

DEPARTMENT OF TRADE AND INDUSTRY

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**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 in consultation with the Financial Reporting Standards Council, under section 204 of the Companies Act, 2008 (Act 71 of 2008), hereby publish the draft Financial Reporting Pronouncement (FRP) as a guide in terms of section 29(3) of the Act.

Interested persons may submit written comments on the proposed Amendment Regulations not later than thirty (30) days from the date of publication of this notice to:

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Dr Rob Davies, MP
Minister of Trade and Industry

24 November 2017

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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TRANSACTIONS UNDER IFRS****CONTENTS**

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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.

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

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. 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 instruments¹ 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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3. In the context of empowerment of black people² 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 elements³:
 - 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.

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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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?

FRP 2 ACCOUNTING FOR BLACK ECONOMIC EMPOWERMENT (BEE) TRANSACTIONS UNDER IFRS**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 xxx⁴. 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.

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

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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 separable, 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)