TAX LAWS UNDER INTERNATIONAL FINACIAL REPORTING STANDARDS AND INTERNATIONAL FINANCIAL REPORTING STANDARDS FOR SMALL AND MEDIUM ENTERPRISES

I, Dr Rob Davies, Minister of Trade and Industry, pursuant to the publication of notice 1446 in government gazette no 41338 dated 18 December 2017 for wider public consultation, publish the final notice on Financial Reporting Pronouncement 1. The final notice comes into force on the date of publication.



Dr Rob Davies, MP
Minister of Trade and Industry
__ February 2018

FINANCIAL REPORTING PRONOUNCEMENT 1

SUBSTANTIVELY ENACTED TAX RATES AND TAX LAWS UNDER IFRS AND IFRS FOR SMEs

Issued xxx 2017

FRP 1 SUBSTANTIVELY ENACTED TAX RATES AND TAX LAWS UNDER IFRS AND IFRS FOR SMEs

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FRP 1 SUBSTANTIVELY ENACTED TAX RATES AND TAX LAWS UNDER IFRS AND IFRS FOR SMEs

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FRP 1 SUBSTANTIVELY ENACTED TAX RATES AND TAX LAWS UNDER IFRS AND IFRS FOR SMEs

PREFACE

Financial Reporting Pronouncement 1 (FRP 1) has been issued by the Financial Reporting Standards Council (FRSC). It is applicable to companies within the ambit of the Companies Act 71 of 2008 applying either International Financial Reporting Standards (IFRS) or IFRS for SMEs. It is applicable to both the 2009 and 2015 version of IFRS for SMEs.

FRP 1 addresses the issue of when changes in tax rates and tax laws that are announced by the Minister of Finance during the annual Budget Statement are regarded as substantively enacted, in a South African context, under IFRS and IFRS for SMEs.

With reference to the Preface to Documents Issued by the FRSC (Preface), the FRSC may issue Financial Reporting Pronouncements (FRPs) to provide authoritative guidance to preparers, auditors and users of financial statements, thus facilitating the standardisation of financial reporting.

This FRP has the same authority as IFRS and IFRS for SMEs.

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FRP 1 SUBSTANTIVELY ENACTED TAX RATES AND TAX LAWS UNDER IFRS AND IFRS FOR SMEs

SUBSTANTIVELY ENACTED TAX RATES AND TAX LAWS

References

IFRS:
- IAS 8 – *Accounting Policies, changes in Accounting Estimates and Errors*
- IAS 10 *Events after the Reporting Period*
- IAS 12 *Income Taxes*

IFRS for SMEs:
- Section 10 – *Accounting Policies, Estimates and Errors*
- Section 29 *Income Taxes*
- Section 32 *Events after the End of the Reporting Period*

Background

1. The Accounting Practices Board (APB) issued AC 502 – *Substantively Enacted Tax Rates and Tax Laws* in 2006 as a local interpretation. Following the proposed withdrawal of Statements of Generally Accepted Accounting Practice (GAAP) in 2012, SAICA issued this local interpretation as Financial Reporting Guide 1. The Financial Reporting Standards Council (FRSC) has considered the content of this Guide and has decided to issue it as a Financial Reporting Pronouncement (FRP). Although AC 502 and the SAICA Financial Reporting Guide 1 were local interpretations of IFRS, they address a concept that is equally relevant under IFRS for SMEs. Hence, this FRP applies to both IFRS and IFRS for SMEs. The only changes of substance relate to incorporating the relevant references from IFRS for SMEs as well as revising the illustrative examples to reflect both a change in corporate tax rate and a change to the inclusion rate for capital gains.

2. The Minister of Finance may announce changes in tax rates and tax laws during the annual Budget Statement.

3. In terms of paragraphs 46 and 47 of IAS 12, paragraphs 29.6 and 29.18 of IFRS for SMEs (2009 version) and paragraphs 29.6 and 29.27 of IFRS for SMEs (2015 version[1]), both current and deferred tax assets and liabilities are to be measured using the tax rates and tax laws that have been enacted or substantively enacted by the end of the reporting period

[1] IFRS for SMEs 2015 version has a mandatory effective date of annual periods commencing on or after 1 January 2017.

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4. Paragraphs 29.6 and 29.18 of IFRS for SMEs (2009 version) and paragraphs 29.6 and 29.27 of IFRS for SMEs (2015 version) state that tax rates and tax laws are regarded as substantively enacted when the remaining steps in the enactment process have not affected the outcome in the past and are unlikely to do so.

Issue

5. In a South African context, the issue is: when should changes in tax rates and tax laws that are announced by the Minister of Finance during the annual Budget Statement be regarded as substantively enacted?

Consensus

6. Changes in tax rates should be regarded as substantively enacted from the time that they are announced in terms of the Minister of Finance's Budget Statement. However, this only applies where the change in tax rates is not inextricably linked to other changes in the tax laws. To be regarded as substantively enacted there should be the required degree of certainty that the announced changes would be promulgated in a substantially unchanged manner.

7. When changes in the tax rates are inextricably linked to other changes in the tax laws, they should be regarded as being substantively enacted when they have been approved by Parliament and signed by the President.

8. Changes in tax laws other than those covered in paragraphs 6 and 7 above, should be regarded as being substantively enacted when they have been approved by Parliament and signed by the President.

9. The changes in tax rates and tax laws should be applied to the period to which they relate. For example, a change in tax rates could be announced during a tax year as being applicable to the following year, in which case the current tax balances in the balance sheet would be based on the previous tax rate, whereas the deferred tax balance in the balance sheet would be based on the new tax rate.

Effective date

10. An entity shall apply this FRP for annual periods beginning on or after xxx[2]. Earlier application is permitted and is encouraged. If an entity applies this FRP for an earlier period, it shall disclose that fact.

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[2] Proposed effective date is annual periods beginning on or after 1 January 2018.

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FRP 1 SUBSTANTIVELY ENACTED TAX RATES AND TAX LAWS UNDER IFRS AND IFRS FOR SMEs

11. This FRP shall be applied retrospectively subject to the provisions of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* (for entities applying IFRS) and Section 10 *Accounting Policies, Estimates and Errors* (for entities applying IFRS for SMEs).

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Illustrative examples and disclosure guidance

These examples accompany, but are not part of this FRP. The examples are merely illustrative and do not purport to reflect the tax laws and tax rates applicable in South Africa.

IE1 Capital gains are included in taxable income on a proportionate basis. On 23 February 20X5 the Minister of Finance in the Budget Statement announces the following changes:

- a change in the corporate tax rate from 30% to 29%. This change is effective for entities with a year of assessment ending on or after 1 April 20X5; and
- a change in the inclusion rate of capital gains from 66.6% to 80%. This change is effective from years of assessment begininng on or after 1 March 20X5.

IE2 On the basis of this FRP, the date of substantive enactment for both the corporate tax rate, and the capital gains tax rate, change is 23 February 20X5, this being the date of the Budget Statement. However, for entities with a year end prior to 1 April 20X5, the rate of tax to be used for current tax is 30%, since the corporate tax rate change applies to entities with years ending on or after 1 April 20X5. For capital gains arising in years of assessment beginning before 1 March 20X5, 66.6% of such gains should be included in the calculation of current tax; whereas an inclusion rate of 80% should be used for capital gains arising in years of assessment beginning on or after 1 March 20X5.

IE3 In terms of paragraph 28 of IAS 34 – *Interim Financial Reporting*[3], an entity is to apply the same accounting policies in its interim financial statements as are applied in its annual financial statements, which means that current and deferred tax balances in interim financial statements are to be measured using tax rates and tax laws that have been enacted or substantively enacted by the date of the interim balance sheet.

IE4 In keeping with the previous paragraphs, the current and deferred tax amounts in the balance sheet should be dealt with as outlined below.

<u>Entity's year end is before 23 February 20X5</u>

- Current tax balances should be measured at 30% and 66.6% of capital gains should be included in the calculation of taxable income (i.e. an effective CGT rate of 19.98%[4] should be used).

[3] IFRS for SMEs does not address interim financial reporting.
[4] 66.6% x 30% = 19.98%

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- The deferred tax balance disclosed on the balance sheet at year end should be based on a tax rate of 30% and an inclusion rate for capital gains of 66.6%. Where these financial statements are approved for issue after 23 February 20X5, the entity should include a subsequent event note in the financial statements to the effect that the deferred tax balance will change in the future as a result of the change in corporate tax rate from 30% to 29% and the change in CGT rate from 19.98% to 23.2%[5]. For these entities the change in tax rates will be reflected in the following year's financial statements.

Entity's year end is between 23 February and 31 March 20X5

- Current tax balances should be measured at 30% and 66.6% of capital gains should be included in the calculation of taxable income (i.e. an effective CGT rate of 19.98% should be used).
- The deferred tax balance shown on the balance sheet at year end should be measured using a tax rate of 29% and an inclusion rate for capital gains of 80% for gains (i.e. an effective CGT rate of 23.2%).

Entity's year end is after 31 March 20X5, but before 28 February 20X6

- Current tax balances should be measured at 29% and 66.6% of capital gains should be included in the calculation of taxable income (i.e. an effective CGT rate of 19.31%[6] should be used).
- The deferred tax balance shown on the balance sheet at year end should be measured using a tax rate of 29% and an inclusion rate for capital gains of 80% (i.e. an effective CGT rate of 23.2%).

[5] 80% x 29% = 23.2%
[6] 66.6% x 29% = 19.31%

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Entity's interim results are for a period ending before 23 February 20X5 for an entity with a year ending after 31 March 20X5 (but before 28 February 20X6), with the results being published after 23 February 20X5

- Current tax balances should be measured at 30% and 66.6% of capital gains should be included in the calculation of taxable income (i.e. an effective CGT rate of 19.98% should be used).
- The deferred tax balance disclosed on the balance sheet at interim should be based on a tax rate of 30% and an inclusion rate for capital gains of 66.6%.
- A subsequent event note should be included commenting that the results for the full year will measure current and deferred tax balances at 29%. And that for deferred tax, the inclusion rate for capital gains expected to arise after the end of the current annual financial reporting period will increase to 80% resulting in an effective CGT rate of 23.2%.

Entity's interim results are for a period ending on or after 23 February 20X5 for an entity with a year ending after 31 March 20X5, but before 28 February 20X6

- The current and deferred tax balances should be measured using a 29% tax rate.
- For current tax, the inclusion rate for capital gains should be 66.6%.

  For deferred tax, the inclusion rate for capital gains should be 66.6% for capital gains expected to be included in taxable income by the end of the current annual financial reporting period and 80% for capital gains expected to be included in taxable income after the end of the current annual period.

IE5 In terms of IAS 12, paragraphs 80 and 81, the following, amongst other things, should be disclosed:

5.1 The amount of deferred tax income/expense that relates to a change in tax rates or to the imposition of new taxes.

5.2 A reconciliation between the effective tax rate and the applicable tax rate.

5.3 An explanation of the change in the applicable tax rate compared to the previous accounting period.

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IE6 In terms of paragraphs 29.31 and 29.32 of IFRS for SMEs (2009 version), the following, amongst other things, should be disclosed:

6.1 The amount of deferred tax income/expense that relates to a change in tax rates or to the imposition of new taxes.

6.2 An explanation of the change in the applicable tax rate compared to the previous accounting period.

IE7 In terms of paragraphs 29.39 and 29.40 of IFRS for SMEs (2015 version), the following, amongst other things, should be disclosed:

7.1 The amount of deferred tax income/expense that relates to a change in tax rates or to the imposition of new taxes.

7.2 An explanation of any significant differences between the tax expense (income) an accounting profit multiplied by the applicable tax rate.

7.3 An explanation of the change in the applicable tax rate compared to the previous accounting period.

IE8 In terms of IAS 10 paragraph 21, paragraph 32.10 of IFRS for SMEs (both 2009 and 2015 versions) an entity shall disclose the following for each material category of non-adjusting events after the reporting period:

8.1 the nature of the event, and

8.2 an estimate of its financial effect, or a statement that such an estimate cannot be made.

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FRP 1 SUBSTANTIVELY ENACTED TAX RATES AND TAX LAWS UNDER IFRS AND IFRS FOR SMEs

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of the FRP.

BC1 IAS 12 states the following:

1.1 *"Current tax liabilities (assets) for the current and prior periods shall be measured at the amount expected to be paid to (recovered from) the taxation authorities, using the tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period."* (paragraph 12.46[7])

1.2 *"Deferred tax assets and liabilities shall be measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on the rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period."* (paragraph 12.47[8])

1.3 *"Current and deferred tax assets and liabilities are usually measured using the tax rates (and tax laws) that have been enacted. However, in some jurisdictions, announcements of tax rates (and tax laws) by the government have the substantive effect of actual enactment, which may follow the announcement by a period of several months. In these circumstances, tax assets and liabilities are measured using the announced tax rate (and tax laws)."* (paragraph 12.48)

BC2 IFRS for SMEs provides the following additional guidance:

2.1 *"An entity shall regard tax rates and tax laws as substantively enacted when the remaining steps in the enactment process have not effected the outcome in the past and are unlikely to do so."* (paragraphs 29.6 and 29.18 of IFRS for SMEs (2009 version) and paragraphs 29.6 and 29.27 of IFRS for SMEs (2015 version))

BC3 In order to interpret the meaning of substantive enactment and the required degree of certainty that the announced changes would be promulgated in a substantially unchanged manner, it would be appropriate to regard a tax rate or tax law as substantively enacted where there is persuasive evidence that:

3.1 the government is able to enact and is committed to enacting the proposed change in the foreseeable future; and

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[7] The equivalent reference in IFRS for SMEs is paragraph 29.6 (both 2009 and 2015 versions).
[8] The equivalent reference in IFRS for SMEs is paragraph 29.18 (2009 version) and paragraph 29.27 (2015 version).

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FRP 1 SUBSTANTIVELY ENACTED TAX RATES AND TAX LAWS UNDER IFRS AND IFRS FOR SMEs

3.2 the entity expects to be assessed on the basis of the announced rates/ laws, where the change relates to the current year.

In addition, the requirements of this paragraph would usually exist only when the proposed change is specified in sufficient detail to be understood and applied in practice, and once the change has been tabled in Parliament.

BC4 In South Africa, the change in tax rates is only actually enacted when the necessary legislation is passed by Parliament, which occurs some months after the Budget Statement. However, the Income Tax Act provides, in paragraph 17(4) of the Fourth Schedule, that provisional tax should be based on the rate *"in respect of that year foreshadowed by the Minister of Finance in his budget statement"* if the rate for that year has not been fixed by Parliament. Accordingly, the rate as announced by the Minister of Finance is given legal standing in the Income Tax Act and is to be used for tax payment purposes.

BC5 Furthermore, the budget is presented in Parliament by a member of the ruling party, which has a substantial majority, meaning that the ruling party is able to ensure that the revised tax rate will be passed by Parliament.

BC6 The factor in BC4, supplemented by that in BC5, is regarded as meeting the requirement in IAS 12, paragraph 48, that the announcement of the new rates has the substantive effect of actual enactment. BC4 and BC5 also provide a basis for meeting the requirement in paragraphs 29.6 and 29.18 of IFRS for SMEs (2009 version) and paragraphs 29.6 and 29.27 of IFRS for SMEs (2015 version).

BC7 A change in tax rate, however, needs to be distinguished from other changes in tax legislation. Paragraphs 46 to 48 of IAS 12 and Section 29 of IFRS for SMEs not only refer to tax rates, but also to tax laws. Whilst the Minister of Finance might announce changes in tax laws in the Budget Statement, these changes are generally only drafted at a later stage. This means that the detail of the changes is only decided upon at this later stage, and could incorporate amendments made subsequent to the proposals announced in the Budget Statement. In addition, changes to the proposed legislation can be made as a result of debates in Parliament and in committees as well as in response to comments received when draft legislation is released for public comment. In this case, because the detail of the changes is generally only decided upon at a later date, substantive enactment would be regarded as occurring when the legislation is approved, seeing that prior to this date there is not sufficient certainty as to the details to be applied in practice when the changes are actually enacted. This is distinguished from a change in tax rates that only requires one amount to be changed and is therefore a change that can be made without interpretation issues arising, which are only resolved when the legislation is finally approved.

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BC8 Where an announcement of a change in tax rates is inextricably linked to another change in tax laws, the change in tax rates should be regarded in the same way as a change in tax laws. This would apply, for example, if a change in tax rates were linked to a change in the basis of taxation (e.g. from a taxable income base to tax being based on a percentage of accounting profit). The same would apply if a new tax were introduced because the details of the legislation would only be enacted at a later date. Normally changes to tax laws, such as changes made to close perceived tax loopholes, are made independently of any changes in tax rates.

BC9 As noted above, the current and deferred tax balances are to be measured on the basis of the tax rates and tax laws that have been enacted or substantively enacted by the balance sheet date. This means that, if the tax rates and tax laws are regarded as being enacted or substantively enacted after the balance sheet date, they are regarded as non-adjusting events after the balance sheet date, even when the changes to the tax rates and tax laws are applied retrospectively. In this case, the required disclosures in terms of IAS 10 (under IFRS) and Section 32 (under IFRS for SMEs) are to be provided.

BC10 This FRP only addresses issues related to the selection of the tax rate to be used to calculate the deferred tax balance and the current tax expense. It does not address the subsequent implications relating to the recognition of any related income or expense, and therefore does not address the issue of whether the tax effect of the current year's temporary differences should be calculated using the current or prior rate, and further whether the tax rate change should be made to the opening or closing balance of deferred tax. As these issues are not addressed in IAS 12 or IFRS for SMEs, it is not appropriate for this FRP to address these issues.

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DEPARTMENT OF TRADE AND INDUSTRY

NO. 233 **16 MARCH 2018**

COMPANIES ACT, 2008 (Act 71 of 2008)

FINANCIAL REPORTING PRONOUNCEMENT 2 ACCOUNTING FOR BLACK ECONOMIC EMPOWERMENT (BEE) TRANSACTIONS UNDER INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

I, Dr Rob Davies, Minister of Trade and Industry, pursuant to the publication of notice 1447 in government gazette no 41338 dated 18 December 2017 for wider public consultation, publish the final notice on Financial Reporting Pronouncement 2. The final notice comes into force on the date of publication.

Dr Rob Davies, MP
Minister of Trade and Industry
12 February 2018

FINANCIAL REPORTING PRONOUNCEMENT 2

ACCOUNTING FOR BLACK ECONOMIC EMPOWERMENT (BEE) TRANSACTIONS UNDER IFRS

Issued xxxx 2017

FRP 2 ACCOUNTING FOR BLACK ECONOMIC EMPOWERMENT (BEE) TRANSACTIONS UNDER IFRS

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FRP 2 ACCOUNTING FOR BLACK ECONOMIC EMPOWERMENT (BEE) TRANSACTIONS UNDER IFRS

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FRP 2 ACCOUNTING FOR BLACK ECONOMIC EMPOWERMENT (BEE) TRANSACTIONS UNDER IFRS

PREFACE

Financial Reporting Pronouncement 2 (FRP 2) has been issued by the Financial Reporting Standards Council (FRSC). It is applicable to companies within the ambit of the Companies Act 71 of 2008 applying International Financial Reporting Standards (IFRS).

Under IFRS, IFRS 2 – *Share-based Payment* applies to the accounting for Black Economic Empowerment (BEE) transactions where the value of cash and other assets received is less than the fair value of equity instruments granted to the BEE partner, i.e. for the BEE equity credentials.

While IFRS 2 addresses the broad principle that equity instruments issued at a discount are within the scope of IFRS 2 it does not address issues specific to BEE transactions. This FRP seeks to address certain of these issues:

- Should the difference between the fair value of the equity instruments granted and the fair value of the cash and other assets received, i.e. the BEE equity credentials, be recognised as an intangible asset or as an expense?
- Where BEE equity credentials are obtained as part of the net assets acquired in a business combination, how should the BEE equity credentials acquired be accounted for?
- Assuming that BEE equity credentials do not meet the criteria for recognition as an intangible asset, how should vesting conditions be interpreted in the context of a BEE transaction?

A separate FRP (FRP 3 *Accounting for Black Economic Empowerment (BEE) Transactions under IFRS for SMEs*) addresses these issues for companies applying IFRS for SMEs.

With reference to the Preface to Financial Reporting Pronouncements and Guides issued by the FRSC, the FRSC may issue Financial Reporting Pronouncements (FRPs) to provide authoritative guidance to preparers, auditors and users of financial statements, thus facilitating the standardisation of financial reporting.

This FRP has the same authority as IFRS.

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ACCOUNTING FOR BLACK ECONOMIC EMPOWERMENT (BEE) TRANSACTIONS UNDER IFRS

Paragraph .16 of IAS 1Presentation of Financial Statements requires an entity whose financial statements comply with IFRSs to make an explicit and unreserved statement of such compliance in the notes. An entity shall not describe financial statements as complying with IFRSs unless they comply with all the requirements of IFRSs. Paragraph .7 states that assessing whether an omission or misstatement could influence economic decisions of users, and so be material, requires consideration of the characteristics of those users.

References

(a) *Conceptual Framework for Financial Reporting;*

(b) IAS 8 – *Accounting Policies, changes in Accounting Estimates and Errors;*

(c) IAS 38 – *Intangible Assets*;

(d) IFRS 2 – *Share-based Payment*; and

(e) IFRS 3 – *Business Combinations.*

Background

1. The Accounting Practices Board (APB) issued AC 503 – *Accounting for Black Economic Empowerment (BEE) Transactions* in 2006 as a local interpretation. Following the proposed withdrawal of South African Statements of Generally Accepted Accounting Practice (SA GAAP) in 2012, SAICA issued this local interpretation as Financial Reporting Guide 2. The Financial Reporting Standards Council (FRSC) has considered the content of this Guide and has decided to issue it as a Financial Reporting Pronouncement (FRP).

2. Paragraph 13A of IFRS 2 clarifies that the standard applies to transactions in which goods or services are received as consideration for equity instruments[1] of the entity or for the entity incurring a liability to transfer cash or other assets for amounts that are based on the price (or value) of the entity's shares or other equity instruments of the entity, even when the entity cannot specifically identify some or all of the goods or services received.

[1] These include equity instruments of the entity, the entity's parent and other entities in the same group as the entity

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FRP 2 ACCOUNTING FOR BLACK ECONOMIC EMPOWERMENT (BEE) TRANSACTIONS UNDER IFRS

3. In the context of empowerment of black people[2] through meaningful participation in the South African economy, entities may issue equity instruments to black people or entities controlled by black people at a discount to fair value. The goods or services received from the black people or entities controlled by them in return for the equity instruments may or may not be specifically identifiable.

4. IFRS 2, therefore, applies to the accounting for BEE transactions where the fair value of cash and other assets received is less than the fair value of equity instruments granted to the BEE partner, i.e. to the BEE equity credentials.

5. While IFRS 2 addresses the broad principle that equity instruments issued at a discount are within the scope of IFRS 2, it does not address issues specific to BEE transactions. This FRP seeks to address certain of these issues.

Scope

6. BEE credentials are determined based on a scorecard that measures the following 5 elements[3]:

   a) Ownership

   b) - Management control

   c) - Skills Development

   d) - Enterprise and Supplier Development

   e) - Socio-economic development

7. This FRP considers only those BEE transactions where the entity grants equity instruments to black people (directly or indirectly) and the fair value of the cash and other assets received (or to be received), if any, is less than the fair value of the equity instruments granted.

8. The equity instruments may take many legal forms, such as:

   (a) Ordinary shares;

   (b) Deferred ordinary shares;

   (c) Share options; and

   (d) Convertible preference shares or debentures.

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2 As defined in terms of the Broad-Based Black Economic Empowerment Act No.53 of 2003

3 Amended Broad-Based Black Economic Empowerment Codes of Good Practice October 2012

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FRP 2 ACCOUNTING FOR BLACK ECONOMIC EMPOWERMENT (BEE) TRANSACTIONS UNDER IFRS

9. The difference between the fair value of the cash and other assets received and the fair value of the equity instruments granted may arise because of specific goods or services that the BEE partner provides to the entity, or because of the BEE equity credentials that the entity has received. This FRP applies only to BEE transactions where there is a difference that arises from the entity obtaining BEE equity credentials. It does not apply to transactions where the BEE partner is issued with equity instruments for transactions that are unrelated to the entity obtaining BEE equity credentials, because the requirements of IFRS 2 are adequate for such transactions.

10. Types of structures that are considered to be within the scope of this FRP include, but are not limited to, the following:

    (a) Leveraged buyout structures where equity is issued to an empowerment partner and the issuer of the equity (or a related party) provides or guarantees the borrowings required to purchase the equity;

    (b) Structures where equity is issued at a nominal amount by a new entity to all participants so that the entity can obtain BEE equity credentials;

    (c) Structures where equity is issued to or acquired by the BEE partner at a price equal to its fair value, where such issue or acquisition is funded by a notional loan whereby the loan is repaid via the dividends from the equity instruments;

    (d) Transactions between shareholders of an entity that enable the entity to obtain BEE equity credentials;

    (e) Transactions that facilitate BEE through a special-purpose entity for obtaining BEE equity credentials; and

    (f) Business combinations between BEE businesses in order for at least one entity to obtain further BEE equity credentials.

Issues

11. **Issue 1**: Should the difference between the fair value of the equity instruments granted and the fair value of the cash and other assets received, i.e. the BEE equity credentials, be recognised as an intangible asset or as an expense?

12. **Issue 2**: Where BEE equity credentials are obtained as part of the net assets acquired in a business combination, how should the BEE equity credentials acquired be accounted for?

13. **Issue 3**: Assuming that BEE equity credentials do not meet the criteria for recognition as an intangible asset, how should vesting conditions be interpreted in the context of a BEE transaction?

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Consensus

14. **Issue 1**: The difference between the fair value of the equity instruments granted and the fair value of the cash and other assets received, i.e. the BEE equity credentials, represents an intangible item that does not meet the definition of an intangible asset and, therefore, does not qualify for recognition as an intangible asset. The difference should be expensed.

15. Where the cost of the BEE equity credentials is directly attributable to the acquisition of another intangible asset, then such an intangible asset should be valued at its fair value and any additional BEE equity credential costs should be expensed.

16. **Issue 2**: Where BEE equity credentials are obtained as part of the net assets acquired in a business combination, the BEE equity credentials do not qualify for recognition as an intangible asset and shall, therefore, form part of goodwill.

17. Where the business combination element of the transaction is insignificant or contrived, this would indicate that the substance of the transaction is in fact two separate transactions – a BEE transaction and a business combination. These two transactions should be accounted for separately. The BEE transaction should be accounted for under IFRS 2, and the business combination should be accounted for under IFRS 3.

18. **Issue 3**: The entity should assess whether the terms of the BEE transaction include service conditions, performance conditions, or non-vesting conditions.

19. Where the BEE transaction includes service conditions, the fair value of the equity instruments shall be measured at grant date and the expense should be recognised over the vesting period, which is the period over which services are rendered to the entity. The service condition shall not be taken into account when estimating the fair value of the equity instrument. Where the BEE transaction includes no service conditions, the fair value of the equity instruments shall be measured at grant date and the expense should be recognised immediately on grant date.

20. Performance conditions exist where the counterparty must complete a service period and a performance target must be met. A performance condition may be either a market performance condition or a non-market performance condition.

21. Non-market performance conditions exist when the BEE partner must complete a specified period of service, and meet a non-market performance target, such as an earnings target. Where such non-market performance conditions exist, these shall not be taken into account when estimating the fair value of the equity instruments at the grant date. Instead, the number of equity instruments included in the measurement of the transaction amount shall be adjusted so that the cumulative amount recognised for goods or services received (i.e. BEE equity credentials) as consideration for the

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equity instruments granted shall be based on the number of equity instruments that the BEE partner will become entitled to.

22. Market performance conditions exist when the BEE partner must complete a specified period of service, and meet a market performance target, such as a share price target. Where such conditions exist, the market performance target shall be taken into account when estimating the fair value of the equity instruments granted.

23. Where a non-vesting condition exists in a BEE transaction, it shall be taken into account when estimating the fair value of the equity instruments granted.

24. A post-vesting restriction on the transfer of the equity instruments is a non-vesting condition, and must be taken into account in determining the fair value of equity instruments granted to the extent that the restriction would affect the price that a knowledgeable, willing market participant would pay for those equity instruments.

25. Restrictions on transfer or other restrictions that exist during the vesting period shall not be taken into account when estimating the grant date fair value of the equity instruments granted because those transfer restrictions stem from the existence of vesting conditions.

Effective Date

26. An entity shall apply this FRP for annual periods beginning on or after xxx[4]. Earlier application is permitted and encouraged. If an entity applies this FRP for an earlier period, it shall disclose that fact.

27. This FRP shall be applied retrospectively subject to the provisions of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

[4] Proposed effective date is annual periods beginning on or after 1 January 2018. To be determined once finalised.

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Illustrative Examples

These examples accompany, but are not part of this FRP.

These examples of the application of the scope of the FRP and its consensus are not an exhaustive list, as other fact patterns are possible.

Illustrative Examples of the application of the scope

Exclusion of goods or services that are unrelated to obtaining BEE equity credentials (paragraphs 6 to 10 of the FRP)

Example 1

Facts

IE1 A BEE partner is paid commission, through the issue of equity instruments, on the basis of profits from contracts that it is instrumental in obtaining on behalf of the entity. The fair value of the service received by the entity is equal to the fair value of the equity instruments. Is the payment of commission within the scope of this FRP?

Conclusion

IE2 The recognition of the commission and equity instruments issued is not within the scope of this FRP because there is no BEE equity credential element in the transaction.

IE3 The payment of this commission is, however, clearly within the scope of IFRS 2.

Example 2

Facts

IE4 An entity issues equity instruments to a BEE partner for the purpose of acquiring a building. The fair value of the building acquired is lower than the fair value of the equity instruments given up. Is this transaction within the scope of this FRP?

Conclusion

IE5 IFRS 2 applies to transactions in which goods or services are received. IFRS 2, therefore, clearly applies to the building element, as this is identifiable through its fair value. Assuming that there are no other clearly identifiable goods or services, the difference between the fair value of the building and the fair value of the equity instruments is attributable to BEE equity credentials and is, therefore, within the scope of this FRP.

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Example of partial capitalisation of BEE equity credentials as part of the acquisition of another intangible asset (paragraph 15 of the FRP)

Example 3

Facts

IE6 Company A enters into a BEE transaction with a black-owned company, Company B, in which it sells 25% of its ordinary share capital to Company B at a 20% discount to the fair value of the shares. In return, Company B has contractually agreed to buy a specific minimum number of tyres exclusively from A over the next seven years to meet its production requirements. Assume that the right to future revenue arising from the supply contract meets the definition of an intangible asset in terms of IAS 38.

Conclusion

IE7 In terms of the facts, Company A has issued shares in order to secure future revenue through the supply of tyres to Company B over the next seven years. The supply contract is considered to be 'goods' received, in the form of intangible assets, in terms of IFRS 2 paragraph 7. IFRS 2 requires that *"the entity shall measure the goods or services received, and the corresponding increase in equity, directly, at the fair value of the goods or services received, unless the fair value cannot be estimated reliably"*.

IE8 IFRS 2, therefore, clearly applies to the intangible asset arising from the supply contract. Assuming that there are no other clearly identifiable goods or services, the difference between the fair value of the intangible asset arising from the supply contract and the fair value of the equity instruments is attributable to BEE equity credentials. Also, assuming that the supply contract and the BEE equity credentials are directly linked, the difference should be capitalised to the intangible asset in accordance with paragraph 15 of this FRP only to the extent of the fair value of the supply contract. Any excess over the fair value of the supply contract should be expensed in terms of this FRP.

Examples of application of the consensus in relation to vesting conditions (paragraphs 18 to 25 of the FRP)

Example 4

Facts

IE9 In order to obtain BEE equity credentials, Company A introduces a BEE share incentive scheme for its black directors. In terms of the scheme, Company A grants share options to these black directors in return for which the black directors are required to remain in the company's employ for three years. The number of options that the black directors will be entitled to depends on profit growth at the end of the three years. Therefore, the actual number of options to be delivered to the black directors will not be finalised until the end

of year three. Over what period should the expense related to these options be recognised?

Conclusion

IE10 In terms of IFRS 2 paragraph 15, the services received in relation to a share-based payment arrangement, to which payment the counterparty does not become entitled to immediately should be recognised as an expense over the vesting period. Performance conditions require the counterparty to complete a specified period of service and to meet specified performance targets (such as a specified increase in the entity's profit over a specified period of time).

IE11 Because the black directors are required to be in the employment of the company for a service period in order to be entitled to a certain number of options, and are required to meet a specified profit target, the grant has a non-market performance condition. The expense should be recognised over the three-year service period. As the vesting condition is a non-market performance condition, it shall not be taken into account when estimating the fair value of the equity instruments at the measurement date. Instead, the number of equity instruments included in the measurement of the transaction amount shall be adjusted so that the cumulative amount recognised for goods or services received as consideration for the equity instruments granted shall be based on the number of equity instruments that the black directors will become entitled to.

Example 5

Facts

IE12 Company B grants share options to a BEE consortium. The BEE consortium does not need to provide any further identifiable service or deliver goods, although it is locked into the BEE transaction for a period of five years. The number of share options that the BEE consortium will be entitled to depends on the profit growth over the next five years. Therefore, the actual number of share options to be delivered will not be finalised until after year five. Over what period should the expense related to these options be recognised? What are the implications of the profit target and the post-vesting transfer on the valuation of the expense?

Conclusion

IE13 The BEE consortium is not required to complete a specified period of service. Therefore, there are no services or performance vesting conditions attached to the grant, and the expense should be recognised in profit and loss on grant date. The profit target and the post-vesting transfer restrictions are non-vesting conditions, which should be taken into account when estimating the fair value of the equity instrument, and should not be included as an adjustment to the number of options the BEE consortium is expected to be entitled to.

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Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of the FRP.

BC1 This Basis for Conclusions summarises the considerations of the Financial Reporting Standards Council (FRSC) in reaching its consensus. Individual FRSC members gave greater weight to some factors than to others.

Issue 1

BC2 The South African government has issued various BEE documents, including the Broad-Based Black Economic Empowerment Act, Act No. 53 of 2003. This Act empowers the Minister of Trade and Industry to issue codes of good practice, which currently are not legally binding, with the purpose of achieving meaningful participation by black people in the South African economy. These codes will be applied in determining both foreign and local entities' BEE credentials that are necessary for the granting of tenders, licences and other concessions by government in South Africa.

BC3 In a BEE transaction, the entity, therefore, issues equity instruments in order to obtain a certain number of points that contribute to the entity's overall BEE scorecard and the entity's ability to tender for business.

BC4 Entities that do not have favourable BEE credentials are finding it difficult to operate effectively as a result of tender criteria that require, amongst other things, minimum participation of black people. Entities, therefore, enter into BEE transactions with the intention of either preventing loss of future revenue or increasing opportunities to obtain future revenues.

BC5 Because an entity relies on the market and government (its customers) to decide whether a BEE transaction increases or maintains the entity's ability to operate and tender for business, it is difficult to determine whether the entity has actually received goods or services, as contemplated by accounting frameworks, as a result of concluding the BEE transaction.

BC6 In addition, the issue of equity instruments is merely one element that contributes to the determination of the entity's BEE scorecard, as mentioned in paragraph 6 of this FRP, and, therefore, the issue of equity instruments has no direct relationship to the value the entity's customers will place on the issue of the equity instruments or the amount of business the entity will obtain from its customers.

BC7 The nature of BEE equity credentials may, therefore, be likened to internally generated intangible assets, where in terms of paragraph 51 of IAS 38:

"*It is sometimes difficult to assess whether an internally generated intangible asset qualifies for recognition because of problems in*:

(a) *Identifying whether and when there is an identifiable asset that will*

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generate expected future economic benefits; and

(b) *Determining the cost of the asset reliably. In some cases, the cost of generating an intangible asset internally cannot be distinguished from the cost of maintaining or enhancing the entity's internally generated goodwill or of running day-to-day operations.*

Therefore, in addition to complying with the general requirements for the recognition and initial measurement of an intangible asset, an entity applies the requirements and guidance in paragraphs 52 – 67 to all internally generated intangible assets."

BC8 **Definition of intangible asset:** Paragraph 8 of IAS 38 defines an intangible asset as "*an identifiable non-monetary asset without physical substance*".

BC9 An intangible asset is identifiable in terms of paragraph 12 of IAS 38 "when it:

(a) *Is seperable, i.e. is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability; regardless of whether the entity intends to do so*; or

(b) *Arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations."*

BC10 An asset is defined as "a resource:

(a) *Controlled by an entity as a result of past events; and*

(b) *From which future economic benefits are expected to flow to the entity."*

(paragraph 8 of IAS 38)

BC11 The BEE equity credentials that may be created in a BEE transaction are a non- monetary item without physical substance.

BC12 **Identifiable:** The BEE equity credentials are not separable as they are linked to the business as a whole and the BEE partner to whom the equity instruments have been granted. The BEE equity credentials are, therefore, not capable of being sold, transferred, licensed, rented or exchanged separately from the business.

BC13 The BEE equity credentials may arise from contractual rights where the BEE transaction includes a contract between the entity and the BEE partner. Where this is the case, the BEE equity credentials could be considered identifiable.

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BC14 **Control**: IAS 38 paragraph 13 states that "*An entity controls an asset if the entity has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits. The capacity of an entity to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law. In the absence of legal rights, it is more difficult to demonstrate control. However, legal enforceability of a right is not a necessary condition for control because an entity may be able to control the future economic benefits in some other way.*"

BC15 Furthermore, IAS 38 paragraph 16 states that "*An entity may have a portfolio of customers or a market share and expect that, because of its efforts in building customer relationships and loyalty, the customers will continue to trade with the entity. However, in the absence of legal rights to protect, or other ways to control, the relationships with customers or the loyalty of the customers to the entity, the entity usually has insufficient control over the expected economic benefits from customer relationships and loyalty for such items (e.g., portfolio of customers, market shares, customer relationships and customer loyalty) to meet the definition of intangible assets. In the absence of legal rights to protect customer relationships, exchange transactions for the same or similar non-contractual customer relationships (other than as part of a business combination) provide evidence that the entity is nonetheless able to control the expected future economic benefits flowing from the customer relationships. Because such exchange transactions also provide evidence that the customer relationships are separable, those customer relationships meet the definition of an intangible asset.*"

BC16 Therefore, in terms of IAS 38, control over an intangible asset may be evidenced in two ways:

(a) as legal rights that are enforceable by law; or

(b) as exchange transactions for the same or similar non-contractual customer relationships.

BC17 In BEE transactions, a contract is usually entered into with a BEE partner. The contract between the entity and the BEE partner may include a contractual lock-in period or a clause that only allows the transfer of such equity instruments to another BEE partner. However, the contract does not provide the entity with legal rights that give it the power to obtain the future economic benefits arising from the BEE transaction, nor the ability to restrict the access of others to those benefits.

BC18 In the absence of a specific contract between the entity and a counterparty, for example a sales or supply agreement with a customer which provides the entity with legal rights that give it the power to obtain the future economic benefits arising from the BEE transaction and the ability to restrict the access of others to those benefits and which is concluded on the basis

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of the BEE transaction and at the time that the BEE transaction is concluded, the contract between the entity and the BEE partner does not establish control over future economic benefits.

BC19 In addition, exchange transactions do not exist for BEE equity credentials because BEE equity credentials are linked to the business as a whole and the BEE partner to whom the equity instruments have been granted. Therefore, BEE equity credentials are not capable of being exchanged separately from the business.

BC20 This means that, in a BEE transaction, the BEE equity credentials are not controlled by the entity because the entity is not able to demonstrate that the entity has the power to obtain the future economic benefits flowing from the underlying resource either through legal rights or through exchange transactions.

BC21 **Future economic benefits**: Paragraph 17 of IAS 38 states that "*the future economic benefits flowing from an intangible asset may include revenue from the sale of products, services, cost savings, or other benefits resulting from the use of the asset by the entity*". As mentioned previously, all organs of state and public entities must take an entity's BEE status into account when determining awards of business contracts. Entities may, therefore, enter into BEE transactions with the aim of either preventing loss of future revenue or increasing opportunities to obtain future revenue. The protection or enhancement of future revenues represents an economic benefit as envisaged by IAS 38.

BC22 **Conclusion on definition of intangible asset**: Paragraphs 8 and 9 of IFRS 2 require that "*when the goods or services received or acquired in a share-based payment transaction do not qualify for recognition as assets, they shall be recognised as expenses*".

BC23 Per the discussion above, BEE equity credentials do not meet the definition of an intangible asset:

Criteria	**Conclusion**
Identifiable non-monetary resource without physical substance	Yes
Controlled by the entity as a result of past events	No (however, refer to BC25)
From which future economic benefits are expected to flow	Yes, maybe

BC24 Therefore, the BEE equity credentials are expensed in profit or loss, except under the circumstances referred to in paragraph BC25 of this FRP.

BC25 It is considered extremely rare that the expenditure incurred to create or obtain BEE equity credentials may be capitalised as an asset. Only two

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situations are envisaged where BEE equity credentials may be capitalised as an asset:

(a) Where the BEE equity credentials are created or obtained in a business combination as discussed in Issue 2; or

(b) Where the cost of the BEE equity credentials is directly attributable to the acquisition of another intangible asset. In this situation the cost may be capitalised to the cost of the other intangible asset in accordance with paragraph 27(b) of IAS 38. (Refer to Illustrative Example 3.)

BC26 **Further discussions:** The FRSC also had further discussions with respect to the recognition of BEE equity credentials as intangible assets. These discussions are detailed below in paragraphs BC27 to BC36 of this FRP.

BC27 In terms of IAS 38, an item shall only be recognised as an intangible asset if an entity is able to demonstrate that:

(a) The item meets the above definition of an intangible asset;

(b) It is probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and

(c) The cost of the asset can be measured reliably.

BC28 While the FRSC agreed that the definition of intangible asset is not met, the FRSC had certain further discussions regarding criteria (b) and (c) above.

BC29 In applying the recognition criteria, the FRSC discussed whether the creation of BEE equity credentials through a BEE transaction is a separate acquisition or whether it is expenditure relating to internally generated goodwill. The FRSC concluded that the creation of BEE equity credentials is not a separate acquisition, but rather part of the development of the entity (i.e. internally generated). An entity ordinarily enters into a BEE transaction because of the requirement prescribed by government that it distribute equity instruments of the entity among black people.

BC30 IAS 38 paragraphs 48 to 50 state that:

"Internally generated goodwill shall not be recognised as an asset.

In some cases, expenditure is incurred to generate future economic benefits, but it does not result in the creation of an intangible asset that meets the recognition criteria in this Standard. Such expenditure is often described as contributing to internally generated goodwill. Internally generated goodwill is not recognised as an asset because it is not an identifiable resource (i.e. it is not separable nor does it arise from contractual or other legal rights) controlled by the entity that can be measured reliably at cost.

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Differences between the market value of an entity and the carrying amount of its identifiable net assets at any time may capture a range of factors that affect the value of the entity. However, such differences do not represent the cost of intangible assets controlled by the entity."

BC31 BEE equity credentials are measured with reference to the fair value of the equity instruments granted in terms of IFRS 2 because it is not possible to estimate reliably the fair value of the BEE equity credentials received. In other words, the total BEE transaction can be measured with reference to the equity instruments granted by the entity, but the amount that relates specifically to obtaining or creating BEE equity credentials cannot be reliably measured.

BC32 A number of factors indicate that the BEE equity credentials cannot be reliably measured and that the fair value of the equity instruments issued does not necessarily equal the fair value of the BEE equity credentials. For example:

(a) The entity relies on the market and government (its customers) to decide whether the BEE transaction increases or maintains the entity's ability to operate and tender for business.

(b) The percentage of equity instruments granted to a BEE partner is often driven by the minimum BEE equity ownership that is encouraged by government in the various industry charters. This implies that, if an entity with a smaller equity value enters into a BEE transaction and grants a certain percentage of its equity to the BEE partner, the value of the BEE equity credentials is less than it would be for an entity with a larger equity value. However, this is not necessarily the economic reality. The benefit that the entity receives does not necessarily increase proportionately as its equity value increases. Therefore, while the entity may gain value from the BEE transaction, this asset value is not capable of being reliably measured.

(c) The benefits an entity receives are dependent on the extent to which other entities and its competitors are 'empowered'.

(d) There may be other elements embodied in the discount given to the BEE partner that cannot be specifically identified, such as social responsibility.

(e) Where the BEE transaction requires that the BEE partner be employed for a specified period, the BEE transaction comprises two elements:

(i) services; and

(ii) BEE equity credentials.

Because of the nature of both of these elements, IFRS 2 requires them to be measured with reference to the fair value of the equity

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instruments granted; therefore, it would not be possible for an entity to split out and reliably measure the fair value of each element.

BC33 The BEE equity credentials created in a BEE transaction can, therefore, be likened to internally generated goodwill because the expenditure incurred through the issue of equity instruments merely contributes to the internally generated goodwill of the entity and cannot be distinguished from the cost of maintaining or enhancing the entity's internally generated goodwill.

BC34 Further, paragraphs 63 and 64 of IAS 38, which relate to internally generated assets, state that:

"Internally generated brands, mastheads, publishing titles, customer lists and items similar in substance shall not be recognised as intangible assets.

Expenditure on internally generated brands, mastheads, publishing titles, customer lists and items similar in substance cannot be distinguished from the cost of developing the business as a whole. Therefore, such items are not recognised as intangible assets."

BC35 Expenditure incurred on BEE equity credentials is in substance similar to the items mentioned in the above paragraphs because the BEE equity credentials cannot be distinguished from the cost of developing the business as a whole.

BC36 Expenditure incurred on BEE equity credentials is also similar in nature to expenditure on items such as advertising and promotional expenditure, which are described in paragraph 69 of IAS 38 and which are required to be expensed.

Issue 2

BC37 Paragraph 68 of IAS 38 requires that "*expenditure on an intangible item shall be recognised as an expense when it is incurred unless*:

(a) *It forms part of the cost of an intangible asset that meets the recognition criteria …*; or

(b) The item is acquired in a business combination and cannot be recognised as an intangible asset. If this is the case, it forms part of the amount recognised as goodwill at the acquisition date (see IFRS 3).

BC38 As discussed in Issue 1, the BEE equity credentials acquired represent an intangible item, which should not be recognised as an intangible asset. Therefore, where the BEE equity credentials are acquired as part of a business combination, this intangible item shall form part of the amount attributed to goodwill at the acquisition date.

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BC39 Paragraph BC3.26 of the *Conceptual Framework for Financial Reporting* states that:

"...Faithful representation means that financial information represents the substance of an economic phenomenon rather than merely its legal form. Representing a legal form that differs from the economic substance of the underlying economic phenomenon could not result in a faithful representation."

BC40 Where the business combination element of the transaction is insignificant or contrived, this would indicate that the substance of the transaction is in fact two separate transactions, a BEE transaction and a business combination. These two transactions should be accounted for separately, and the BEE transaction should be accounted for under IFRS 2.

Issue 3

BC41 Paragraph 15 of IFRS 2 states that:

"If the equity instruments granted do not vest until the counterparty completes a specified period of service, the entity shall presume that the services to be rendered by the counterparty as consideration for those equity instruments will be received in the future, during the vesting period. The entity shall account for those services as they are rendered by the counterparty during the vesting period, with a corresponding increase in equity." (emphasis added)

BC42 Paragraphs 19 to 21A of IFRS 2 state that:

"A grant of equity instruments might be conditional upon satisfying specified vesting conditions. For example, a grant of shares or share options to an employee is typically conditional on the employee remaining in the entity's employ for a specified period of time. There might be performance conditions that must be satisfied, such as the entity achieving a specified growth in profit or a specified increase in the entity's share price. Vesting conditions, other than market conditions, shall not be taken into account when estimating the fair value of the shares or share options at the measurement date. Instead, vesting conditions shall be taken into account by adjusting the number of equity instruments included in the measurement of the transaction amount so that, ultimately, the amount recognised for goods or services received as consideration for the equity instruments granted shall be based on the number of equity instruments that eventually vest. Hence, on a cumulative basis, no amount is recognised for goods or services received if the equity instruments granted do not vest because of failure to satisfy a vesting condition, eg. the counterparty fails to complete a specified service period, or a performance condition is not satisfied, subject to the requirements of paragraph 21. (emphasis added)

To apply the requirements of paragraph 19, the entity shall recognise an

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amount for the goods or services received during the vesting period based on the best available estimate of the number of equity instruments expected to vest and shall revise that estimate, if necessary, if subsequent information indicates that the number of equity instruments expected to vest differs from previous estimates. On vesting date, the entity shall revise the estimate to equal the number of equity instruments that ultimately vested, subject to the requirements of paragraph 21. (emphasis added)

Market conditions, such as a target share price upon which vesting (or exercisability) is conditioned, shall be taken into account when estimating the fair value of the equity instruments granted. Therefore, for grants of equity instruments with market conditions, the entity shall recognise the goods or services received from a counterparty who satisfies all other vesting conditions (e.g. services received from an employee who remains in service for the specified period of service), irrespective of whether that market condition is satisfied." (emphasis added)

"Similarly, an entity shall take into account all non-vesting conditions when estimating the fair value of the equity instruments granted. Therefore, for grants of equity instruments with non-vesting conditions, the entity shall recognise the goods and services received from the counterparty that satisfies all vesting conditions that are not market conditions, (e.g. services received from an employee who remains in service for the specified period of service) irrespective of whether those non-vesting conditions are satisfied."

BC43 Appendix A to IFRS 2 defines vesting conditions as *"the conditions that determine whether the entity receives the services that entitle the counterparty to receive cash or other assets or* ***equity instruments*** *of the entity, under a* ***share- based payment arrangement****. Vesting conditions are either service conditions or performance conditions. Service conditions require the counterparty to complete a specified period of service. Performance conditions require the counterparty to complete a specified period of service and specified performance targets to be met (such as specified increase in the entity's profit over a specified period of time). A performance condition might include a* ***market condition****."*

BC44 Market performance conditions exist when the BEE partner in a share-based arrangement must complete a specified period of service and meet a market performance target, such as a share price target. Where such conditions exist, these shall be taken into account when estimating the fair value of the equity instruments granted.

BC45 Other conditions are defined as being non-vesting conditions. Under IFRS 2, non-vesting conditions are considered when determining the fair value of the equity instruments granted to employees.

BC46 Non-market performance conditions, such as hurdle rates based on earnings or headline earnings, create a vesting period in BEE transactions only if the BEE partner is required to perform a specific period of service.

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Paragraph 19 of IFRS 2 requires that non-market performance conditions shall adjust the measurement of the transaction such that the expense is based on the number of equity instruments that the BEE partner eventually becomes entitled to.

BC47 IFRS 2 requires the expense, which is recognised for BEE equity credentials, to be recognised as the related services are rendered.

BC48 If no services are required to be rendered by the BEE partner, an expense shall be recognised immediately.

BC49 This effectively results in recognition of the expense during the vesting period, but on a basis that reflects when the goods and services, i.e. BEE equity credentials, are received.

BC50 Transfer and other restrictions are currently common within BEE transactions. Paragraphs B2 and B3 of Appendix B to IFRS 2 provide the following guidance on restrictions that may be incorporated into an issue of shares:

"For shares granted to employees, the fair value of the shares shall be measured at the market price of the entity's shares (or an estimated market price, if the entity's shares are not publicly traded), adjusted to take into account the terms and conditions upon which the shares were granted (except for vesting conditions that are excluded from the measurement of fair value in accordance with paragraphs 19–21).

For example, if the employee is not entitled to receive dividends during the vesting period, this factor shall be taken into account when estimating the fair value of the shares granted. Similarly, if the shares are subject to restrictions on transfer after vesting date, that factor shall be taken into account, but only to the extent that the post-vesting restrictions affect the price that a knowledgeable, willing market participant would pay for that share. For example, if the shares are actively traded in a deep and liquid market, post-vesting transfer restrictions may have little, if any, effect on the price that a knowledgeable, willing market participant would pay for those shares. Restrictions on transfer or other restrictions that exist during the vesting period shall not be taken into account when estimating the grant date fair value of the shares granted, because those restrictions stem from the existence of vesting conditions, which are accounted for in accordance with paragraphs 19–21." (emphasis added)

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DEPARTMENT OF TRADE AND INDUSTRY

NO. 234 **16 MARCH 2018**

COMPANIES ACT, 2008 (Act 71 of 2008)

FINANCIAL REPORTING PRONOUNCEMENT 3 ACCOUNTING FOR BLACK ECONOMIC EMPOWERMENT (BEE) TRANSACTIONS UNDER INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS) FOR SMALL AND MEDIUM ENTERPRISES

I, Dr Rob Davies, Minister of Trade and Industry, pursuant to the publication of notice 1448 in government gazette no 41338 dated 18 December 2017 for wider public consultation, publish the final notice on Financial Reporting Pronouncement 3. The final notice comes into force on the date of publication.

Dr Rob Davies, MP
Minister of Trade and Industry
12 February 2018

FINANCIAL REPORTING PRONOUNCEMENT 3

ACCOUNTING FOR BLACK ECONOMIC EMPOWERMENT (BEE) TRANSACTIONS UNDER IFRS FOR SMEs

Issued XXX 2017

FRP 3 ACCOUNTING FOR BLACK ECONOMIC EMPOWERMENT (BEE) TRANSACTIONS UNDER IFRS FOR SMEs

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FRP 3 ACCOUNTING FOR BLACK ECONOMIC EMPOWERMENT (BEE) TRANSACTIONS UNDER IFRS FOR SMEs

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FRP 3 ACCOUNTING FOR BLACK ECONOMIC EMPOWERMENT (BEE) TRANSACTIONS UNDER IFRS FOR SMEs

PREFACE

Financial Reporting Pronouncement 3 (FRP 3) has been issued by the Financial Reporting Standards Council (FRSC) and applies to companies applying IFRS for SMEs. It is applicable to both the 2009 and 2015 version of IFRS for SMEs.

Under IFRS for SMEs, Section 26 *Share-based Payment*, applies to the accounting for Black Economic Empowerment (BEE) transactions where the value of cash and other assets received is less than the fair value of equity instruments granted to the BEE partner, i.e. for the BEE equity credentials.

While Section 26 addresses the broad principle that equity instruments issued at a discount are within the scope of Section 26 it does not address issues specific to BEE transactions. This FRP seeks to address certain of these issues:

- Should the difference between the fair value of the equity instruments granted and the fair value of the cash and other assets received, i.e. the BEE equity credentials, be recognised as an intangible asset or as an expense?
- Where BEE equity credentials are obtained as part of the net assets acquired in a business combination, how should the BEE equity credentials acquired be accounted for?
- Assuming that BEE equity credentials do not meet the criteria for recognition as an intangible asset, how should vesting conditions be interpreted in the context of a BEE transaction?

A separate FRP (FRP 2 *Accounting for Black Economic Empowerment (BEE) Transactions under IFRS*) addresses these issues for companies applying IFRS.

With reference to the Preface to Financial Reporting Pronouncements and Guides Issued by the FRSC, the FRSC may issue Financial Reporting Pronouncements (FRPs) to provide authoritative guidance to preparers, auditors and users of financial statements, thus facilitating the standardisation of financial reporting.

This FRP has the same authority as IFRS for SMEs.

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ACCOUNTING FOR BLACK ECONOMIC EMPOWERMENT (BEE) TRANSACTIONS UNDER IFRS FOR SMEs

Paragraph 3.3 of Section 3 of IFRS for SMEs (Financial Statement Presentation) requires an entity whose financial statements comply with IFRS for SMEs to make an explicit and unreserved statement of such compliance in the notes. An entity shall not describe financial statements as complying with IFRS for SMEs unless they comply with all the requirements of IFRS for SMEs. Paragraph 3.16 states that assessing whether an omission or misstatement could influence economic decisions of users, and so be material, depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item or a combination of both, could be the determining factor.

References

(a) Section 2 – *Concepts and Pervasive Principles*;

(b) Section 10 – *Accounting Policies, Estimates and Errors*;

(c) Section 18 – *Intangible Assets other than Goodwill*;

(d) Section 26 – *Share-based Payment*;

(e) Section 19 – *Business Combinations and Goodwill*; and

(f) Appendix B – *Glossary of terms*

Background

1. The FRSC issued FRP 2 *Accounting for Black Economic Empowerment (BEE) Transactions under IFRS* in November 2016. Given that entities applying IFRS for SMEs may also enter into BEE transactions, the FRSC considered it would be useful to issue a similar FRP addressing the same issues under IFRS for SMEs.

2. Paragraph 26.17 of Section 26 of IFRS for SMEs clarifies that if the identifiable consideration received appears to be less than the fair value of the equity instruments granted or the liability incurred, this typically indicates that other consideration (i.e. unidentifiable goods or services) has been (or will be) received.

3. In the context of empowerment of black people[1] through meaningful participation

[1] As defined in terms of the Broad-Based Black Economic Empowerment Act No.53 of 2003

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in the South African economy, entities may issue equity instruments to black people or entities controlled by black people at a discount to fair value. The goods or services received from the black people or entities controlled by them in return for the equity instruments may or may not be specifically identifiable.

4. Section 26, therefore, applies to the accounting for BEE transactions where the fair value of cash and other assets received is less than the fair value of equity instruments granted to the BEE partner, i.e. to the BEE equity credentials.

Scope

5. While Section 26 addresses the broad principle that equity instruments issued at a discount are within the scope of Section 26, it does not address issues specific to BEE transactions. This FRP seeks to address certain of these issues.

6 BEE credentials are determined based on a scorecard that measures the following 5 elements[2]:

a) Ownership

b) - Management control

c) - Skills Development

d) - Enterprise and Supplier Development

e) - Socio-economic development

7 BEE credentials may be obtained in various ways, such as:

(a) equity ownership;

(b) management control;

(c) compliance with the Employment Equity Act;

(d) contribution to skills development;

(e) preferential procurement; and

(f) enterprise development.

8 This FRP considers only those BEE transactions where the entity grants equity instruments to black people (directly or indirectly) and the fair value of the cash and other assets received (or to be received), if any, is less than the fair value of the equity instruments granted.

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2 Amended Broad-Based Black Economic Empowerment Codes of Good Practice October 2012

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9 The equity instruments may take many legal forms, such as:

(a) ordinary shares;

(b) deferred ordinary shares;

(c) share options; and

(d) convertible preference shares or debentures.

10 The difference between the fair value of the cash and other assets received and the fair value of the equity instruments granted may arise because of specific goods or services that the BEE partner provides to the entity, or because of the BEE equity credentials that the entity has received. This FRP applies only to BEE transactions where there is a difference that arises from the entity obtaining BEE equity credentials. It does not apply to transactions where the BEE partner is issued with equity instruments for transactions that are unrelated to the entity obtaining BEE equity credentials, because the requirements of Section 26 are adequate for such transactions.

11 Types of structures that are considered to be within the scope of this FRP include, but are not limited to, the following:

(a)leveraged buyout structures where equity is issued to an empowerment partner and the issuer of the equity (or a related party) provides or guarantees the borrowings required to purchase the equity;

(b)structures where equity is issued at a nominal amount by a new entity to all participants so that the entity can obtain BEE equity credentials;

(c)structures where equity is issued to or acquired by the BEE partner at a price equal to its fair value, where such issue or acquisition is funded by a notional loan whereby the loan is repaid via the dividends from the equity instruments;

(d)transactions between shareholders of an entity that enable the entity to obtain BEE equity credentials;

(e)transactions that facilitate BEE through a special-purpose entity for obtaining BEE equity credentials; and

(f) business combinations between BEE businesses in order for at least one entity to obtain further BEE equity credentials.

Issues

12 **Issue 1**: Should the difference between the fair value of the equity instruments granted and the fair value of the cash and other assets received, i.e. the BEE equity credentials, be recognised as an intangible asset or as an expense?

13 **Issue 2**: Where BEE equity credentials are obtained as part of the net assets acquired in a business combination, how should the BEE equity credentials

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acquired be accounted for?

14 **Issue 3**: *Assuming that BEE equity credentials do not meet the criteria for recognition as an intangible asset, how should vesting conditions be interpreted in the context of a BEE transaction?*

Consensus

15 **Issue 1**: The difference between the fair value of the equity instruments granted and the fair value of the cash and other assets received, i.e. the BEE equity credentials, represents an internally generated intangible item. Such items (even if they meet the definition of an intangible asset) do not qualify for recognition as assets under IFRS for SMEs. The difference should be expensed.

16 Where the cost of the BEE equity credentials is directly attributable to the acquisition of another intangible asset that does qualify for recognition, then such an intangible asset should be valued at its fair value and any additional BEE equity credential costs should be expensed.

17 **Issue 2**: Where BEE equity credentials are obtained as part of the net assets acquired in a business combination, the BEE equity credentials do not qualify for recognition as an intangible asset and shall, therefore, form part of goodwill.

18 Where the business combination element of the transaction is insignificant or contrived, this would indicate that the substance of the transaction is in fact two separate transactions – a BEE transaction and a business combination. These two transactions should be accounted for separately. The BEE transaction should be accounted for under Section 26, and the business combination should be accounted for under Section 19.

19 **Issue 3**: The entity should assess whether the terms of the BEE transaction include service conditions, performance conditions, or non-vesting conditions.

20 Where the BEE transaction includes service conditions, the fair value of the equity instruments shall be measured at grant date and the expense should be recognised over the vesting period, which is the period over which services are rendered to the entity. The service condition shall not be taken into account when estimating the fair value of the equity instrument. Where the BEE transaction includes no service conditions, the fair value of the equity instruments shall be measured at grant date and the expense should be recognised immediately on grant date.

21 Performance conditions exist where the counterparty must complete a service period and a performance target must be met. A performance condition may be either a market performance condition or a non-market performance condition.

22 Non-market performance conditions exist when the BEE partner must complete a specified period of service, and meet a non-market performance target, such as an earnings target. Where such non-market performance conditions exist, these

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shall not be taken into account when estimating the fair value of the equity instruments at the grant date. Instead, they shall be taken into account when estimating the number of equity instruments expected to vest. This estimate shall be revised if new information indicates that the estimate has changed. On vesting, the estimate shall be revised to equal the number of equity instruments that ultimately vested. This means that the cumulative amount recognised for goods or services received (i.e. BEE equity credentials) as consideration for the share-based payment shall be based on the number of equity instruments that the BEE partner will become entitled to.

23 Market performance conditions exist when the BEE partner must complete a specified period of service, and meet a market performance target, such as a share price target. Where such conditions exist, the market performance target shall be taken into account when estimating the fair value of the equity instruments granted.

24 Where a non-vesting condition exists in a BEE transaction, it shall be taken into account when estimating the fair value of the equity instruments granted.

Effective Date

25 An entity shall apply this FRP for annual periods beginning on or after xxx[3].. Earlier application is permitted and encouraged. If an entity applies this FRP for an earlier period, it shall disclose that fact.

26 This FRP shall be applied retrospectively subject to the provisions of section 10 *Accounting Policies, Estimates and Errors* of IFRS for SMEs.

[3] Proposed effective date is annual periods beginning on or after 1 January 2018.

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FRP 3 ACCOUNTING FOR BLACK ECONOMIC EMPOWERMENT (BEE) TRANSACTIONS UNDER IFRS FOR SMEs

Illustrative Examples

These examples accompany, but are not part of this FRP.

These examples of the application of the scope of the FRP and its consensus are not an exhaustive list, as other fact patterns are possible.

Illustrative Examples of the application of the scope

Exclusion of goods or services that are unrelated to obtaining BEE equity credentials (paragraphs 6 to 10 of the FRP)

Example 1

Facts

IE1 A BEE partner is paid commission, through the issue of equity instruments, on the basis of profits from contracts that it is instrumental in obtaining on behalf of the entity. The fair value of the service received by the entity is equal to the fair value of the equity instruments. Is the payment of commission within the scope of this FRP?

Conclusion

IE2 The recognition of the commission and equity instruments issued is not within the scope of this FRP because there is no BEE equity credential element in the transaction.

IE3 The payment of this commission is, however, clearly within the scope of Section 26.

Example 2

Facts

IE4 An entity issues equity instruments to a BEE partner for the purpose of acquiring a building. The fair value of the building acquired is lower than the fair value of the equity instruments given up. Is this transaction within the scope of this FRP?

Conclusion

IE5 Section 26 applies to transactions in which goods or services are received. Section 26, therefore, clearly applies to the building element, as this is identifiable through its fair value. Assuming that there are no other clearly identifiable goods or services, the difference between the fair value of the building and the fair value of the equity instruments is attributable to BEE equity

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credentials and is, therefore, within the scope of this FRP.

Example of partial capitalisation of BEE equity credentials as part of the acquisition of another intangible asset (paragraph 15 of the FRP)

Example 3

Facts

IE6 Company A enters into a BEE transaction with a black-owned company, Company B, in which it sells 25% of its ordinary share capital to Company B at a 20% discount to the fair value of the shares. In return, Company B has contractually agreed to buy a specific minimum number of tyres exclusively from A over the next seven years to meet its production requirements. Assume that the right to future revenue arising from the supply contract meets the definition of an intangible asset in terms of Section 18.

Conclusion

IE7 In terms of the facts, Company A has issued shares in order to secure future revenue through the supply of tyres to Company B over the next seven years. The supply contract is considered to be 'goods' received, in the form of intangible assets, in terms of Section 26 paragraph 26.3. Paragraph 26.7 requires that "*the entity shall measure the goods or services received, and the corresponding increase in equity, at the fair value of the goods or services received, unless the fair value cannot be estimated reliably*".

IE8 Section 26, therefore, clearly applies to the intangible asset arising from the supply contract. Assuming that there are no other clearly identifiable goods or services, the difference between the fair value of the intangible asset arising from the supply contract and the fair value of the equity instruments is attributable to BEE equity credentials. Also, assuming that the supply contract and the BEE equity credentials are directly linked, the difference should be capitalised to the intangible asset in accordance with paragraph 15 of this FRP only to the extent of the fair value of the supply contract. Any excess over the fair value of the supply contract should be expensed in terms of this FRP.

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FRP 3 ACCOUNTING FOR BLACK ECONOMIC EMPOWERMENT (BEE) TRANSACTIONS UNDER IFRS FOR SMEs

Examples of application of the consensus in relation to vesting conditions (paragraphs 18 to 23 of the FRP)

Example 4

Facts

IE9 In order to obtain BEE equity credentials, Company A introduces a BEE share incentive scheme for its black directors. In terms of the scheme, Company A grants share options to these black directors in return for which the black directors are required to remain in the company's employ for three years. The number of options that the black directors will be entitled to depends on profit growth at the end of the three years. Therefore, the actual number of options to be delivered to the black directors will not be finalised until the end of year three. Over what period should the expense related to these options be recognised?

Conclusion

IE10 In terms of paragraph 26.6 of Section 26, the services received in relation to a share-based payment arrangement, to which payment vests only once the counterparty completes a specified service period, shall be recognised as an expense over the vesting period.

IE11 Because the black directors are required to be in the employment of the company for a service period in order to be entitled to a certain number of options, and are required to meet a specified profit target, the grant has a non-market performance or vesting condition. The expense should be recognised over the three-year service period. Per paragraph 26.9(a) of Section 26 as meeting a specified profit target is a non-market performance condition, it shall not be taken into account when estimating the fair value of the equity instruments at the measurement date.

Instead, the non-market perfomance condition shall be taken into account when estimating the number of equity instruments expected to vest. Subsequently, the estimate shall be revised if new information indicates that it is expected to be different. On vesting date, the estimate shall be revised to equal the number of equity instruments that the black directors will become entitled to.

Example 5

Facts

IE12 Company B grants share options to a BEE consortium. The BEE consortium does not need to provide any further identifiable service or deliver goods, although it is locked into the BEE transaction for a period of five years. The number of share options that the BEE consortium will be entitled to depends on the profit growth over the next five years. Therefore, the actual number of share options to be delivered will not be finalised until after year five. Over what period

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should the expense related to these options be recognised? What are the implications of the profit target and the post-vesting transfer on the valuation of the expense?

Conclusion

IE13 The BEE consortium is not required to complete a specified period of service. Therefore, there are no services or performance vesting conditions attached to the grant, and the expense should be recognised in profit and loss on grant date. The profit target and the post-vesting transfer restrictions are non-vesting conditions, and in terms of paragraph 26.9(b) they should be taken into account when estimating the fair value of the equity instruments granted, and should not be included as an adjustment to the number of options the BEE consortium is expected to be entitled to.

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Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of the FRP.

BC1 This Basis for Conclusions summarises the considerations of the Financial Reporting Standards Council (FRSC) in reaching its consensus. Individual FRSC members gave greater weight to some factors than to others.

Issue 1

BC2 The South African government has issued various BEE documents, including the Broad-Based Black Economic Empowerment Act, Act No. 53 of 2003. This Act empowers the Minister of Trade and Industry to issue codes of good practice, which currently are not legally binding, with the purpose of achieving meaningful participation by black people in the South African economy. These codes will be applied in determining both foreign and local entities' BEE credentials that are necessary for the granting of tenders, licences and other concessions by government in South Africa.

BC3 In a BEE transaction, the entity, therefore, issues equity instruments in order to obtain a certain number of points that contribute to the entity's overall BEE scorecard and the entity's ability to tender for business.

BC4 Entities that do not have favourable BEE credentials are finding it difficult to operate effectively as a result of tender criteria that require, amongst other things, minimum participation of black people. Entities, therefore, enter into BEE transactions with the intention of either preventing loss of future revenue or increasing opportunities to obtain future revenues.

BC5 Because an entity relies on the market and government (its customers) to decide whether a BEE transaction increases or maintains the entity's ability to operate and tender for business, it is difficult to determine whether the entity has actually received goods or services, as contemplated by accounting frameworks, as a result of concluding the BEE transaction.

BC6 In addition, the issue of equity instruments is merely one element that contributes to the determination of the entity's BEE scorecard, as mentioned in paragraph 6 of this FRP, and, therefore, the issue of equity instruments has no direct relationship to the value the entity's customers will place on the issue of the equity instruments or the amount of business the entity will obtain from its customers.

BC7 The nature of BEE equity credentials may, therefore, be likened to internally generated intangible items. Given that paragraph 18.4(c) of Section 18, does not permit internally generated intangible assets to be recognised as assets under IFRS for SMEs, it is not necessary to assess whether the BEE credentials meet the definition of an intangible asset. Even if they do, paragraph 18.14 of Section 18 requires expenditure incurred internally on internally generated intangible assets to be expensed unless it forms part of the cost of another asset that meets the recognition criteria in Section 18.

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BC8 Paragraph 18.15 of IFRS for SMEs provides examples of items the expenditure on which should be expensed:

(a) internally generated brands, logos, publishing titles, customer lists and items similar in substance;

(b) Start-up activities;

(c) Training activities;

(d) Advertising and promotional activities;

(e) Relocating or reorganising part or all of the entity; and

(f) Internally generated goodwill.

BC9 **Conclusion on recognition of an asset**: Since paragraph 18.4(c) prohibits the capitalisation of internally generated intangible assets, even if the BEE equity credentials met the definition of intangible assets, they would not qualify for recognition as an asset. Paragraph 26.4 requires that *"when the goods or services received or acquired in a share-based payment transaction do not qualify for recognition as assets, the entity shall recognise them as expenses"*.

BC10 Therefore, the BEE equity credentials are expensed in profit or loss, except under the circumstances referred to in paragraph BC11 of this FRP.

BC11 It is considered extremely rare that the expenditure incurred to create or obtain BEE equity credentials may be capitalised as an asset. Only two situations are envisaged where BEE equity credentials may be capitalised as an asset:

(a) Where the BEE equity credentials are created or obtained in a business combination as discussed in Issue 2; or

(b) Where the cost of the BEE equity credentials is directly attributable to the acquisition of another intangible asset that qualifies for recognition under Section 18. In this situation the cost may be capitalised to the cost of the other intangible asset in accordance with Paragraph 18.14. (Refer to Illustrative Example 3.)

Issue 2

BC12 Section 19 of IFRS for SMEs deals with business combinations. Paragraphs 19.15 and 18.8 require the acquirer to recognise separately the acquiree's identifiable assets, liabilities and contingent liabilities at the date of acquisition only if certain criteria are satisfied. In the case of an intangible asset, the only criterion is that its fair value can be measured reliably without undue cost or effort.

BC13 Appendix B *Glossary of terms* of IFRS for SMEs defines an intangible asset as *"An identifiable non-monetary asset without physical substance. Such an asset*

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is identifiable when it

(a) *is separable, ie is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability; or*

(b) *arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations."*

BC14 An asset is defined in Appendix B of IFRS for SMEs as "a resource:

(c) *controlled by an entity as a result of past events; and*

(d) *from which future economic benefits are expected to flow to the entity*."

BC15 The BEE equity credentials that may be created in a BEE transaction are a non- monetary item without physical substance.

BC16 **Identifiable**: The BEE equity credentials are not separable as they are linked to the business as a whole and the BEE partner to whom the equity instruments have been granted. The BEE equity credentials are, therefore, not capable of being sold, transferred, licensed, rented or exchanged separately from the business.

BC17 The BEE equity credentials may arise from contractual rights where the BEE transaction includes a contract between the entity and the BEE partner. Where this is the case, the BEE equity credentials could be considered identifiable.

BC18 **Control**: In BEE transactions, a contract is usually entered into with a BEE partner. The contract between the entity and the BEE partner may include a contractual lock-in period or a clause that only allows the transfer of such equity instruments to another BEE partner. However, the contract does not provide the entity with legal rights that give it the power to obtain the future economic benefits arising from the BEE transaction, nor the ability to restrict the access of others to those benefits.

BC19 In the absence of a specific contract between the entity and a counterparty, for example a sales or supply agreement with a customer which provides the entity with legal rights that give it the power to obtain the future economic benefits arising from the BEE transaction and the ability to restrict the access of others to those benefits and which is concluded on the basis of the BEE transaction and at the time that the BEE transaction is concluded, the contract between the entity and the BEE partner does not establish control over future economic benefits.

BC20 In addition, exchange transactions do not exist for BEE equity credentials because BEE equity credentials are linked to the business as a whole and the BEE partner to whom the equity instruments have been granted. Therefore,

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BEE equity credentials are not capable of being exchanged separately from the business.

BC21 This means that, in a BEE transaction, the BEE equity credentials are not controlled by the entity because the entity is not able to demonstrate that the entity has the power to obtain the future economic benefits flowing from the underlying resource either through legal rights or through exchange transactions.

BC22 **Future economic benefits**: As mentioned previously, all organs of state and public entities must take an entity's BEE status into account when determining awards of business contracts. Entities may, therefore, enter into BEE transactions with the aim of either preventing loss of future revenue or increasing opportunities to obtain future revenue. The protection or enhancement of future revenues represents an economic benefit as envisaged by the definition of an intangible asset.

BC23 **Conclusion on definition of intangible asset**: The BEE equity credentials acquired do not meet the definition of an intangible asset. Accordingly, where the BEE equity credentials are acquired as part of a business combination, this intangible item shall form part of the amount attributed to goodwill at the acquisition date.

BC24 Paragraph 2.8 of Section 2 states that:

"Transactions and other events and conditions should be accounted for and presented in accordance with their substance and not merely their legal form. This enhances the reliability of financial statements."

BC25 Where the business combination element of the transaction is insignificant or contrived, this would indicate that the substance of the transaction is in fact two separate transactions, a BEE transaction and a business combination. These two transactions should be accounted for separately, and the BEE transaction should be accounted for under Section 26 of IFRS for SMEs.

Issue 3

BC26 Paragraph 26.3 of Section 26 requires the recognition of the goods or services received or acquired in a share-based payment transaction when those goods are obtained or the services are received.

BC27 Paragraph 26.5 of Section 26 states that:

"If the share-based payments granted to employees vest immediately, the employee is not required to complete a specified period of service before becoming unconditionally entitled to those share-based payments. In the absence of evidence to the contrary, the entity shall presume that services rendered by employees have been received. In this case, on grant date the entity shall recognise the services received in full, with a corresponding increase in equity and liabilities. (emphasis added)

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FRP 3 ACCOUNTING FOR BLACK ECONOMIC EMPOWERMENT (BEE) TRANSACTIONS UNDER IFRS FOR SMEs

BC28 Paragraph 26.6 of Section 26 states that:

"If the share-based payments do not vest until the employee completes a specified period of service, the entity shall presume that the services to be rendered by the counterparty as consideration for those share-based payments will be received in the future, during the vesting period. The entity shall account for those services as they are rendered by the employee during the vesting period, with a corresponding increase in equity or liabilities" (emphasis added)

BC29 Vesting conditions are defined in Appendix B of IFRS for SMEs as:

"The conditions that determine whether the entity receives the services that entitle the counterparty to receive cash, other assets or equity instruments of the entity under a share-based payment arrangement. Vesting conditions are either service conditions or performance conditions. Service conditions require the counterparty to complete a specified period of service. Performance conditions require the counterparty to complete a specified period of service and specified performance targets to be met (such as a specified increase in the entity's profit over a specified period of time). A performance condition might include a market vesting condition."

BC 30 A market vesting condition is defined in Appendix B of IFRS for SMEs as:

"A condition upon which the exercise price, vesting or exercisability of an equity instrument depends that is related to the market price of the entity's equity instruments, such as attaining a specified share price or a specified amount of intrinsic value of a share option, or achieving a specified target that is based on the market price of the entity's equity instruments relative to an index of market prices of equity instruments of other entities."

BC 31 According to paragraph 26.9(a):

"All vesting conditions related to employee service or to a non-market performance condition shall be taken into account when estimating the number of equity instruments expected to vest. Subsequently, the entity shall revise that estimate if new information indicates that the number of equity instruments expected to vest differs from previous estimates. On the vesting dates, the entity shall revise the estimate to equal the number of equity instruments that ultimately vested. Vesting conditions related to employee service or to a non-market performance condition shall not be taken into account when estimating the fair value of the shares, share options or other equity instruments at the measurement date."

BC 32 According to paragraph 26.9(b):

"All market vesting conditions and non-vesting conditions shall be taken into account when estimating the fair value of the shares, share options or other equity instruments at the measurement date, with no subsequent adjustment to the estimated fair value, irrespective of the outcome of the market or non-vesting condition, provided that all other vesting conditions are satisfied."

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FRP 3 ACCOUNTING FOR BLACK ECONOMIC EMPOWERMENT (BEE) TRANSACTIONS UNDER IFRS FOR SMEs

BC33 Based on the requirements of Section 26, if no services are required to be rendered by the BEE partner, an expense shall be recognised immediately, even if there is a lock-in period (i.e. a period during which the BEE partner may not sell their shares) or even if there are other conditions, such as earnings targets or share price targets.

BC34 This effectively results in recognition of the expense during the vesting period, but on a basis that reflects when the goods and services, i.e. BEE equity credentials, are received.

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DEPARTMENT OF TRADE AND INDUSTRY

NO. 235 **16 MARCH 2018**

COMPANIES ACT, 2008 (Act 71 of 2008)

FINANCIAL REPORTING PRONOUNCEMENT 5
SUMMARY FINANCIAL STATEMENTS

I, Dr Rob Davies, Minister of Trade and Industry, pursuant to the publication of notice 1444 in government gazette no 41338 dated 18 December 2017 for wider public consultation, publish the final notice on Financial Reporting Pronouncement 5. The final notice comes into force on the date of publication.

Dr Rob Davies, MP
Minister of Trade and Industry
12 February 2018

FINANCIAL REPORTING PRONOUNCEMENT 5

SUMMARY FINANCIAL STATEMENTS

Issued ... 2017

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PREFACE

Financial Reporting Pronouncement 5 – Summary Financial Statements has been issued by the Minister of Trade and Industries in terms of section 29 (4) of the Companies Act 2008, No 71 of 2008, to provide guidance on the requirements for preparing summary financial statements which may be provided in terms of section 29 (3) of this Act. This pronouncement was prepared by the Financial Reporting Standards Council (FRSC) and was submitted to the Minister to issue as a regulation in terms of section 204 of this Act.

With reference to the Preface to Financial Reporting Pronouncements and Guides issued by the FRSC, the FRSC may issue Financial Reporting Pronouncements (FRPs) to provide authoritative guidance to preparers, auditors and users of financial statements.

BACKGROUND

1. In terms of section 29(3) of the Companies Act 2008, No 71 of 2008 (the Act), a company may provide any person with a summary of any particular financial statements. This section requires the summary financial statements to comply with certain requirements as specified in the appendix to this Financial Reporting Pronouncement, but other than this does not specify requirements in relation to the form and content of such summary financial statements.

ISSUES

2. As the Act does not specify all the requirements for summary financial statements, this Financial Reporting Pronouncement deals with the following issues:
   - 2.1 What requirements should companies follow in determining what information should be included in summary financial statements, other than that specified in the Act;
   - 2.2 Should the requirements that companies follow be the same for all companies; and
   - 2.3 Should the requirements that companies follow be the same for all types of financial statements?

CONSENSUS

3. The requirements of this Financial Reporting Pronouncement apply to all categories of companies, except for those that in terms of the regulations to the Act use financial reporting standards as determined by the company as long as no Financial Reporting Standard is prescribed.

4. The requirements of this Financial Reporting Pronouncement only apply to annual financial statements and consolidated financial statements prepared in terms of Section 29(3) of the Act. No summary financial statements are to be prepared for other categories of financial statements as defined by the Act.

5. Other financial documents not prepared in terms of Section 29(3) of the Act, are not required to comply with the requirements of this Pronouncement, even if they termed as summary

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financial statements, financial information, an extract from annual financial statements or another term. To ensure summary financial statements prepared in terms of Section 29(3) of the Act are properly identified, the disclosures required by Section 29(3)(b) of the Act to be included on the first page of the summary financial statements are also to include a note that the summary has been prepared in terms of Section 29(3) of the Act.

6. If companies elect to issue summary financial statements then the summary financial statements are as a minimum to comply with the presentation and disclosure requirements of the International Accounting Standard 34 *Interim Financial Reporting* (IAS 34) as issued by the International Accounting Standards Board.

7. A regulator or stock exchange may have its own requirements for financial statements, including summary financial statements. A company is required to comply with the Act's requirements in relation to summary financial statements regardless of these other requirements. For example, a listed company may not be required to send a financial report comprising summary financial statements to its shareholders if this information is the same as that sent to shareholders before the issue of its annual financial statements, but as the financial report would not meet the requirements for summary financial statements a company still needs to send annual financial statements or summary financial statements to its shareholders.

8. If an auditor has performed an engagement to report on summary financial statements derived from financial statements, then the summary financial statements are to include an audit report's prepared in accordance with the International Standard on Auditing ISA 810 *Engagements to Report on Summary Financial Statements,* issued by the International Auditing and Assurance Standards Board.

9. If companies use International Financial Reporting Standards for Small and Medium-sized Entities (IFRS for SMEs) for the preparation of financial statements then such companies shall replace any reference in IAS 34 to IFRS to the directly comparable requirements in IFRS for SMEs. This means that the requirements of IAS 34 for a condensed statement of comprehensive income and condensed statement of changes in equity should be replaced with a condensed statement of income and retained earnings in those cases where companies using IFRS for SMEs are allowed to provide a single statement of income and retained earnings. The disclosure requirements contained in IAS 34 are to be complied with to the extent that such disclosures are required by IFRS for SMEs in annual financial statements. This also means the references in IAS 34 to earnings per share and segment information would not apply to companies using IFRS for SMEs.

EFFECTIVE DATE

10. A company shall apply this Financial Reporting Pronouncement with effect for annual periods beginning on or after 1 January 2018. Earlier application is encouraged.

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APPENDIX

Section 29(3) of the Companies Act 2008, No 71 of 2008 contains the following requirements in relation to summary financial statements:

"(3) A company may provide any person with a summary of any particular financial statements, but

(a) any such summary must comply with any prescribed requirements; and

(b) the first page of the summary must bear a prominent notice—

(i) stating that it is a summary of particular financial statements prepared by the company, and setting out the date of those statements;

(ii) stating whether the financial statements that it summarises have been audited, independently reviewed, or are unaudited, as contemplated in subsection (1) (e);

(iii) stating the name, and professional designation, if any, of the individual who prepared, or supervised the preparation of, the financial statements that it summarises; and

(iv) setting out the steps required to obtain a copy of the financial statements that it summarises."

BASIS OF CONCLUSION

Whether requirements should be issued

BC1 While the Act requires summary financial statements to comply with *'any prescribed requirements'*, this is interpreted as meaning that if no requirements are prescribed then it would be difficult to argue that any published summary financial statements would not be in compliance with the Act, if the other requirements of the Act are complied with. Thus prescribed requirements are not required to be issued in terms of the Act and accordingly companies can issue summary financial statements even if no prescribed requirements have been issued.

BC2 However, it is believed it would be desirable for requirements to be issued to ensure that the same minimum requirements are complied with by companies. This would ensure that a user of the summary financial statements would be able to determine what to expect regarding the form and content of summary financial statements, as well as enabling a user to ascertain whether all the required information has been provided. The issuing of requirements assists to ensure that companies know what is expected regarding the form and content of summary financial statements, as it appears that some companies have asked for this information, as well as providing more detail concerning requirements not specified in the Act.

BC3 In addition, such requirements promote sound and consistent accounting practices.

Which accounting standards should be used

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BC4 In the absence of any specified requirements it needs to be considered what guidance, if any, companies would use for preparing summary financial statements. It is likely that companies would use International Accounting Standard 34 *Interim Financial Reporting* (IAS 34) issued by the International Accounting Standards Board as appropriate guidance.

BC5 With IAS 34 being used for reporting for an interim period, which is defined as *'a financial reporting period shorter than a full financial year'* it would appear that it is not appropriate guidance for an annual period, but IAS 34 has been used in South Africa by listed companies for full financial years.

BC6 A local stock exchange has required or allowed companies to prepare various financial reports that as a minimum were to contain the information required by IAS 34, even though they covered an annual period. Such reports include those termed as condensed or summary financial statements.

BC7 Accordingly South African listed companies have used IAS 34 to report on annual information and have been accustomed to using the word 'summary' in relation to information prepared in accordance with IAS 34.

BC8 As listed companies have already using IAS 34 to provide annual summary information to shareholders, it is believed it would be appropriate to allow them to continue to report in a largely unchanged manner, as there does not appear to be significant concerns regarding providing summary financial statements in terms of IAS 34. This would mean that the summary financial statements would present the same information as contained in the other financial reports sent to shareholders before the issue of the annual financial statements or summary financial statements if there was no change in the information between their respective dates of issue and there would be little need to provide different or additional information or information in a different format, which is an approach that companies would want to avoid.

BC9 The International Accounting Standards Board has no other guidance applicable to summary financial statements and thus if IAS 34 was not used, guidance would have to be specifically developed. As any such guidance would take some time to develop and because IAS 34 appears to meet the needs of users of financial statements wanting summary financial statements, it is believed that companies should use IAS 34 as a basis to prepare summary financial statements. If a user wants additional information they can exercise their right to obtain a copy of the full set of financial statements.

Which companies the requirements should apply to

BC10 While the Act provides for different standards to be applicable to profit and non-profit companies as well as for different categories of profit companies, it is believed the requirements should provide for the same requirements to apply to all companies, except as dealt with below.

BC11 The reason for this is that it is possible that listed companies may make more use of the option to provide summary financial statements than unlisted companies as their annual reports are commonly longer than those of unlisted companies and thus there might be less of

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a demand for guidance for unlisted companies. In addition, it is believed that unlisted companies can apply the requirements of IAS 34 without undue cost or effort and that it is appropriate for unlisted companies to also have guidance which they should use. With a possible lesser demand for guidance for unlisted companies it is believed that the effort involved in preparing, producing and maintaining separate guidance for such companies would not be cost effective.

BC12 While the regulations to the Act presently still refer to South African Generally Accepted Accounting Practice (SA GAAP) as a basis that companies can use to prepare annual financial statements, the Financial Reporting Standards Council previously announced its use ceased for annual periods commencing on or after 1 December 2012. Accordingly there is no need for guidance on summary financial statements to refer to SA GAAP.

BC13 Certain companies may use International Financial Reporting Standards for Small and Medium-sized Entities (IFRS for SMEs) to prepare annual financial statements, but it does not provide guidance for the preparation of interim reports. It is believed that such companies could also use the presentation and disclosure requirements of IAS 34 to prepare summary financial statements. The one area where clarity should be provided is that IFRS for SMEs allows companies, in certain circumstances, to combine the statement of comprehensive income and statement of changes in equity into a single statement of income and retained earnings. In this case the requirements of IAS 34 for a condensed statement of comprehensive income and condensed statement of changes in equity should be replaced with a condensed statement of income and retained earnings. As IAS 34 may require disclosures not required by IFRS for SMEs, companies using IFRS for SMEs would not be required to provide these additional disclosures.

BC14 In terms of the regulations to the Companies Act certain companies may use financial reporting standards as determined by the company as long as no financial reporting standard is prescribed. At present no financial reporting standards have been specified for such companies and as such it is believed that the requirements for summary financial statements should not apply to such companies.

Which financial statements the requirements should apply to

BC15 Section 1 of the Act defines financial statements as including

'*(a) annual financial statements and provisional annual financial statements;*

(b) interim or preliminary reports;

(c) group and consolidated financial statements in the case of a group of companies; and

(d) financial information in a circular, prospectus or provisional announcement of results, that an actual or prospective creditor or holder of the company's securities, or the Commission, Panel or other regulatory authority, may reasonably be expected to rely on.'

BC16 Some of the items included in this definition, such as provisional, interim or preliminary reports and financial information in a circular, prospectus or provisional announcement may already be summary financial statements.

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BC17 Accordingly it is believed that summary financial statements should only apply to financial statements that would normally be made available to shareholders in an unabridged form and which might be summarised. Therefore summary financial statements should only apply to annual financial statements and consolidated financial statements. International Financial Reporting Standards and the Act do not define group financial statements, but colloquially it is an alternate term for consolidated financial statements.

BC18 Listed companies, in terms of stock exchange requirements, may not be required to publish financial reports if, for example, the information contained in their financial report published before the annual financial statements are published is unchanged. This, however, would not alter the requirement for such companies to provide summary financial statements to its shareholders if such an election is made. The reasons for this are as follows:

18.1 The previously issued report is typically issued before the annual financial statements are issued and thus would not have contained all the information required by section 29(3)(b) of the Act; and

18.2 Those who are shareholders at the time the summary financial statements are issued may not have been shareholders when the previously issued report was issued.

BC19 Companies may issue various financial reports, either for distribution to shareholders or for specific parties (e.g. bankers or potential acquirers). These may be termed by various names, including integrated reports, summary financial statements or extracts from annual financial statements. These financial reports are excluded from the scope of this pronouncement if they are not prepared in terms of Section 29(3) of the Act. To ensure summary financial statements prepared in terms of this Section of the Act are properly identified, they are to contain a note that they have been prepared in terms of Section 29(3) of the Act.

Requirements where financial statements have been audited

BC20 If the credibility of the summary financial statements is to be enhanced by a company engaging its auditor to examine these financial statements, the summary financial statements should contain a report from the company's auditors as to whether the summary financial statements derived from the audited financial statements are consistent in all material respects with those financial statements in accordance with the International Standard on Auditing 810 – *Engagements to Report on Summary Financial Statements*. At present there is no requirement for summary financial statements to be examined by the company's auditors, but it may elect to do so.

Effective date of requirements

BC21 The issue of when the requirements become effective also needs to be considered. As many companies reporting summary financial statements are already using IAS 34, the requirement to apply IAS 34 is not likely to affect many companies. In addition, other companies should be able to apply IAS 34 without undue cost and effort and would not require an extensive notice period. Therefore it is believed that companies be given at least three months' notice to

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comply with the requirements, but allowing companies to apply the requirements earlier if they so wish.

APPROVAL BY THE FINANCIAL REPORTING STANDARDS COUNCIL (FRSC) OF THE FINANCIAL REPORTING PRONOUNCEMENT ON SUMMARY FINANCIAL STATEMENTS

The Financial Reporting Pronouncement on Summary Financial Statements was approved by the requisite majority of members of the FRSC on 15 April 2016.

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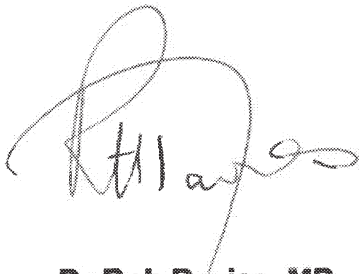
DEPARTMENT OF TRADE AND INDUSTRY

NO. 236 **16 MARCH 2018**

COMPANIES ACT, 2008 (Act 71 of 2008)

FINANCIAL REPORTING PRONOUNCEMENT 4
THE LIMIT ON A DEFINED BENEFIT ASSET, MINIMUM FUNDING REQUREMENTS AND THEIR INTERACTION UNDER INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS) IN THE SOUTH AFRICAN PENSION FUND ENVIRONMENT

I, Dr Rob Davies, Minister of Trade and Industry, pursuant to the publication of notice 1445 in government gazette no 41338 dated 18 December 2017 for wider public consultation, publish the final notice on Financial Reporting Pronouncement 4. The final notice comes into force on the date of publication.



Dr Rob Davies, MP
Minister of Trade and Industry
12 February 2018

FINANCIAL REPORTING PRONOUNCEMENT 4

THE LIMIT ON A DEFINED BENEFIT ASSET, MINIMUM FUNDING REQUIREMENTS AND THEIR INTERACTION UNDER IFRS IN THE SOUTH AFRICAN PENSION FUND ENVIRONMENT

Issued XXX 2017

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FRP 4 THE LIMIT ON A DEFINED BENEFIT ASSET, MINIMUM FUNDING REQUIREMENTS AND THEIR INTERACTION UNDER IFRS IN THE SOUTH AFRICAN PENSION FUND ENVIRONMENT

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FRP 4 THE LIMIT ON A DEFINED BENEFIT ASSET, MINIMUM FUNDING REQUIREMENTS AND THEIR INTERACTION UNDER IFRS IN THE SOUTH AFRICAN PENSION FUND ENVIRONMENT

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FRP 4 THE LIMIT ON A DEFINED BENEFIT ASSET, MINIMUM FUNDING REQUIREMENTS AND THEIR INTERACTION UNDER IFRS IN THE SOUTH AFRICAN PENSION FUND ENVIRONMENT

PREFACE

Financial Reporting Pronouncement 4 (FRP 4) has been issued by The Financial Reporting Standards Council (FRSC). It is applicable to companies within the ambit of the Companies Act 71 of 2008 applying International Financial Reporting Standards (IFRS).

This FRP provides guidance under IFRS on the application of IFRIC 14 – IAS 19 – *The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction* in South Africa in relation to defined benefit pension obligations (governed by the Pension Funds Act, 1956 (the Act)) within the scope of IAS 19 – *Employee Benefits*. Accordingly, this FRP applies to the employer entity and not to the pension fund. This FRP should be read together with IFRIC 14 and IAS 19.

FRP 4 only focuses on the following issues:

- What are minimum funding requirements?
- When should refunds be regarded as available in accordance with the definition of the asset ceiling in paragraph 8 of IAS 19 and how should they be measured?
- When should reductions in future contributions be regarded as available in accordance with the definition of the asset ceiling in paragraph 8 of IAS 19 and how should they be measured? And
- When would minimum funding requirements give rise to an additional liability?

There is no equivalent pronouncement for entities applying IFRS for SMEs because IFRS for SMEs does not contain an equivalent to IFRIC 14.

With reference to Preface to Financial Reporting Pronouncements and Guides issued by the FRSC, the FRSC may issue Financial Reporting Pronouncements (FRPs) to provide authoritative guidance to preparers, auditors and users of financial statements, thus facilitating the standardization of financial reporting.

This FRP has the same authority as IFRS.

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FRP 4 THE LIMIT ON A DEFINED BENEFIT ASSET, MINIMUM FUNDING REQUIREMENTS AND THEIR INTERACTION UNDER IFRS IN THE SOUTH AFRICAN PENSION FUND ENVIRONMENT

THE LIMIT ON A DEFINED BENEFIT ASSET, MINIMUM FUNDING REQUIREMENTS AND THEIR INTERACTION UNDER IFRS IN THE SOUTH AFRICAN PENSION FUND ENVIRONMENT

Paragraph .16 of IAS 1 – Presentation of Financial Statements, requires an entity whose financial statements comply with IFRSs to make an explicit and unreserved statement of such compliance in the notes. Financial statements shall not be described as complying with IFRSs unless they comply with all the requirements of IFRSs. Paragraph .7 states that assessing whether an omission or misstatement could influence economic decisions of users, and so be material, requires consideration of the characteristics of those users.

References

a) IFRIC 14 – IAS 19 – *The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction*

b) IAS 8 – *Accounting Policies, changes in Accounting Estimates and Errors*

c) IAS 19 – *Employee Benefits*

d) Pension Funds Act, 1956

e) Circular PF No. 66 – *Section 18 of the Pension Funds Act, 1956: Fund not in a sound financial condition*

Background

1. The Accounting Practices Board (APB) issued AC 504– *The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction in the South African Pension Fund Environment* in October 2010 as a local interpretation. Following the withdrawal of Statements of Generally Accepted Accounting Practice (GAAP) in 2012, SAICA issued the local interpretation as Financial Reporting Guide 3 after making necessary revisions to reflect the changes made to IFRIC 14 and IAS 19 in 2011. The Financial Reporting Standards Council (FRSC) has considered the content of this Guide and has issued it as a Financial Reporting Pronouncement (FRP).

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FRP 4 THE LIMIT ON A DEFINED BENEFIT ASSET, MINIMUM FUNDING REQUIREMENTS AND THEIR INTERACTION UNDER IFRS IN THE SOUTH AFRICAN PENSION FUND ENVIRONMENT

2. FRP 4 has been issued to provide guidance on the application of IFRIC 14 – *IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction* in South Africa in relation to a defined benefit pension obligations (governed by the Pension Funds Act, 1956 (the Act) within the scope of IAS 19 – *Employee Benefits*. Accordingly, this FRP applies to the employer entity and not to the pension fund.

3. FRP 4 should be read together with IFRIC 14 and IAS 19.

4. Paragraph 63 of IAS 19 requires an entity to recognise the net defined benefit (pension) liability/asset in the statement of financial position.

5. The net defined benefit liability/asset is the deficit or surplus adjusted for any effect of applying the asset ceiling limit.

6. The deficit or surplus is:

   a. The present value of the defined benefit obligation less

   b. The fair value of plan assets

7. The asset ceiling is defined as the present value of any economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan.

8. IFRIC 14 provides guidance on the following issues:

   - When refunds or reductions in future contributions should be regarded as 'available' in accordance with the definition of the asset ceiling.
   - How a minimum funding requirement might affect the availability of reductions in future contributions.
   - When a minimum funding requirement might give rise to an additional liability.

9. Section 16 of the Act requires the financial condition of a fund to be determined (at a minimum) every three years by a qualified actuary. Such valuations are known as statutory valuations. Statutory valuations are also used as the basis for determining the level of contributions. For the purpose of this FRP, any deficits arising from such valuations are referred to as 'statutory deficits' and any surpluses as 'statutory surpluses'. The valuation is performed in terms of section 16 of the Act and Professional Guidance Note 201 issued by the Actuarial Society of South Africa.

10. The present value of the defined benefit obligation determined in accordance with IAS 19 less the fair value of the plan assets, if positive, is referred to as the 'accounting deficit' and, if negative, is referred to as the 'accounting surplus' for the purpose of this FRP.

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11. The requirements for determining the accounting deficit or surplus may not necessarily be the same as the requirements and guidelines used in determining the statutory deficit or surplus. The main reason for the differences stems from the fact that the IAS 19 valuation reflects the financial position of the fund at a point in time, while the purpose of the statutory valuation is to determine the appropriate level of funding for the long-term pension obligation.

12. Given the long-term nature of the obligation and the variables which may affect the amount and timing of the cash outflows as well as the variables which may affect the amount and timing of the cash inflows of the assets of the fund, the net financial position may fluctuate quite significantly over time. This could result in fluctuating contribution levels. To achieve a more stable contribution level, the Act permits certain reserves to be created in the determination of the statutory deficit or surplus.

    Such reserves may include solvency reserves; contingency reserves; contribution reserves; and data, risk and processing error reserves. The determination of the accounting deficit or surplus is set out in paragraph 10 of this FRP. IAS 19 does not permit the recognition of liabilities for such reserves, nor does it permit the plan assets to be measured at an amount other than fair value.

13. As a result of the above, the accounting deficit or surplus may be quite different from the statutory deficit or surplus. This FRP focuses on the accounting deficit or surplus[1] since this amount forms part of the net defined benefit liability/asset required to be recognised in terms of paragraph 63 of IAS 19.

Scope

14. This FRP considers only defined benefit pension plans governed by the Act from the perspective of the employer.

15. The word 'employer' is used in the South African retirement funds industry to denote the 'entity' in IFRIC 14 and IAS 19. The words are used interchangeably in this FRP.

Issues

16. This FRP only focuses on the following issues in the application of IFRIC 14 by Pension Funds Act:

    I. Issue 1: What are minimum funding requirements?

[1] References to accounting deficit or surplus also include a nil position where the defined benefit obligation is equal to the fair value of the plan assets

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ii. **Issue 2: When should refunds be regarded as available in accordance with the definition of the asset ceiling in paragraph 8 of IAS 19 and how should they be measured?**

In this FRP, four possible scenarios are considered to illustrate the application of IFRIC 14 in a South African context. (It is not relevant whether a surplus apportionment exercise has been completed in terms of the Pension Funds Second Amendment Act, 2001.) The scenarios are as follows:

- Scenario 1 – the rules of the fund are silent regarding statutory surplus allocations (i.e. statutory surplus allocations are made at the discretion of the trustees);
- Scenario 2 – the rules of the fund indicate that all statutory surpluses are to be allocated to the employer;
- Scenario 3 – the rules of the fund indicate that all statutory surpluses are to be allocated to the members of the fund; and
- Scenario 4 – the rules of the fund indicate that all statutory surpluses are to be allocated in a specified proportion between the employer and members of the fund (for example 60% to the employer and 40% to the members).

iii **Issue 3: When should reductions in future contributions be regarded as available in accordance with the definition of the asset ceiling in paragraph 8 of IAS 19 and how should they be measured?**

iv. **Issue 4: When would minimum funding requirements give rise to an additional liability?**

Consensus

Issue 1: Minimum funding requirements

17. As outlined in paragraph 2 of IFRIC 14: *"Minimum funding requirements exist in many countries to improve the security of the post-employment benefit promise made to members of an employee benefit plan. Such requirements normally stipulate a minimum amount or level of contributions that must be made to a plan over a given period."*

18. Paragraph 5 of IFRIC 14 states that, for the purpose of that interpretation, *"... minimum funding requirements are* ***any requirements to fund*** *a post-*

employment or other long-term defined benefit plan." (emphasis added).

19. Paragraph 18 of IFRIC 14 requires an entity to "... *analyse any minimum funding requirement at a given date into contributions that are required to cover (a) any existing shortfall for past service on the minimum funding basis and (b) future service".*

20. In a South African pension fund context, the contributions required to "*bring the fund into a financially sound condition within a reasonable period*" in accordance with the requirements of section 18 of the Act constitute a minimum funding requirement as contemplated in paragraph 18(a) of IFRIC 14 (i.e. a minimum funding requirement to cover any existing shortfall for past service on the minimum funding basis). (The contributions being referred to here are only those which are required in order to bring the fund into a financially sound condition, i.e. they exclude any contributions which will be payable to cover future service.) This type of minimum funding requirement is relevant for the purposes of considering whether an additional liability may be required to be recognised (refer to issue 4).

21. In a South African pension fund context, "*the contribution rate the valuator recommends be payable by the employer, taking into account the circumstances of the fund and ignoring any surplus or deficit*", as referred to in the definition of a "contribution holiday" in section 1 of the Act, constitutes a minimum funding requirement as contemplated in paragraph 18(b) of IFRIC 14 (i.e. a minimum funding requirement to cover future service). This type of minimum funding requirement is relevant in determining the availability of economic benefits in the form of reductions in future contributions (refer to Issue 3).

22. In some instances, the rules of the fund may specify the contribution rate payable by the employer. In such instances, this rate would be the minimum funding requirement to cover future service unless the contribution rate the valuator would recommend be payable is higher, in which case the higher rate would constitute such a minimum funding requirement.

23. As noted in paragraph 18 of IFRIC 14, actuaries/ valuators will be required to analyse an entity's contributions between those described in paragraph 18 (a) and (b) for the entity to be able to apply IFRIC 14.

Issue 2: Availability of an economic benefit in the form of a refund in accordance with the definition of the asset ceiling in paragraph 8 of IAS 19 and its measurement

24. Paragraph 11 of IFRIC 14 states that a "*refund is available to an entity only if the entity has an unconditional right to a refund*".

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25. The amount of any accounting surplus[2] that represents an economic benefit available as a refund is considered to be the following in the four scenarios outlined in paragraph 17(ii) of this FRP:

- Scenario 1 – The balance of any Employer Surplus Account (ESA) at the reporting date (limited to the accounting surplus) less any costs that would be incurred upon realisation.
- Scenario 2 – The accounting surplus at the reporting date less any costs that would be incurred upon realisation.
- Scenario 3 – The balance of any ESA[3] at the reporting date (limited to the accounting surplus[2]) less any costs that would be incurred upon realisation.
- Scenario 4 – The accounting surplus[2] at the reporting date less any costs that would be incurred upon realisation.

Issue 3: Availability of an economic benefit in the form of a reduction in future contributions in accordance with the definition of the asset ceiling in paragraph 8 of IAS 19 and its measurement

26. In accordance with paragraph 20 of IFRIC 14, if there is a minimum funding requirement for contributions relating to future service, the economic benefit available as a reduction in future contributions should be calculated as the sum of:

    a) any amount that reduces future minimum funding requirement contributions for future service because the entity made a prepayment (i.e. paid the amount before being required to do so); and

    b) the estimated future IAS 19 service cost to the entity in each period over the shorter of the expected life of the plan and the expected life of the entity, less the estimated minimum funding requirement contributions that would be required for future service in those periods if there were no prepayment as described in a). The future service cost to the entity excludes amounts that will be borne by employees.

27. In a South African pension fund context, prepayments of contributions for future

[2] In accordance with IAS 19 any surpluses to be allocated to the members increase the defined benefit obligation and hence result in a reduced accounting surplus. For example, if the accounting surplus is 100 before considering any allocations and the amount to be allocated to members (based on the rules and including any existing Member Surplus Account (MSA) balance) is 30, the resulting accounting surplus is 70 after consideration of such allocations. It is this amount that is being referred to when reference is made to determining the extent to which the accounting surplus is available as an economic benefit.
[3] This could be the case for example where an ESA existed at the date the rules changed to require subsequent surpluses to be allocated to the members.

services are not something that is contemplated in terms of the Act. Should an entity pay more than the contribution required to be paid in a particular year, it is most likely that such additional payment would be credited to the ESA. This is to ensure that the entity retains the right to access those funds in accordance with Section 15E (1) of the Act.

Since the Act does not contemplate prepayments of contributions for future service, it is likely that any such payments would not automatically reduce the future minimum funding requirement contributions for future service (i.e. the contribution rate recommended by the valuator). However, since the additional payment would be credited to the ESA, the entity would be able to use such amounts to take a contribution holiday. For this reason, even if there is a prepayment, the amount in paragraph 26 a) will be nil. The balance on the ESA would be taken into account in determining the economic benefit available in the form of a refund (refer to Issue 2).

28. With regard to the four scenarios outlined in Issue 2 (paragraph 16(ii)), the amount of any accounting surplus[2] that represents an economic benefit available as a reduction in future contributions for each scenario is considered to be:

- the estimated future IAS 19 service cost to the entity in each period over the shorter of the expected life of the plan and the expected life of the entity, less
- the estimated contributions that the valuator recommends be payable by the employer (taking into account the circumstances of the fund but ignoring any statutory surplus or deficit) in that year or the contributions specified in the rules if that is higher than the contributions that the valuator would otherwise have recommended.

29. Since a 'contribution holiday' as defined in section 1 of the Act, can only be taken by using amounts allocated to the employer, the benefits to the employer of a contribution holiday have in essence been taken into account in the calculation of the amount available in the form of a refund discussed under Issue 2. Therefore, the estimated contribution rate that the valuator recommends be payable (taking into account the circumstances of the fund but ignoring any statutory surplus or deficit), as referred to in paragraph 28, should ignore the effects of any contribution holiday (if any) that has been agreed to by the trustees.

Otherwise, such a benefit would be regarded as both an economic benefit available as a refund and as a reduction in future contributions which would result in a double-counting of such a benefit. Refer to paragraph 31. Alternatively, to avoid double-counting, in calculating the benefit available as a refund (refer to Issue 2), any approved contribution holiday should be taken into account by reducing the ESA.

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30. The benefit that is being calculated as the reduction in future contributions effectively represents the expected utilisation of the current accounting surplus to fund the shortfall between the present value of the future IAS 19 service cost and the present value of the minimum funding requirement for future service. For example, assume the accounting surplus is 120, the present value of the future IAS 19 service cost is 500 and the present value of the minimum funding requirement for future service is 400.

    All things being equal, in order to fund the future IAS 19 service cost, the future contributions should be 500. However, because of the surplus, the future contributions of 500 that would otherwise be required to be paid can be reduced to 400. Therefore, 100 would represent the benefit available in the form of a reduction in future contributions in accordance with paragraph 20 of IFRIC 14.

31. As noted in paragraph 9 of IFRIC 14, an entity needs to determine the maximum economic benefit that is available from refunds, reductions in future contributions, or a combination of both. It is not appropriate to consider economic benefits from a combination of refunds and reductions in future contributions based on assumptions which are mutually exclusive.

    Therefore, continuing the example in paragraph 30, if the amount available as a refund is 70 (which include any amount of the ESA to be used to take a contribution holiday), the maximum benefit would be 120 and not 170. This is because the accounting surplus is only 120, therefore it is not possible to obtain a refund of 70 and benefit from a reduction in future contributions to the extent of 100. However, if the amount available as a refund is 5 (which includes any amount of the ESA to be used to take a contribution holiday), the maximum benefit would be 105.

Issue 4: When minimum funding requirements might give rise to an additional liability

32. As noted in paragraph 19 of this FRP, minimum funding requirements need to be analysed between those that are required to cover (a) any existing shortfall for past service on the minimum funding basis and (b) future service.

33. In determining whether a minimum funding requirement may give rise to an additional liability, paragraph 23 of IFRIC 14 only considers minimum funding requirements "*to pay contributions to cover an existing shortfall on the minimum funding basis in respect of services already received*". Such minimum funding requirements are those referred to in paragraph 18(a) of IFRIC 14.

34. As noted in paragraph 20 of this FRP, when a fund is not in a financially sound condition it is required to submit a scheme to the Registrar of Pension Funds setting out the contributions which are required to be made in order to bring the fund into a financially sound condition within a reasonable period. (The

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contributions being referred to here are only those which are required in order to bring the fund into a financially sound condition, i.e. they exclude any contributions which will be payable to cover future service.) Such contributions constitute a minimum funding requirement to cover an existing shortfall on the minimum funding basis in respect of services already received as contemplated in paragraph 18(a) of IFRIC 14.

35. If an entity is required to make contributions to cover an existing shortfall in respect of services already received (contributions under paragraph 18(a) of IFRIC 14), it needs to assess to what extent it will benefit from them. In other words, if the payment of such contributions would result in the creation or increase of an accounting surplus, the entity needs to determine the maximum economic benefit available as a refund, reduction in future contributions or a combination of both. This should be done following the guidance provided in IFRIC 14 and in this FRP.

36. To the extent that the contributions payable to cover an existing shortfall in respect of services already received (contributions under paragraph 18(a) of IFRIC 14) will not be available to the entity after they have been paid into the plan, the entity should recognise a liability at the reporting date. The basis for such a liability is founded on the principles of an onerous contract. The liability should reduce any net defined benefit asset or increase any net defined benefit liability (refer to paragraph 24 of IFRIC 14).

Effective Date

37. An entity shall apply this FRP for annual periods beginning on or after xxx[4]. Earlier application is permitted and encouraged. If an entity applies this FRP for an earlier period, it shall disclose that fact.

38. This FRP shall be applied retrospectively subject to the provisions of IAS 8. *Accounting Policies, changes in Accounting Estimates and Errors.*

[4] Proposed effective date is annual periods beginning on or after 1 January 2018.

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Appendix A

The following table summarises the application of the asset ceiling under IAS 19 to the four scenarios contemplated in this FRP based on the consensus reached regarding the availability of a refund or reduction in future contributions.

	Rules of the fund	**Accounting surplus available as a refund**	**Accounting surplus available as a reduction in future contributions**
Scenario 1	**Silent on the treatment of statutory surpluses (i.e. statutory surplus allocation is at the discretion of the trustees)**	ESA balance (if any) (limited to the accounting surplus) less costs of realisation	The difference in each year between the estimated IAS 19 service cost and the contribution rate recommended by the actuary/valuator
Scenario 2	**All statutory surpluses to be allocated to the employer**	Accounting surplus less costs of realisation	The difference in each year between the estimated IAS 19 service cost and the contribution rate recommended by the actuary/valuator.
Scenario 3	**All statutory surpluses to be allocated to the members of the fund**	ESA balance (if any) (limited to the accounting surplus) less costs of realisation	The difference in each year between the estimated IAS 19 service cost and the contribution rate recommended by the actuary/valuator.
Scenario 4	**Statutory surpluses to be allocated in a specified proportion between the employer and the members of the fund**	Accounting surplus less costs of realisation	The difference in each year between the estimated IAS 19 service cost and the contribution rate recommended by the actuary/valuator

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Illustrative examples

These examples accompany, but are not part of this FRP.

Example 1 – Effect of the minimum funding requirement (paragraph 18 (a) of IFRIC 14) when there is an accounting surplus and the minimum funding contributions payable are fully refundable to the entity

IE1 An entity has submitted a scheme, in accordance with the requirements of section 18 of the Act, to the Registrar of Pension Funds to bring the fund into a financially sound condition within a reasonable period. Under the minimum funding requirement, the entity has an obligation to make additional contributions to the retirement fund over the next three years to make good the deficit. The present value of those contributions amounts to 200 at the reporting date. The retirement fund rules require all statutory surpluses to be allocated to the employer. There is no Member Surplus Account (MSA). The year-end IAS 19 valuations for the retirement fund are set out below.

Fair value of plan assets	1,200
Present value of defined benefit obligation under IAS 19	(1,100)
Accounting surplus	100
Net defined benefit asset (before consideration of the minimum funding requirement)	100

Application of requirements

IE2 Paragraph 24 of IFRIC 14 requires the entity to recognise a liability to the extent that the contributions payable are not fully available. Payment of the contributions with a present value of 200 will increase the accounting surplus from 100 to 300. Under the rules of the retirement fund all statutory surpluses are required to be allocated to the employer and there is no MSA, therefore this amount would be fully refundable to the entity with no associated costs. Therefore, no liability is recognised for the obligation to pay the contributions in respect of past service. In respect of the accounting surplus, the entity would recognise a net defined benefit asset of 100 since all surpluses are required to be allocated to the employer. Hence, 100 is available as an economic benefit in the form of a refund.

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Example 2—Effect of minimum funding requirements (paragraphs 18(a) and (b) of IFRIC 14) when there is an accounting deficit and the minimum funding contributions payable would not be fully available

IE3 An entity has submitted a scheme to the Registrar of Pension Funds to bring the fund into a financially sound condition within a reasonable period. Under the minimum funding requirement, the entity has an obligation to make additional contributions to the retirement fund over the next three years to make good the deficit. The present value of those contributions amounts to 300 at the reporting date.

The retirement fund rules provide for surplus allocation to the Employer Surplus Account (ESA) at the trustees' discretion. No amounts have been allocated to the ESA or MSA at the reporting date. The estimated contribution rate that the valuator would recommend taking into account the circumstances of the fund, but ignoring any statutory deficit or surplus happens to equal the future IAS 19 service cost to the entity. The year-end IAS 19 valuations for the retirement fund are set out below.

Fair value of plan assets	1,000
Present value of defined benefit obligation under IAS 19	(1,100)
Accounting deficit	(100)
Net defined benefit liability (before consideration of the minimum funding requirement)	(100)

Application of requirements

IE4 The payment of the contribution with a present value of 300 would change the accounting deficit of 100 to a surplus of 200. However, of this remaining 200, nothing is refundable until it has been formally allocated to the ESA. Also, the amount available as a reduction in future contributions is nil because the entity is not permitted to reduce its contributions below the contribution rate recommended by the valuator (taking account of the circumstances of the fund, but ignoring any statutory surplus or deficit), which happens to equal the future IAS 19 service cost to the entity.

IE5 Therefore, of the contributions with a present value of 300, 100 eliminate the accounting deficit, but the remaining 200 is not available as an economic benefit to the entity.

IE6 Paragraph 24 of IFRIC 14 requires the entity to recognise a liability to the extent

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that the additional contributions payable to fund the deficit are not available to it.

IE7 Therefore, the entity increases the net defined benefit liability by 200. No other liability is recognised in respect of the statutory obligation to pay contributions with a present value of 300 to fund the deficit.

Summary

Fair value of plan assets	1,000
Present value of defined benefit obligation under IAS 19	(1,100)
Accounting deficit	(100)
Net defined benefit liability (before consideration of the minimum funding requirement)	(100)
Adjustment in respect of minimum funding requirement	(200)
Net liability recognized	(300)

IE8 All things being equal, when the contributions with a present value of 300 are paid into the retirement fund, the net liability recognised will become 0 (300 – 300).

Example 3—Effect of a minimum funding requirement (paragraphs 18 (a) and (b) of IFRIC 14) when the contributions payable would not be fully available and the effect on the economic benefit available as a reduction in future contributions

IE9 The entity's valuator has recommended a funding level which is measured on a different basis from the service cost under IAS 19. The entity has also submitted a scheme to the Registrar of Pension Funds to bring the fund into a financially sound condition within a reasonable period. The recommended contributions are therefore required to make good the deficit on the minimum funding requirement basis (shortfall) and to cover future service.

IE10 The retirement fund has an accounting surplus at the reporting date of 50. The retirement fund rules provide for surplus allocation to the Employer Surplus Account (ESA) at the trustees' discretion. No amounts have been allocated to the ESA or MSA at the reporting date.

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IE11 The nominal amounts of the contributions required to satisfy the minimum funding requirements in respect of the shortfall and the future service for the next three years are set out below.

Year	Total contributions for minimum funding requirement	Contributions required to make good the shortfall	Contributions required to cover future service
1	135	120	15
2	125	112	13
3	115	104	11

Application of requirements

IE12 The entity's present obligation in respect of services already received only includes the contributions required to make good the shortfall. This is a minimum funding requirement under paragraph 18(a) of IFRIC 14. The recommended contributions required to cover future service constitute a minimum funding requirement under paragraph 18(b) of IFRIC 14.

IE13 The present value of the entity's defined benefit obligation in respect of services already received, assuming a discount rate of 6 percent per year, is approximately 300, calculated as follows:

$[120/(1.06) + 112/(1.06)^2 + 104/(1.06)^3]$.

IE14 When these contributions are paid into the retirement fund, the accounting surplus (i.e. the fair value of plan assets less the present value of the defined benefit obligation) would, other things being equal, increase from 50 to 350 (300 + 50).

IE15 However, since the rules are silent on the allocation of surpluses and nothing has been allocated to the entity yet, the entity does not have an unconditional right to a refund, although the accounting surplus may be available as a reduction in future contributions.

IE16 In accordance with paragraph 20 of IFRIC 14, the economic benefit available as a reduction in future contributions is the sum of:

- Any amount that reduces future minimum funding requirement contributions for future service because the entity made a prepayment (i.e. paid the amount

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before being required to do so); and

- The estimated future service cost in each period in accordance with paragraphs 16 and 17, less
- The estimated minimum funding requirement contributions that would be required for future service in those periods if there were no prepayment as described in the first bullet point.

IE17 In this example there is no prepayment. The amounts available as a reduction in future contributions are set out below.

Year	IAS 19 service cost	Minimum contributions required to cover future service	Amount available as contribution reduction
1	13	15	(2)
2	13	13	0
3	13	11	2
4+	13	9	4

IE18 Assuming a discount rate of 6 percent per year, the present value of the economic benefit available as a reduction in future contributions is equal to:

$(2)/(1.06) + 0/(1.06)^2 + 2/(1.06)^3 + 4/(1.06)^4 + \ldots + 4/(1.06)^{50} + \ldots = 56.$

Thus, the asset ceiling, which is the present value of the economic benefit available from future contribution reductions, is 56.

IE19 Paragraph 24 of IFRIC 14 requires the entity to recognise a liability to the extent that the additional contributions payable to fund the deficit will not be fully available. Therefore, the entity reduces the net defined benefit asset by 294 (50 + 300 – 56), resulting in the recognition of a net defined benefit liability of 244 No other liability is recognised in respect of the obligation to make contributions to fund the minimum funding shortfall.

Summary

Accounting surplus	50
Net defined benefit asset (before consideration of the minimum funding requirement)	50
Adjustment in respect of minimum funding requirement	294
	19

Net liability recognized	(244)

IE20 When the contributions with a present value of 300 are paid into the retirement fund, the net defined benefit asset recognised will become 56 (300 – 244), which represents the amount available as a reduction in future contributions, since no refund is available to the entity.

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Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of the FRP.

BC1 The Basis for Conclusions summarises the considerations in reaching the consensus.

Scope

BC2 The applicability of IFRIC 14 to post-retirement medical benefits (PRMB) was considered in the drafting of this FRP. In the South African environment there is no statutory requirement to fund a PRMB by transferring funds into a separate fund or entity. In some cases entities may take out insurance policies in order to fund their PRMB, but they are not required by statute to do so. There could be instances where there may be contractual requirements to fund a PRMB. In such circumstances an entity should consider the applicability of IFRIC 14. However, since it was not expected that IFRIC 14 would be relevant to all PRMB, it was decided to limit the scope of this FRP to defined benefit pension plans.

Issue 1: Minimum funding requirements

BC3 As outlined in paragraph 2 of IFRIC 14: *"Minimum funding requirements exist in many countries to improve the security of the post-employment benefit promise made to members of an employee benefit plan. Such requirements normally stipulate a minimum amount or level of contributions that must be made to a plan over a given period."*

BC4 It is necessary to know what 'minimum funding requirements' are in the South African retirement funds environment because these might require an additional liability to be recognised by the entity and/or these might affect the availability of reductions in future contributions.

BC5 Paragraph 16 of IFRIC 14 requires an entity to "... *analyse any minimum funding requirement at a given date into contributions that are required to cover (a) any existing shortfall for past service on the minimum funding basis and (b) future service*".

BC6 In terms of section 18 of the Act, when a fund is not in a financially sound condition (as clarified by Circular PF No.66), it is required to submit a scheme to the Registrar of Pension Funds, setting out the contributions which will be made to bring the fund into a financially sound condition within a reasonable period. The statutory deficit is usually required to be eliminated within three years. The minimum funding requirements are a statutory requirement and are independent of the status of the fund as determined under IAS 19. Therefore, the contributions required to bring the fund into a financially sound condition within a reasonable period constitute a minimum funding requirement as

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contemplated in paragraph 18(a) of IFRIC 14 (i.e. a minimum funding requirement to cover any existing shortfall for past service on the minimum funding basis).

BC7 Section 15A of the Act states that all statutory surpluses in the fund belong to the fund and that after 7 December 2001 the only portion of the assets of the fund that may be utilised by, or for the benefit of, the employer is any credit balance in the Employer Surplus Account (ESA). One possible usage of the ESA is to take a contribution holiday. A contribution holiday is defined in section 1 of the Act, for a defined benefit category of a fund, as "*the payment by the employer of less than the contribution rate the valuator recommends be payable by the employer taking into account the circumstances of the fund and ignoring any surplus or deficit.*"

Since the only way in which the employer can reduce contributions below the rate recommended by the actuary/valuator is to follow the legal route of taking a contribution holiday, the contribution rate the valuator recommends be payable by the employer to fund future service constitutes a minimum funding requirement to fund future service as contemplated in paragraph 18(b) of IFRIC 14. In instances where the rules of the fund specify the contribution rate, such a rate would be the minimum funding requirement to cover future service unless the contribution rate the valuator would recommend be payable is higher, in which case the higher rate would constitute such a minimum funding requirement.

Issue 2: Availability of an economic benefit in the form of a refund in accordance with the definition of the asset ceiling in paragraph 8 of IAS 19 and its measurement

BC8 Paragraph 11 of IFRIC 14 states that a "*refund is available to an entity only if the entity has an unconditional right to a refund*".

BC9 In terms of section 15A of the Act, all statutory surpluses in the fund belong to the fund. However, the employer acquires certain rights to the statutory surplus that has been allocated to the ESA.

BC10 Any statutory surplus in a fund at the surplus apportionment date (as specified in terms of section 15B of the Act) is required to be apportioned between stakeholders. The Act specifies the process to be followed to determine the allocation but does not specify the amount to be allocated to each stakeholder. This may result in an amount being allocated to the ESA by the trustees of the fund.

BC11 The apportionment of any statutory surplus arising after the surplus apportionment date between the ESA and Member Surplus Account (MSA) is determined in accordance with the rules of the fund and section 15C of the Act. It should be noted that all amendments or additions to the rules of a fund require the approval of the Registrar of Pension Funds. If the rules are silent,

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the fund's board of trustees would determine the apportionment at its own discretion.

BC12 The statutory surplus allocated to the ESA (either in terms of the rules or as determined by the trustees) may be used by the employer for the following purposes, as set out in section 15E (1) of the Act:

(a) funding a contribution holiday (refer to paragraph 19 above, for the definition of a contribution holiday);

(b) payment of pensions, or an increase in pensions in course of payment, so as to compensate members for the loss of any subsidy from the employer of their medical costs after retirement;

(c) meeting, in full or in part, expenses which the employer is obliged to pay in terms of the rules of the fund;

(d) improving the benefits payable to all members, or a category of members as defined in the rules, as determined by the employer;

(e) transferring part, or all, of the ESA in terms of section 15E(2) of the Act to the ESA in another fund where the employer is a participating employer;

(f) on liquidation of the fund in terms of sections 28 or 29, payment in cash to the employer in terms of section 15I;

(g) in order to avoid retrenchment of a significant proportion of the workforce, payment in cash to the employer in terms of section 15J; and

(h) transferring part, or all, of the ESA to the MSA in the same fund.

BC13 Applying the above to each of the four scenarios outlined in Issue 2, the amount of any accounting surplus that represents an economic benefit available as a refund is considered to be the following:

- Scenario 1 – The balance of any ESA at the reporting date (limited to the accounting surplus) less any costs that would be incurred upon realisation. This is because the entity has an unconditional right to access only the amount in the ESA. Since the trustees need to determine the allocation of the surplus, until an amount has been allocated to the ESA, the entity does not have an unconditional right to that amount. In addition, if it so happens that there is an unallocated surplus upon liquidation of a fund, the entity will only be entitled to the amount in the ESA at that date. The unallocated surplus would need to be allocated by the liquidator to the members who left within 12 months prior to liquidation.
- Scenario 2 – The accounting surplus less any costs that would be incurred upon realisation. This is because the rules require all statutory surpluses to be allocated to the employer. Although the statutory surplus might be different from the accounting surplus at the reporting date for the reasons

given in paragraphs 11 to 13 of this FRP, the accounting surplus should be used. From an accounting perspective, the accounting surplus reflects the best estimate, at the reporting date, of the statutory surplus that will exist in the plan assuming the gradual settlement of plan obligations over time until all members have left. Given that the rules require all statutory surpluses to be allocated to the employer, the employer has an unconditional right to a refund equal to the accounting surplus. As discussed in the footnote 2 on page 10, the accounting surplus being referred to is the amount of the surplus *after* any allocations of surpluses to the members.

- Scenario 3 – The balance of any ESA at the reporting date (limited to the accounting surplus) less any costs that would be incurred upon realisation. There may have been an amount allocated to the ESA as a result of the first surplus apportionment after the surplus apportionment date. In this scenario the rules require all statutory surpluses arising after surplus apportionment to be allocated to the members, with the result that no refund (other than that which may have been allocated to the ESA) is available to the entity.
- Scenario 4 – The accounting surplus less any costs that would be incurred upon realisation. As discussed in the footnote 2 on page 10, the accounting surplus being referred to is the amount of the surplus *after* any allocations of surpluses to the members.

Issue 3: Availability of an economic benefit in the form of a reduction in future contributions in accordance with the definition of the asset ceiling in paragraph 8 of IAS 19 and its measurement

BC14 IFRIC 14, BC17 states that the amount of the contribution reduction available to an entity should be measured with reference to the amount that the entity would have been required to pay had there been no accounting surplus. The IFRIC believes that this is represented by the future IAS 19 service cost to the entity.

BC15 In terms of paragraph 16 of IFRIC 14, if there is no minimum funding requirement for contributions relating to future service the economic benefit available as a reduction in future contributions is:

- the future IAS 19 service cost to the entity for each period over the shorter of the expected life of the plan and the expected life of the entity._The future service cost to the entity excludes amounts that will be borne by employees.

BC16 In terms of paragraph 20 of IFRIC 14, if there is a minimum funding requirement for contributions relating to future service, the economic benefit available as a reduction in future contributions is the sum of:

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a) Any amount that reduces future minimum funding requirement contributions for future service because the entity made a prepayment (i.e. paid the amount before being required to do so); and

b) The estimated future IAS 19 service cost to the entity in each period over the shorter of the expected life of the plan and the expected life of the entity, less the estimated minimum funding requirement contributions for future service in those periods if there were no prepayment described in a).

BC17 As concluded in paragraph BC7, the contribution rate the valuator recommends be payable by the employer to fund the future accrual of benefits, taking into account the circumstances of the fund and ignoring any surplus or deficit, or if higher, any rate specified in the rules, constitutes a minimum funding requirement in respect of future services as contemplated in paragraph 18(b) of IFRIC 14.

BC18 In terms of paragraph 22 of IFRIC 14 "*When an entity determines the amount described in paragraph 20(b), if the future minimum funding requirement contributions for future service exceeds the future IAS 19 service cost in any given period, that excess reduces the amount of the economic benefit available as a reduction in future contributions. However, the amount described in paragraph 20(b) can never be less then zero.*"

BC19 The IFRIC considered whether an asset should be recognised in respect of reductions in future contributions only to the extent that there was a formal agreement between the trustees and the entity specifying contributions payable lower than the future IAS 19 service cost. The IFRIC did not agree with this and concluded that "*…an entity is entitled to assume that, in general, it will not be required to make contributions to a plan in order to maintain a surplus and hence that it will be able to reduce contributions if the plan had a surplus.*" (Refer to paragraph BC18 of IFRIC 14.)

BC20 With regard to prepayments of contributions for future service, these are not contemplated in the Act. Should an entity pay more than the contribution required to be paid in a particular year, it is most likely that such additional payment would be credited to the ESA. This is to ensure that the entity retains the right to access those funds in accordance with Section 15 E(1) of the Act. Since the Act does not contemplate prepayments of contributions for future service, it is likely that any such payments would not automatically reduce the future minimum funding requirement contributions for future service (i.e. the contribution rate recommended by the valuator). However, since the additional payment would be credited to the ESA, the entity would be able to use such amounts to take a contribution holiday. For this reason, even if there is a prepayment, the amount in paragraph 20(a) of IFRIC 14 will be nil. The balance on the ESA would be taken into account in determining the economic benefit available in the form of a refund (refer to Issue 2).

BC21 The amount of any accounting surplus that represents an economic benefit

available as a reduction in future contributions is therefore considered to be the following for all four scenarios:

The difference between the estimated future IAS 19 service cost to the entity and the estimated contributions that the valuator would recommend be payable by the employer (taking into account the circumstances of the fund but ignoring any statutory surplus or deficit), or, if higher, any contributions payable as specified in the rules, in each period (over the shorter of the expected life of the plan and the expected life of the entity). This is because the employer is only required to pay the contributions recommended by the valuator (or the contributions specified in the rules) and not the IAS 19 service cost.

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