Qualification Programme

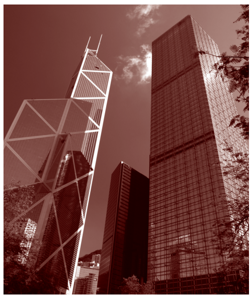
Module A: Financial Reporting

FOURTH EDITION

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

Hong Kong's
CPA Qualification
香港會計師專業資格

LEARNING PACK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Module A
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Director's message

Welcome to the Qualification Programme (QP) of the Hong Kong Institute of Certified Public Accountants (HKICPA).

You have made the decision to complete the HKICPA's QP which entails completing the training programme, passing professional examinations and acquiring practical experience under an authorized employer or supervisor. This marks a further step on your pathway to a successful business career as a CPA and becoming a valued member of the HKICPA.

The QP comprising four core modules and a final examination will provide you with a foundation for life-long learning and assist you in developing your technical, intellectual, interpersonal and communication skills. You will find this programme challenging with great satisfaction that will open a wide variety of career opportunities bringing in attractive financial rewards.

A module of the QP involves approximately 120 hours of self-study over fourteen weeks, participation in two full-day workshops and a three-hour open-book module examination at the module end. We encourage you to read this Learning Pack which is a valuable resource to guide you through the QP.

The four core modules of the QP are as follows:

Module A: Financial Reporting
Module B: Corporate Financing
Module C: Business Assurance
Module D: Taxation

Should you require any assistance at any time, please feel free to contact us on (852) 2287 7228.

May I wish you every success in your QP!

Jonathan Ng

Executive Director
Hong Kong Institute of Certified Public Accountants

Introduction

This is the fourth edition of the Learning Pack for Module A Financial Reporting of the HKICPA Qualification Programme.

The Institute is committed to updating the content of the Learning Pack on an annual basis to keep abreast of the latest developments. This edition has been developed after having consulted and taken on board the feedback received from different users of the previous edition. Some of the examples and self-test questions have been rewritten to better reflect current working practices in industry and facilitate the learning process for users of the Learning Pack.

The Learning Pack has been written specifically to provide a complete and comprehensive coverage of the learning outcomes devised by HKICPA, and has been reviewed and approved by the HKICPA Qualification and Examinations Board for use by those studying for the qualification.

The HKICPA Qualification Programme comprises two elements: the examinations and the workshops. The Learning Pack has been structured so that the order of the topics in which you study is the order in which you will encounter them in the workshops. There is a very close inter-relationship between the module structure, the Learning Pack and the workshops. It is important that you have studied the chapters of the Learning Pack relevant to the workshops before you attend the workshops, so that you can derive the maximum benefit from them.

On page (ix) you will see the HKICPA learning outcomes. Each learning outcome is mapped to the chapter in the Learning Pack in which the topic is covered. You will find that your diligent study of the Learning Pack chapters and your active participation in the workshops will prepare you to tackle the examination with confidence.

One of the key elements in examination success is practice. It is important that not only you fully understand the topics by reading carefully the information contained in the chapters of the Learning Pack, but it is also vital that you take the necessary steps to practise the techniques and apply the principles that you have learned.

In order to do this, you should:

- work through all the examples provided within the chapters and review the solutions, ensuring that you understand them;
- complete the self-test questions within each chapter, and then compare your answer with the solution provided at the end of the chapter; and
- attempt the exam practice questions that you will find at the end of the chapter. Many of these are HKICPA past examination questions, which will give an ideal indication of the standard and type of question that you are likely to encounter in the examination itself. You will find the solutions to exam practice questions at the end of the book.

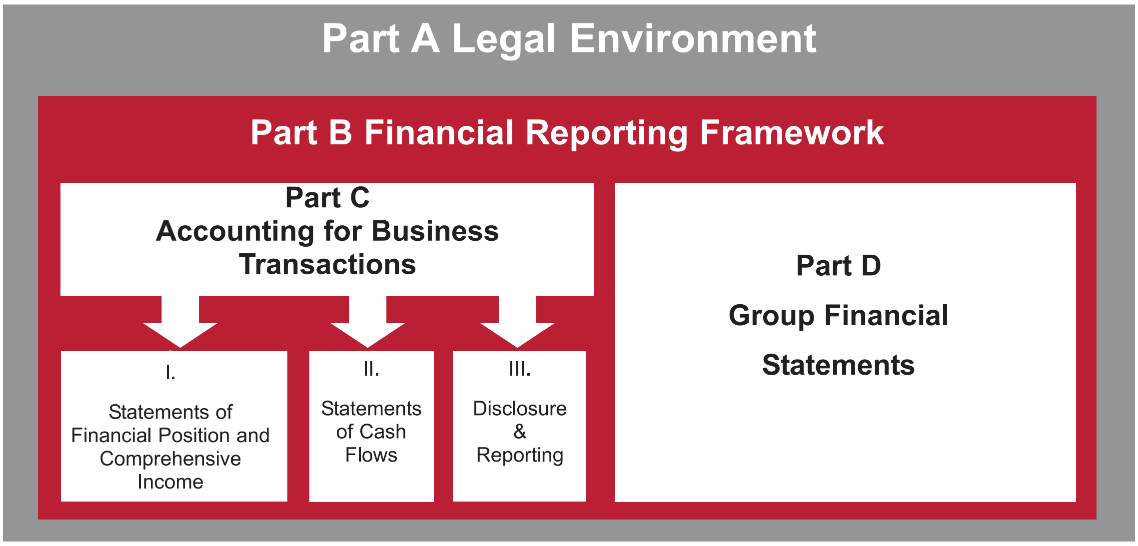
In addition, you will find at the end of the Learning Pack a bank of past HKICPA case-study style questions. These are past 'Section A' examination questions, which present a case study testing a number of different topics within the syllabus. These questions will provide you with excellent examination practice when you are in the revision phase of your studies, bringing together, as they do, the application of a variety of different topics to a scenario.

Please note that the Learning Pack is not intended to be a 'know-it-all' resource. You are required to undertake background reading including standards, legislations and recommended texts for the preparation for workshop and examination.

Module Structure

This module will enable you to exercise judgment in selecting and applying accounting policies to prepare financial statements (both at individual company and group levels) in compliance with the relevant Hong Kong Financial Reporting Framework and Hong Kong Accounting Standards ('HKFRSs'). Please refer to the QP Learning Centre for the six-month rule and examinable standards.

Overall Structure of Module A (Financial Reporting)



Chapter features

Each chapter contains a number of helpful features to guide you through each topic.

Topic list	Tells you what you will be studying in the chapter. The topic items form the numbered headings within the chapter.
Learning focus	Puts the chapter topic into perspective and explains why it is important, both within your studies and within your practical working life.
Learning Outcomes	The list of Learning Outcomes issued for the Module by HKICPA, referenced to the chapter in the Learning Pack within which coverage will be found.
Topic highlights	Summarise the key content of the particular section that you are about to start. They are also found within sections, when an important issue is introduced other than at the start of the section.
Key terms	Definitions of important concepts. You really need to know and understand these before the examination, and understanding will be useful at the workshops too.
Examples	Illustrations of particular techniques or concepts with a worked solution or explanation provided immediately afterwards.
Case study	An example or illustration not requiring a solution, designed to enrich your understanding of a topic and add practical emphasis. Often based on real world scenarios and contemporary issues.
Self-test questions	These are questions that enable **you** to practise a technique or test your understanding. You will find the answer at the end of the chapter.
Formula to learn	You may be required to apply financial management formulae in Module B, Corporate Financing.
Topic recap	Reviews and recaps on the key areas covered in the chapter.
Exam practice	A question at the end of the chapter to enable you to practise the techniques that you have learned. In most cases this will be a past HKICPA examination question, updated as appropriate. You will find the answers in a bank at the end of the Learning Pack entitled Answers to Exam Practice Questions.
Further reading	In Modules B and D you will find references to further reading that will help you to understand the topics and put them into the practical context. The reading suggested may be books, websites or technical articles.
Bold text	Throughout the Learning Pack you will see that some of the text is in bold type. This is to add emphasis and to help you to grasp the key elements within a sentence or paragraph.

Learning outcomes

HKICPA's learning outcomes for the Module are set out below. They are cross-referenced to the chapter in the Learning Pack where they are covered.

Fields of competency

The items listed in this section are shown with an indicator of the minimum acceptable level of competency, based on a three-point scale as follows:

1 Awareness

To have a general professional awareness of the field with a basic understanding of relevant knowledge and related concepts.

2 Knowledge

The ability to use knowledge to perform professional tasks competently without assistance in straightforward situations or applications.

3 Application

The ability to apply comprehensive knowledge and a broad range of professional skills in a practical setting to solve most problems generally encountered in practice.

Topics

		Competency	Chapter where covered
LO1. Legal environment			
Describe the Hong Kong legal framework and related implications for business activities			
LO1.01	Types and relative advantage of alternative forms of organisation:	2	
	1.01.01 Identify the types and relative advantages of alternative forms of organisation		1
LO1.02	Legal procedures for establishment and governance of companies:	2	
	1.02.01 Describe the legal procedures for the establishment and governance of companies		1
Describe the obligations of directors and officers of companies			
LO1.03	Powers, duties and obligations of directors and company secretaries:	2	
	1.03.01 Describe the powers, duties and obligations of company directors		1
	1.03.02 Describe the powers, duties and obligations of the company secretary		1
Describe the legal requirements associated with company structure, share offerings, debt obligations and restructuring			
LO1.04	Share issues and prospectus requirements:	2	

		Competency	Chapter where covered
	1.04.01 Describe the procedure for issuing shares and the requirement for a prospectus		1
LO1.05	Debt instruments and registration of charges:	2	
	1.05.01 Describe the procedure for the issue of debt instruments		1
	1.05.02 Describe the procedure for the registration of charges over company debt		1
LO1.06	Statutory reporting and documentation requirements:	3	
	1.06.01 Explain the statutory registers that must be kept by a company		1
	1.06.02 Identify the financial statements that a company must prepare		1
LO1.07	Appointment and removal of auditors:	3	
	1.07.01 Describe the procedures for the appointment, removal and resignation of company auditors		1
LO1.08	Restructuring, including appointment of receivers and liquidators:	1	
	1.08.01 Identify the reasons for which a company may restructure, including the appointment of receivers and liquidators		1
LO2. Financial reporting framework			
Describe the financial reporting framework in Hong Kong and the related implications for business activities			
LO2.01	The role and setting of accounting standards:	2	
	2.01.01 Understand the role of accounting standards		2
	2.01.02 Understand the role of the HKICPA, Securities and Futures Commission (SFC), Financial Reporting Council (FRC), the Hong Kong Insurance Authority (HKIA), the Hong Kong Monetary Authority (HKMA) and the Hong Kong Stock Exchange (HKEx)		2
LO2.02	Hong Kong Financial Reporting Standards:	2	
	2.02.01 Describe how Hong Kong Financial Reporting Standards are set		2
LO2.03	Small and Medium-sized Entity Financial Reporting Framework and Financial Reporting Standard:	2	
	2.03.01 Identify the conditions under which an entity may adopt the *SME Financial Reporting Framework and Financial Reporting Standard*		3
	2.03.02 Describe the requirements of the *SME Financial Reporting Framework and Financial Reporting Standard*		3

		Competency	Chapter where covered
LO2.04	Hong Kong Financial Reporting Standard for Private Entities	2	
	2.04.01 Identify the conditions under which an entity may adopt the *HKFRS for Private Entities*		3
	2.04.02 Describe the requirements of the *HKFRS for Private Entities*		3
LO2.05	Code of Ethics for Professional Accountants:	3	
	2.05.01 Explain the requirements of the Code of Ethics for Professional Accountants		2
LO2.06	Hong Kong (IFRIC) Interpretations, Hong Kong Interpretations and Hong Kong (SIC) Interpretations:	2	
	2.06.01 Describe the status of Hong Kong (IFRIC) Interpretations, Hong Kong Interpretations and Hong Kong (SIC) Interpretations		2
LO2.07	Other professional pronouncements and exposure drafts:	2	
	2.07.01 Identify other professional pronouncements and exposure drafts relevant to the financial reporting Conceptual Framework		2
LO2.08	Regulatory bodies and their impact on accounting:	2	
	2.08.01 Identify relevant regulatory bodies and their impact on accounting		2
LO2.09	Accounting principles and conceptual frameworks:	2	
	2.09.01 Explain what is meant by a conceptual framework and GAAP		2
	2.09.02 Identify the advantages and disadvantages of a conceptual framework		2
	2.09.03 Identify the components and requirements of the HKICPA's *Conceptual Framework*		2
	2.09.04 Explain those requirements of HKAS 1 *Presentation of Financial Statements* which overlap with the HKICPA's *Conceptual Framework*		2
LO2.10	Current developments	2	
	2.10.01 Identify areas of accounting in which current developments are occurring		2
LO3. Accounting for business transactions			
Account for transactions in accordance with Hong Kong Financial Reporting Standards			
LO3.01	Accounting policies, changes in accounting estimates and errors:	3	
	3.01.01 Distinguish between accounting policies and accounting estimates in accordance with HKAS 8		21

		Competency	Chapter where covered
	3.01.02 Account for a change in accounting policy		21
	3.01.03 Account for a change in accounting estimate		21
	3.01.04 Correct a prior period error		21
LO3.02	Revenue:	3	
	3.02.01 Define revenue and identify revenue within the scope of HKAS 18		14
	3.02.02 Measure revenue at the fair value of consideration received		14
	3.02.03 Identify revenue transaction including multiple element arrangements		14
	3.02.04 Determine the recognition criteria for specified types of revenue items including sales of goods, rendering of services and interest, royalties and dividends		14
	3.02.05 Disclose revenue as appropriate in the financial statements		14
	3.02.06 Explain the recognition and measurement principles		14
LO3.03	Government grants and assistance:	3	
	3.03.01 Accounting and presentation of government grants		7
	3.03.02 Disclosure of government grants and assistance in accordance with HKAS 20		7
LO3.04	Employee benefits:	2	
	3.04.01 Identify short-term employee benefits in accordance with HKAS 19 and apply the recognition and measurement principles in respect of short-term employee benefits		16
	3.04.02 Distinguish between defined contribution plans and defined benefit plans		16
	3.04.03 Account for defined contribution plans		16
	3.04.04 Identify termination benefits in accordance with HKAS 19 and apply the recognition and measurement principles in respect of termination benefits		16

		Competency	Chapter where covered
LO3.05	Share-based payment:	2	
	3.05.01 Identify and recognise share-based payment transactions in accordance with HKFRS 2		13
	3.05.02 Account for equity-settled and cash-settled share-based payment transactions		13
	3.05.03 Account for share-based payment transactions with cash alternatives		13
	3.05.04 Account for unidentified goods or services in a share-based payment transaction		13
	3.05.05 Account for group and treasury share transactions		13
	3.05.06 Disclosure requirement of share option		13
LO3.06	Inventories:	3	
	3.06.01 Scope and definition of HKAS 2 *Inventories*		10
	3.06.02 Calculate the cost of inventories in accordance with HKAS 2		10
	3.06.03 Use accepted methods of assigning costs including the allocation of overheads to inventories		10
	3.06.04 Explain the potential impact of net realisable value falling below cost and make the required adjustments		10
	3.06.05 Calculate and analyse variances in a standard costing system and advise on the appropriate accounting treatment to be adopted in respect of inventories		10
	3.06.06 Prepare a relevant accounting policy note and other required disclosures in respect of inventories		10
LO3.07	Construction contracts:	3	
	3.07.01 Define a construction contract		12
	3.07.02 Explain when contract revenue and costs should be recognised in accordance with HKAS 11		12
	3.07.03 Explain how contract revenue and costs should be measured and apply these principles		12
	3.07.04 Account for the expected loss and changes in estimates		12
	3.07.05 Disclose information related to construction contracts in the financial statements		12

			Competency	Chapter where covered
LO3.08	Property, plant and equipment:		3	
	3.08.01	Identify the non-current assets which fall within or outside the scope of HKAS 16		5
	3.08.02	State and apply the recognition rules in respect of property, plant and equipment		5
	3.08.03	Determine the initial measurement of property, plant and equipment, including assets acquired by exchange or transfer		5
	3.08.04	Determine the accounting treatment of subsequent expenditure on property, plant and equipment		5
	3.08.05	Determine the available methods to measure property, plant and equipment subsequent to initial recognition		5
	3.08.06	Account for the revaluation of property, plant and equipment		5
	3.08.07	Define "useful life" and allocate an appropriate useful life for an asset in a straightforward scenario		5
	3.08.08	Explain the different methods of depreciation: straight line and diminishing balance, and calculate the depreciation amount in respect of different types of asset		5
	3.08.09	Account for the disposal of property, plant and equipment		5
	3.08.10	Disclose relevant information relating to property, plant and equipment in the financial statements		5
LO3.09	Intangible assets:		3	
	3.09.01	Define an intangible asset and scope of HKAS 38		8
	3.09.02	Apply the definition of an intangible asset to both internally-generated and purchased intangibles		8
	3.09.03	Account for the recognition and measurement of intangible assets in accordance with HKAS 38		8
	3.09.04	Describe the subsequent accounting treatment of intangible assets including amortisation		8
	3.09.05	Distinguish between research and development and describe the accounting treatment of each		8
	3.09.06	Explain how goodwill arises		8
	3.09.07	Account for goodwill		8
	3.09.08	Disclose relevant information in respect of intangible assets under HKAS 38		8

		Competency	Chapter where covered
LO3.10	Investment property:	3	
	3.10.01 Identify an investment property within the scope of HKAS 40 and situation when a property can be transferred in and out of the investment property category		6
	3.10.02 Distinguish investment property from other categories of property holdings and describe the difference in accounting treatment		6
	3.10.03 Apply the recognition and measurement rules relating to investment property		6
	3.10.04 Account for investment property		6
	3.10.05 Disclose relevant information, including an accounting policy note, for investment property		6
LO3.11	Financial assets, financial liabilities and equity instruments:	2	
	3.11.01 Discuss and apply the criteria for the recognition and de-recognition of a financial asset or financial liability		18
	3.11.02 Discuss and apply the rules for the classification of a financial asset, financial liability and equity, and their measurement (including compound instrument)		18
	3.11.03 Discuss and apply the treatment of gains and losses arising on financial assets or financial liabilities		18
	3.11.04 Discuss the circumstances that give rise to and apply the appropriate treatment for the impairment of financial assets		18
	3.11.05 Account for derivative financial instruments and simple embedded derivatives, including the application of own-use exemption		18
	3.11.06 Disclose relevant information with regard to financial assets, financial liabilities and equity instruments		18

			Competency	Chapter where covered
LO3.12	Borrowing costs:		3	
	3.12.01	Identify the expenses which constitute borrowing costs in accordance with HKAS 23		17
	3.12.02	Identify the assets which are qualifying assets		17
	3.12.03	Determine when the capitalisation of borrowing costs shall commence, be suspended and cease		17
	3.12.04	Calculate the amount of borrowing costs to be capitalised from specific borrowing and general borrowing		17
	3.12.05	Prepare journal entries for borrowing costs, including expensed and capitalised borrowing costs		17
	3.12.06	Disclose relevant information with regard to borrowing costs		17
LO3.13	Impairment of assets:		3	
	3.13.01	Identify assets that are within the scope of HKAS 36		8
	3.13.02	Identify an asset that may be impaired by reference to common external and internal indicators		8
	3.13.03	Identify the cash generating unit an asset belongs to		8
	3.13.04	Calculate the recoverable amount with reference to value-in-use and fair value less cost to sell		8
	3.13.05	Calculate the impairment loss, including the loss relating to cash-generating units		8
	3.13.06	Allocate impairment loss and account for subsequent reversal		8
	3.13.07	Disclose relevant information with regard to impairment loss, including critical judgement and estimate		8

			Competency	Chapter where covered
LO3.14	Leases:		3	
	3.14.01	Identify the types of lease within the scope of HKAS 17 and define the terminology used in relation to leases		9
	3.14.02	Classify leases as operating or finance leases by looking at the substance of the transaction		9
	3.14.03	Account for operating leases from the perspective of both the lessee and the lessor		9
	3.14.04	Disclose the relevant information relating to operating leases in the accounts of both the lessee and the lessor		9
	3.14.05	Account for finance leases from the perspective of both the lessee and the lessor		9
	3.14.06	Disclose the relevant information relating to finance leases in the accounts of both the lessee and the lessor		9
	3.14.07	Account for manufacturer/dealer leases		9
	3.14.08	Account for sale and leaseback transactions		9
	3.14.09	Explain the term off-balance sheet finance and the importance of substance over form		9
	3.14.10	Explain how to determine whether an arrangement contains a lease		9
LO3.15	Events after the reporting period:		3	
	3.15.01	Explain the period during which there is responsibility for reporting events in accordance with HKAS 10		21
	3.15.02	Define adjusting and non-adjusting events		21
	3.15.03	Explain when the financial statements should be prepared on a basis other than going concern		21
LO3.16	Provisions, contingent liabilities and contingent assets:		3	
	3.16.01	Define provisions, contingent liabilities and contingent assets within the scope of HKAS 37		11
	3.16.02	Distinguish provisions from other types of liabilities		11
	3.16.03	Explain the criteria for recognition of provisions and apply them to specific circumstances		11
	3.16.04	Apply the appropriate accounting treatment for contingent assets and liabilities		11
	3.16.05	Disclose the relevant information relating to contingent liabilities in the financial statements		11
	3.16.06	Account for decommissioning, restoration and similar liabilities and their changes		11
	3.16.07	Disclose the relevant information relating to contingent assets in the financial statements		11

		Competency	Chapter where covered
LO3.17	Hedge accounting:	2	
	3.17.01 Identify fair value hedges, cash flow hedges and hedges for net investment in accordance with HKAS 39		18
	3.17.02 Account for fair value hedges, cash flow hedges and hedges for net investment		18
LO3.18	Income taxes:	2	
	3.18.01 Account for current tax liabilities in accordance with HKAS 12		15
	3.18.02 Record entries relating to income tax in the accounting records		15
	3.18.03 Identify temporary differences (both inside and outside difference) and calculate deferred tax amounts		15
	3.18.04 Account for tax losses and tax credits		15
	3.18.05 Identify initial recognition exemption for assets and liabilities		15
	3.18.06 Account for deferred tax relating to investments in subsidiaries, associates and joint ventures		15
	3.18.07 Determine when tax assets and liabilities can be offset		15
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LO3.19	The effects of changes in foreign exchange rates:	2	
	3.19.01 Determine the functional currency of an entity in accordance with HKAS 21		30
	3.19.02 Translate foreign operation financial statements to the presentation currency		30
	3.19.03 Account for foreign currency transactions within an individual company and in the consolidated financial statements		30
	3.19.04 Account for disposal or partial disposal of a foreign operation		30
LO3.20	Related party disclosures:	3	
	3.20.01 Identify the parties that may be related to a business entity in accordance with HKAS 24		20
	3.20.02 Identify the related party disclosures		20
	3.20.03 Explain the importance of being able to identify and disclose related party transactions		20

			Competency	Chapter where covered
LO3.21	Non-current assets held for sale and discontinued operations:		3	
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	3.21.02	Explain what assets are within the measurement provision of HKFRS 5		4
	3.21.03	Determine when a sale is highly probable		4
	3.21.04	Measure non-current assets held for sale and discontinued operations including initial measurement, subsequent measurement and change of plan		4
	3.21.05	How to account for impairment loss and subsequent reversals		4
	3.21.06	Present the non-current asset held for sale and discontinued operation in the financial statements (including the prior year restatement)		4
LO3.22	Earnings per share:		3	
	3.22.01	Explain the meaning and significance of a company's earnings per share		22
	3.22.02	Calculate the earnings per share, including the impact of a bonus issue, a rights issue and an issue of shares at full market value in accordance with HKAS 33		22
	3.22.03	Explain the relevance of a company's diluted earnings per share		22
	3.22.04	Discuss the limitations of using earnings per share as a performance measure		22
LO3.23	Operating segments:		3	
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	3.23.02	Explain when operating segments should be aggregated and disaggregated		23
	3.23.03	Disclose the relevant information for operating segments and appropriate entity-wide information		23

		Competency	Chapter where covered
LO3.24	Interim financial reporting:	3	
	3.24.01 Identify the circumstances in which interim financial reporting is required in accordance with HKAS 34		24
	3.24.02 Explain the purpose and advantages of interim financial reporting		24
	3.24.03 Explain the recognition and measurement principle of interim financial statements and apply them		24
	3.24.04 Disclose the relevant information for interim financial statements including seasonality		24
LO4. Preparation and presentation of financial statements			
Prepare the financial statements for an individual entity in accordance with Hong Kong Financial Reporting Standards and statutory reporting requirements			
LO4.01	Primary financial statement preparation:	3	
	4.01.01 Prepare the statement of financial position, the statement of profit or loss and other comprehensive income, the statement of changes in equity and the statement of cash flows of an entity in accordance with Hong Kong accounting standards		19, 25
	4.01.02 Explain the minimum line items that should be presented in the financial statements and criteria for additional line items		25
LO4.02	Financial statement disclosure requirements:	3	
	4.02.01 Disclose accounting policy and items required by the HKFRS, Companies Ordinance and other rules and regulations		25
	4.02.02 Explain the importance to disclose significant judgement and estimates		25

		Competency	Chapter where covered
Prepare the financial statements for a group in accordance with Hong Kong Financial Reporting Standards and statutory reporting requirements			
LO4.03	Principles of consolidation:	3	
	4.03.01 Identify and describe the concept of a group as a single economic entity		26
	4.03.02 Define a subsidiary and when a group should start and stop consolidating a subsidiary		26
	4.03.03 Explain what constitutes control and the impact of potential voting rights		26
	4.03.04 Describe the reasons why the directors of a company may not want to consolidate a subsidiary and the circumstances in which non-consolidation is permitted		26
	4.03.05 Explain the purpose of consolidated financial statements		26
	4.03.06 Explain the importance of eliminating intra-group transactions		26
	4.03.07 Explain the importance of uniform accounting policies and coterminous year ends in the preparation of consolidated accounts		26
	4.03.08 Apply the appropriate accounting treatment of consolidated goodwill		26
	4.03.09 Explain how to account for changes in parent's ownership interest in a subsidiary without losing control		29
LO4.04	Acquisition of subsidiaries:	3	
	4.04.01 Prepare a consolidated statement of financial position for a simple/complex group structure including pre and post acquisition profits, non-controlling interests and goodwill		27
	4.04.02 Prepare a consolidated statement of profit or loss and other comprehensive income for a simple/complex group structure, dealing with an acquisition and the non-controlling interest		27
LO4.05	Disposal of subsidiaries:	3	
	4.05.01 Account for the disposal of a subsidiary by a group		29
	4.05.02 Account for the change of ownership in subsidiaries without loss of control		29

		Competency	Chapter where covered
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	4.06.01 Explain the scope of business combinations in accordance with HKFRS 3		26
	4.06.02 Identify business combination and the difference between acquisition of asset and business		26
	4.06.03 Determine the acquisition date of an acquisition		26
	4.06.04 Identify the identifiable assets (including intangibles) and liabilities acquired in a business combination		26
	4.06.05 Explain the recognition principle and measurement basis of identifiable assets and liabilities and the exception		26
	4.06.06 Explain what contingent consideration is and how to account for it initially and subsequently		26
	4.06.07 Explain how to account for acquisition-related costs, including those related to issue debt or equity securities		26
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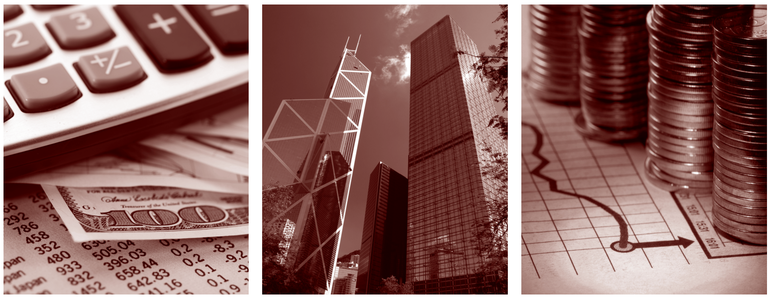
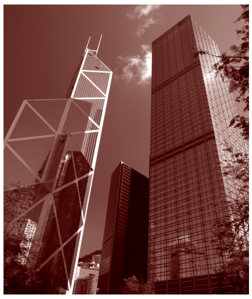


Part A

Legal environment

The emphasis in this section is on the legal environment in Hong Kong. The purpose of this section is to develop your understanding of the Hong Kong legal environment, including the legal framework and the related implications for business activities. This is considered as the basic knowledge and foundation for a future certified public accountant.


chapter 1

Legal environment

Topic list

Learning focus

This chapter is partly background knowledge to set the scene about the legal environment before you look at financial reporting standards. It also discusses the legal framework and related implications for business activities. It is important that you are aware of these both for exam purposes and in practice.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
Describe the Hong Kong legal framework and related implications for business activities		
1.01	**Types and relative advantage of alternative forms of organisation**	2
1.01.01	Identify the types and relative advantages of alternative forms of organisation	
1.02	**Legal procedures for establishment and governance of companies**	2
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1.08	**Restructuring, including appointment of receivers and liquidators**	1
1.08.01	Identify the reasons for which a company may restructure, including the appointment of receivers and liquidators	

1 Hong Kong legal framework

Topic highlights

Certified public accountants need to understand the different forms of business entities that operate in Hong Kong. You can apply the knowledge you obtain from this section of the Learning Pack to demonstrate this competence.

The liability of the members of companies can be **unlimited** or **limited**. We are mainly concerned with limited companies in this section.

1.1 Types and relative advantages of alternative forms of organisation

Topic highlights

Commercial organisations may take a number of forms, including sole trader businesses, partnerships, companies and joint ventures.

These are considered in turn in this section.

1.1.1 Sole trader business

A **sole proprietorship** also known as a **sole trader**, or simply **proprietorship**, is a type of **business entity** which is owned and run by one individual and where there is no legal distinction between the owner and the business. All profits and all losses accrue to the owner (subject to taxation). All assets of the business are owned by the proprietor and all debts of the business are their debts and they must pay them from their personal resources. This means that the owner has unlimited liability. It is a "sole" proprietorship in the sense that the owner has no partners (partnership). A sole proprietor may do business with a **trade name** other than his or her legal name. This also allows the proprietor to open a business account with banking institutions.

This form of business has a major advantage in that it is easy and quick to set up. Furthermore details of the business and its operation remain private as there is no requirement to file documents such as accounts.

There are, however, drawbacks to operating as a sole trader, the main one being that the sole trader is not legally separated from his business and therefore remains individually and personally liable for any losses that the business makes.

In Hong Kong, all the investor needs to do is to apply for a business licence from the Business Registration Office of the **Inland Revenue Department**. Every person carrying on a business shall make such an application within one month of the commencement of the business.

1.1.2 Partnerships

A partnership is a business entity formed by the **Hong Kong Partnerships Ordinance**, which defines a partnership as "the relation between persons carrying on a business in common with a view of profit" and is not a joint stock company or an incorporated company.

There must be at least two partners, but not more than 20 partners, otherwise it would be treated as a company (single entity) unless the partnership is a partnership of professional solicitors, accountants and stockbrokers. The partners share any profits and losses and inject funding by way of partners' capital.

There are two different kinds of partnership. If the business entity registers with the Registrar of Companies it takes the form of a limited partnership defined in the Limited Partnerships Ordinance.

However, if this business entity fails to register with the Registrar of Companies, then it becomes a general partnership as a default.

In a general partnership all partners are general partners so each one is liable for all debts and obligations of the firm.

In a limited partnership the **general partners** are liable for all debts and obligations of the firm while the **limited partners** are liable only for the capital they contributed to the firm.

In a limited partnership the general partners manage the firm while the limited partners may not and should limited partners do so then they become personally liable for the debts of obligations of the firm in the same manner as a general partner.

Unless a partnership agreement between the partners demand otherwise, (1) a majority of the general partners decide ordinary business matters, (2) a limited partner may assign his partnership interests, (3) a limited partner cannot dissolve a partnership, (4) the introduction of a new partner does not require the consent of the existing limited partners.

A partnership business, in common with a sole trader business, is not required to make accounts and other documents public. It also has the additional advantages of:

- greater access to capital since more individuals contribute to the business
- potentially a greater spread of skills provided by the partners
- shared risk

The disadvantages of a partnership include the issue of disputes in the running of the business, and unlimited liability. Additionally, partners are jointly and severally liable for their partners, meaning that any one may be held responsible for losses of the business.

1.1.3 Companies

A company is bound by applicable rules and regulations. This regulated formal structure is a reason why companies are such a popular business structure. It is a comparatively safe and stable system for different groups of people to join together in business activities.

The liabilities of the shareholders of companies in Hong Kong can be either **limited** or **unlimited**. Extracts from Part 1 Division 3 Subdivision 1 of the new Companies Ordinance explain the differences between unlimited companies and companies limited by shares or guarantee:

(a) **Limited by shares** – the members of the company are liable to pay the company's debts only to the extent of the nominal value of their shares.

(b) **Limited by guarantee** – the members of the company are liable to pay the company's debts only to the extent of a stated guarantee. This structure is often used by non-profit organisations which do not want to have share capital, but want the benefits of using the structure of a company.

(c) **Unlimited** – the members of the company are personally responsible for the debts of the company. This type is less common but may suit partnerships who want to use the more formal company structure for their business operation but are restricted by some professional organisation from limiting their liability. In Hong Kong, sole proprietors operating small businesses may also use this form of company.

Advantages of operating as a limited liability company

Advantages of a limited liability company include the following:

(a) The liability of the members is limited so reducing their personal exposure to debts should the company fail.

(b) The separation of ownership and management may result in the smoother running of the business and easier resolution of problems.

(c) A company may have better access to finance than unincorporated businesses and can create a floating charge by the way of security.

(d) The ownership of the business is easily achieved through the transfer of shares.

Drawbacks of operating as a limited liability company

Drawbacks of a limited liability company include the following:

(a) The regulated formal operating structure comes at the cost of registration, secretarial and audit fees.

(b) The stringent reporting requirements mean that details of the operation of the business are made public and this increases the accountability of management.

(c) The process of operating is governed and sometimes inhibited by legal requirements. For example, all limited companies are bound to compile accounts and to have their accounts audited annually.

For these reasons, small business operators may prefer to operate as a sole trader or as a partnership.

1.1.4 Joint ventures

A joint venture is a legal entity formed by two or more parties to undertake an economic activity together. The entity formed (the joint venture) may be any type of legal structure including a partnership or limited liability company.

Joint ventures are often the preferred, or required, method of entry into a new market. By forming a joint venture with another company, entities can reduce the risks associated with accessing new geographical or product markets. In certain jurisdictions, including Saudi Arabia, a foreign entity cannot legally carry out business without forming an alliance with a national entity.

1.2 Legal procedures for establishment of companies

Companies are established under the provisions of the Companies Ordinance (Chapter 32 of the Law of Hong Kong). A company operates under a memorandum or agreement between subscribers or shareholders. It is common to also have articles of association for a company, which are more detailed rules and regulations regarding meetings, resolutions and activities of the company.

The new Companies Ordinance (the “new CO”) for Hong Kong was passed on 12 July 2012 with 21 Parts comprising 921 sections and 11 schedules, and will come into operation in 2014 after the enactment of subsidiary legislation. The new CO was drafted with four major objectives:

1 enhancing corporate governance
2 ensuring better regulation
3 facilitating business
4 modernising the law

On disclosure, the new CO allows companies meeting specified size criteria (e.g. small and medium enterprises or SME) to prepare simplified financial statements and directors’ reports. As before, the new CO does not give a definition of what is a "true and fair view" for preparation of financial statements.

The new CO abolishes the requirement to have a Memorandum of Association (“MA”) as a constitutional document of a local company. A company incorporated in Hong Kong under the new CO is only required to have Articles of Association (“AA”). Under the new CO, the information which was required to be contained in the MA under the Companies Ordinance (Cap. 32) (“Cap. 32”) will be set out in the AA.

The AA of companies incorporated under the new CO must contain the following mandatory clauses (the “Mandatory Articles”) :

- Company name (section 81)
- Members' liabilities (section 83)
- Liabilities or contribution of members (for limited companies) (section 84)

- Capital and initial shareholdings (for companies with a share capital) (section 85(1) and section 8 of Part 5 of Schedule 2 to the new CO)
- For an association to be incorporated with a licence granted under section 103 or a limited company granted with such a licence, its AA must state the company's objects whilst the licence remains in force (section 82).

The new CO adopts a mandatory system of no-par value for all local companies with a share capital and retires the par value of shares, in line with international trends and to provide companies with greater flexibilities in structuring their share capital.

Par value (also known as "nominal value") is the minimum price at which shares can generally be issued. Before the implementation of the new CO, companies incorporated in Hong Kong and having a share capital were required to have a par value ascribed to their shares. The Administration has legislated for the migration to mandatory no-par. Relevant concepts such as nominal value, share premium, and requirement for authorised capital will no longer be necessary and will be abolished.

Schedule 11 part 4 Division 2 of the new CO contains transitional provisions in relation to the abolition of par value. These state that at the beginning of the commencement date of the new legislation, any amount standing to the credit of the company's share premium account and capital redemption reserve becomes part of the company's share capital. Additionally, any amount that would be required by a continuing provision to be transferred to a company's share premium account or capital redemption reserve on or after the commencement date of section 135 becomes part of the company's share capital.

Once registered with the Registrar of Companies, a company is issued with a certificate of incorporation as evidence that all the requirements of the new CO have been met with respect to the registration.

The most common form of business structure in Hong Kong is the limited liability company. Limited companies can be **private limited companies** or **public limited companies**. Any company that cannot meet the legal requirements to remain a private company must register as a public company.

Private companies are devised for the small business and are intended for situations where the members are also the managers of the company.

A private company is defined by new CO Part One Division 3 Subdivision 2 section 11 as a company which by its articles:

(a) restricts the right to transfer its shares; and

(b) limits the number of members to 50, not including employees of the company and former employees who were members of the company whilst employed and who have continued to be members; and

(c) prohibits any invitation to the public to subscribe for any shares or debentures in the company.

For the purposes of this section, two or more persons holding one share jointly are treated as one member.

If a company's articles fail to satisfy the requirements of s.11, it is a public company, although the term "public company" is not actually used in or defined by the new CO.

The main advantage of private companies is that they need not file accounts with their annual return and, subject to a number of exceptions, they may waive compliance with certain requirements as to the content of their accounts (s.359). When a private company sends its annual return to the Registrar of Companies they are signed by a director or the secretary, stating that the company has complied with s.11.

If a company alters its articles so that it no longer satisfies s.11, from the date of alteration the company will cease to be a private company and within 14 days it must deliver to the Registrar a prospectus or a statement in lieu of a prospectus in the form and containing the particulars specified in the Companies (Winding up and Miscellaneous Provisions) Ordinance, which is the revised name for the remaining provisions of the old Companies Ordinance. These documents are also required before a company which is formed as a public company may allot any of its shares or debentures.

Under the new CO s.94, the company must, within 15 days after the date on which the alteration takes effect, deliver to the Registrar for registration:

(a) a notice of the change of the company's status in the specified form; and

(b) a copy (certified by an officer of the company to be true) of the company's annual financial statements that are:

   (i) prepared in accordance with section 379; and

   (ii) prepared for the financial year immediately before the financial year in which the alteration takes effect.

Under the new CO, the annual return of a public company or a guarantee company will no longer be filed with reference to the date of Annual General Meeting ("AGM") as an AGM may be dispensed with under s.612 of the new CO. The requirement is to deliver the annual return in respect of every financial year of the company instead of in each calendar year.

Pursuant to sections 662(3) and (4) of the new CO, the annual return of a public company or a guarantee company should be filed (together with certified true copies of the relevant financial statements, directors' report and auditor's report) within 42 days after the company's return date.

The return date for a public company is 6 months after the end of the company's accounting reference period while the return date for a guarantee company is 9 months after the end of the company's accounting reference period.

The accounting reference period is the period by reference to which the company's annual financial statements are to be prepared. For example, if a company prepares its financial statements up to 31 December every year, the accounting reference period is from the 1 January of a year to 31 December of the same year.

There is no change in the requirement to file annual returns of private companies. Pursuant to sections 662(1) and (2) of the new CO, the annual return of a private company must be delivered for registration within 42 days after the anniversary of the date of incorporation of the company.

1.3 Corporate governance

Topic highlights

Corporate governance has become increasingly important in recent years due to a number of high profile corporate collapses. The new CO seeks to emphasise the importance of corporate governance.

Key term

Corporate governance is the system by which companies are directed and controlled.

(Cadbury Report)

Corporate governance may be defined as the system and processes by which companies are directed and controlled in response to the rights and expectations of shareholders and other stakeholders. Corporate governance therefore covers a very wide range of issues and disciplines from the appointment and the remuneration of directors, the procedures of the directors' meetings and the role of non-executive directors, to the company's objectives, business strategy and risk management, and to investor relations, employee relations and social responsibilities and so on.

Corporate governance has been the subject of much debate in the business world in recent years. The trigger for this debate was the **collapse** of major international companies during the 1980s, including Maxwell, BCCI and Polly Peck. These collapses were often unexpected, and dubious (or even fraudulent) activities were sometimes attributed to their owners and managers. These events represented a nasty shock for countries, such as the UK and the USA, that felt they had well-regulated markets and strong company legislation. It became obvious, however, that part of the problem was the way in which regulation was spread between **different national authorities** for these global conglomerates, so that no one national authority had the whole picture of the affairs of such companies, nor full powers over the whole of the business.

Individual countries began to develop **better guidelines** for the corporate governance, and efforts have been made to produce an international standard on corporate governance.

Since 1995, the Corporate Governance Committee of the Hong Kong Institute of CPAs has made a series of recommendations for enhanced corporate governance disclosure in Hong Kong. In the committee's latest report, Corporate Governance Disclosure in Annual Reports – *A Guide to Current Requirements and Recommendations for Enhancement*, which was published in March 2001, the Committee repeated certain of those recommendations which have not yet been adopted in the Listing Rules and made further recommendations for enhancement.

Some of the recommendations are extracted as follows:

(a) To communicate to shareholders the strength of their corporate governance structure, policies and practices, listed companies and public corporation are encouraged to include in their annual report a statement of corporate governance;

(b) To enhance comparability and transparency of the way directors are compensated, directors' remuneration should be analysed between "performance based" and "non-performance based";

(c) Disclosure requirements in respect of directors' share options should be extended to include disclosure by individual director of the aggregate value realised. Aggregate value realised is calculated as the excess of the market price on the day of exercise of the option over the exercise price multiplied by the number of shares acquired as a result of the exercise of the option;

(d) To aid communication with the reader of the financial statements, the directors should set out in a separate statement their responsibilities in connection with the preparation of the financial statements; and

(e) To increase transparency regarding auditors' independence, disclosure of non-audit fees paid to auditors should be made.

The new CO in Hong Kong has introduced some measures for enhancing corporate governance, in particular in the following areas:

(a) **Strengthening the accountability of directors** by requiring every private company to have at least one natural person acting as director (rather than a corporate director, ie a company acting as director) in order to enhance transparency and accountability.

(b) **Enhancing shareholder engagement in the decision making process** by:

- introducing detailed and comprehensive rules for the passing of written resolutions, thus making it easier for shareholders to vote and companies to pass resolutions;
- by requiring companies to bear the expenses of circulating members' statements relating to AGMs, thus avoiding members being deterred from doing this by the cost;
- educing the threshold requirement for members to demand a poll from 10% to 5% of the total voting rights

(c) **Improving the disclosure of company information** by requiring public companies and large private companies (i.e. those that do not qualify for simplified reporting to prepare a more comprehensive directors' report, including a 'business review'. This will include information relating to environmental and employee matters, thus promoting corporate social responsibility

(d) **Fostering shareholder protection** by:

- introducing rules to deal with directors' conflicts of interests;
- requiring the approval of disinterested shareholders where shareholder approval is required for transactions of public companies and their subsidiaries;
- introducing stricter rules for the ratification of the conduct of directors to prevent conflicts of interest and abuse of power;
- extending the scope of the 'unfair prejudice' remedy

(e) **Strengthening auditors' rights** by empowering auditors to require information or explanations from a wider range of persons than was previously the case.

2 Obligations of directors and officers of companies

Topic highlights

The directors have statutory duties laid down in the Companies Ordinance, common law duties of reasonable care and skill and fiduciary duties in equity.

2.1 Directors' responsibilities

Directors are first and foremost responsible for the operation of a company, ensuring that it operates as the shareholders intended within the corporate legal environment.

The new CO broadens the definition of director to "include any person occupying the position of director by whatever name called". Directors' responsibilities are therefore imposed on the senior management of a company, whether they are the directors, chief executives, senior managers or other officers; it depends on the role they actually fulfil.

Section 456 of the new CO maintains the restriction on corporate directorship in public companies, companies limited by guarantee and private companies which are members of a group of companies of which a listed company is a member. This restriction, however, does not apply to other private companies which are required to have at least one director who is a natural person.

The new CO requires every private company to have at least one director who is a natural person, to enhance transparency and accountability.

The liability of directors is not specifically set out in the Companies Ordinance, and is generally established by case law. In some situations, directors may be held personally liable for losses caused to the company as a result of their actions. The new CO states that any provision in a company's articles or a contract which seeks to enable a director to avoid liability for any negligence, default, breach of duty or breach of trust as a result of their actions will be void (Part 10 Division 3 section 468).

2.1.1 Duties and responsibilities

The Companies Registry issued "A Guide on Directors' Duties" in July 2009. The general principles of directors' duties were explained as follows:

1 duty to act in good faith for the benefit of the company as a whole

2 duty to use powers for a proper purpose for the benefit of members as a whole

3 duty not to delegate powers except with proper authorisation and duty to exercise independent judgment

4 duty to exercise care, skill and diligence

5 duty to avoid conflicts between personal interests and interests of the company

6 duty not to enter into transactions in which the directors have an interest except in compliance with the requirements of the law

7 duty not to gain advantage from use of position as a director

8 duty not to make unauthorised use of the company's property or information

9 duty not to accept personal benefit from third parties conferred because of position as a director

10 duty to observe the company's memorandum and articles of association and resolutions

11 duty to keep proper books of account

These general principles involving duties and operation requirements are summarised further as duties and powers below.

(a) **Fiduciary duties**

Directors must act honestly and in good faith for the benefit of the company. In particular, directors must act in good faith in what they believe to be the best interests of the company. Generally speaking, the interests of the company are to be equated with the interests of its members as a whole. Directors must not act just for the economic advantage of the majority of shareholders disregarding the interests of the minority. The position and interests of creditors must be considered in any case where the company is not fully solvent. The interests of the company's employees must also be taken into account.

Directors must act for a proper purpose. That is, directors must not abuse the powers given to them by using those powers for purposes other than those for which they were granted.

Directors must not obtain a personal profit from transactions entered into by the company without the prior approval of the shareholders; otherwise such profits will be regarded as being held in trust for the company and they may have to account for them.

Directors must not agree to fetter their discretion. As the powers delegated to directors by the memorandum and articles are held in trust by them for the company, they must not restrict their exercise of future discretion.

Directors must act in such a way that there is no possibility of conflict between personal interests and company interests. Directors should also avoid any conflict of interest by not using corporate property, information or opportunity for any purpose other than in the company's interests.

(b) **Duty to exercise skill and care**

Directors must exercise reasonable care and skill in the performance of their duties. The wide range of skills required of directors has meant that there have been no precise standards of skill and care established in case law. In the past the courts have required that directors display the degree of skill and care which may reasonably be expected from a person with that director's knowledge and experience. If employed as having particular skills, for example, as being a certified public accountant, a **director should display the skill or ability expected from a person of that profession**. A certified public accountant may, depending on the circumstances, be held professionally responsible if he or she should be found negligent in the discharge of his or her duties as a director.

However, the new CO has introduced a statutory responsibility on directors to exercise reasonable care, skill and diligence (s 465) which should make it easier for courts to determine whether the duty of care has been exercised.

Statutory duty – various company law statutes impose a number of duties on directors, such as the preparation of annual accounts and duties in relation to auditors.

(c) **Directors' responsibilities in respect of financial reporting**

Directors are responsible for ensuring that all information contained in prospectuses, financial statements and other financial documents is accurate and is presented in accordance with the laws and regulations that apply to the company. In respect of directors' liabilities, directors can be subject to fines and penalties under the Companies Ordinance or subject to other penalties by regulatory bodies and, in the event of legal proceedings, may be personally sued for negligence by investors, shareholders or other parties affected by their actions.

The directors are responsible for ensuring that:

- the company prepares financial statements that give a true and fair view of the company's financial positions and results
- the financial statements are accurate and presented in accordance with law (especially for example the Companies Ordinance) and regulations
- roper books and accounts are kept

2.1.2 Powers and obligations

(a) **Powers of directors**

The general power of managing a company is usually vested in the directors. Formally the powers of directors are defined by articles. The directors may meet together to despatch business, adjourn, and otherwise regulate their meetings as they think fit under Table A, art 100.

At common law, directors can only exercise their powers collectively by passing resolutions at a properly convened meeting of the board of directors; they have no power to act individually as agents for the company. However, a company's articles will usually empower the board of directors to delegate its power to individual directors or to committees of directors (Table A, art 104), and to the managing director (art 111), so that a meeting is not required for each and every decision taken by the board of directors.

(b) **Directors' obligations**

If a person does not comply with his duties as a director he may be liable to civil or criminal proceedings and may be disqualified from acting as a director.

Various important legal issues have been raised locally and overseas with regard to the fulfillment of directors' duties or the execution of their powers. Agency creation is an important topic. An agency relationship is created when one person acquires the authority to act for another, the principal. An agency relationship could be created by:

1. express appointment;
2. conduct of the parties;
3. necessity of the situation;
4. ratification; and
5. estoppel.

Some practical legal views related to the agency theory are as follows.

(a) Indoor Management Rule

The Indoor Management Rule, also known as the Turquand Rule (Royal British Bank v Turquand (1856) 6 E&B 327), entitles an outsider to assume that the internal procedures of a company have been complied with. This is a practical approach to solving problems facing outsiders because an outsider would have difficulty in discovering what is going on in a company, e.g. whether a company director has exceeded his authority as given to him by the Articles of Association, or whether there has been some non-compliance with an internal procedure.

(b) The doctrine of estoppel

English law defines estoppel as: "a principle of justice and of equity. It comes to this: when a man, by his words or conduct, has led another to believe in a particular state of affairs, he will not be allowed to go back on it when it would be unjust or inequitable for him to so." (Moorgate Mercantile v Twitchings [1976] 1 QB 225, CA at 241 per Lord Denning MR). Estoppel could be by record with issue or cause of action. Estoppel could also be by deed of rules, regarded as technical or formal estoppel. Under English law, estoppel by representation of fact, promissory estoppel and proprietary estoppel are regarded as reliance-based estoppels. All three estoppels are estoppels by representation.

Estoppel allows a party to a contract, acting in good faith, to prevent the counterparty from breaking a contract by relying upon certain rights, or upon a set of facts (e.g. words said or actions performed) which is different from an earlier set of facts, in certain situations. For example, the chairman of a board cannot rescind a contract within his powers, signed by a fellow director, on authority grounds, if he is also actively involved in the contract negotiation together with that director.

2.2 Officers of companies

Topic highlights

The secretary of a company is the chief administrative officer. The position involves communications with the Companies Registry and with members in relation to all legal and administrative issues. The secretary usually has actual power to bind the company in respect of actions normally expected of a company secretary.

The term "officer" is a generic one that can be applied to directors, the secretary and some other senior managers. Officers are usually accountable in law for certain actions specified in legislation. Furthermore, they may be accountable under the principles established in decided cases.

The secretary is the chief administrative officer of the company as regards relations with members and the Companies Registry.

Every company must have a secretary. The position may be filled by an individual or a company. It is permitted to have more than one secretary. Details of the secretary must be registered in Chinese and English.

The secretary can be a director of the company unless the company has only one member who is also the only director (section 154, Companies Ordinance). Listed companies must segregate the roles of chairman and secretary under the Listing Rules.

2.2.1 The role of the secretary

The secretary is the vital link between the company and the Companies Registry, and the company and its members.

The secretary receives all formal communications from the Registry. The secretary is responsible for submitting returns and registration of documents such as charges over assets, special resolutions, loans to directors and so on (though it is the directors who are accountable for these actions).

2.2.2 Powers and duties of the company secretary

The secretary:

- makes arrangements for meetings of the board of directors
- makes arrangements for annual and extraordinary general meetings
- records the formal minutes of meetings and makes these available for signature
- maintains the company's records, including the register of members

- deals with matters relating to liaison with members
- deals with formal communications between the company and the Companies Registry

3 Legal requirements associated with company structure, share offerings, debt obligations and restructuring

Topic highlights

There are legal requirements associated with the company structure, share offerings, debt obligations and restructuring.

The issued share capital is made up of the shares already held by members. It is sometimes called subscribed share capital.

A company does not have to issue all of its authorised share capital at once, or even at all if it chooses not to do so. Share capital not issued is called unissued share capital.

3.1 Share issues and prospectus requirements

When a company is first established, shares are issued as follows:

(a) In a private company they are issued by allotment, with the directors passing a resolution at a board meeting stating that shares are to be issued to named persons.

(b) In a public company they are issued by a renounceable allotment letter, which allows issued shares to be transferred by the initial holder within a specified period of time.

The power to allot shares is normally delegated to the directors by the Articles or by an ordinary resolution passed by the members at a general meeting.

When a public company seeks to raise capital from the general public it must issue a prospectus. Detailed requirements of such a prospectus may be found on the website of the Hong Kong Stock Exchange, although knowledge is not required for the Module A exam.

3.2 Debt instruments and registration of charges

Debt instruments are a type of financial instrument. The accounting treatment of these is found in a later chapter. Issuers of debt finance, such as banks, will often require security for their loan in case a company is unable to meet repayments. This security is normally a charge over individual assets (a fixed charge) or over a group of changing assets (a floating charge). Where the borrower defaults on repayment, a floating charge crystallises and the lender takes control of the asset(s) held as security and may sell it or them to realise funds.

3.2.1 Registration of charges

Part 8 of the new CO deals with registrtaion of charges. It specifies that two registers of charges must be maintained:

(a) The Companies Registry must keep a record for each company (section 27)

(b) The company must keep its own register, either at its own office or at a location of which the Registry is aware (Part 8 Division 7 section 352).

Fixed and floating charges must be registered at the Companies Registry within one month of their execution.

Any charge not registered within this time period will be void against the liquidator and any creditor of the company. This does not mean that the company no longer owes the money, but it does relegate the obligation to the level of an unsecured creditor. Therefore, the charge remains valid against the company. Irrespective of the terms of the debenture, failure to register makes the whole debt immediately repayable. This will normally result in insolvency within a short period of time.

Any fixed charge on land and buildings must be registered in the Land Office within one month of being executed. This also applies if any floating charge that includes land or buildings crystallises.

The requirement to register is set out in Part 8 Divisions 2 and 3 of the Companies Ordinance. Not all charges have to be registered, but the exclusions generally fall outside the Module A syllabus.

Charges must be registered by the debtor company, though the creditor can perform this function (Division 2 section 335). Registration secures the position of the creditor and also serves as an indication of the obligation to prospective future lenders if they choose to search the register.

Once registration has occurred, a non-current asset that secures a fixed charge can only be sold with the consent of the secured lender. Some debentures are issued under a trust deed so that only one registration is necessary. Also, if the directors seek release from the charge they need only approach the trustees instead of potentially many lenders.

As we have seen, the creation of a floating charge does not prevent dealing in the asset.

On liquidation, charges are prioritised using the following principles:

- Fixed charges rank ahead of floating charges
- Charges of the same kind are ranked in order of their date of creation

The security to the lender is the value of the asset at disposal and not the debt. Therefore, if a company is liquidated and an asset is sold for $50,000 with a loan outstanding of $70,000, the difference will rank as unsecured.

Some lenders reinforce their position by including a negative pledge clause in their floating charge documents. This is a condition that states that the company will not create any later legal or equitable charges over specific assets ranking in priority to a floating charge.

3.3 Statutory reporting and documentation requirements

A company must keep statutory registers of:

- members
- directors
- directors' interests, including loans to directors
- charges over the company's assets
- meetings
- resolutions
- substantial interests in shares

The records must be kept at the registered office or another location if permission is granted by the Companies Registry.

The company must prepare a

- statement of financial position
- statement of profit or loss and other comprehensive income

Both of these documents must be approved and signed.

These financial statements have to be filed with the Registrar and sent to all members and debenture holders.

A listed public company is permitted to produce summary financial statements for the members in place of the full accounts.

Companies must keep proper accounting records to enable the accounts to be prepared with reasonable accuracy. An annual return must be sent to the Registry.

3.4 Appointment and removal of auditors

The first auditors of a new company are appointed by the first directors of the company.

For existing companies, the appointment or reappointment of auditors is confirmed by the members in the Annual General Meeting. If the AGM does not appoint an auditor, the court can make an appointment.

If the auditors resign from their position, the directors or the shareholders at a general meeting may appoint new auditors.

3.4.1 New auditors

Where new auditors are appointed at a general meeting it is necessary to serve special notice (28 days) to the members. In some cases this may be impossible, but the notice period may not be less than 21 days.

Notification to the members may be by any mode of communication permitted by the Articles of Association.

The remuneration of auditors is determined by whoever appoints the auditors.

3.4.2 Removal and resignation of auditors

The company must pass an ordinary resolution if it wishes to remove the auditors. If this occurs before the expiry of the period of office, special notice of 28 days to the company by the person seeking to remove the auditor is mandatory.

Any representations by the auditors relating to (or relevant to) the removal or resignation must be sent to the members. The removed or resigning auditor is entitled to attend the next AGM.

The auditor can resign in writing at any time. Unless the auditor wishes to make a statement to the members, the notice to the company must state that there are no relevant circumstances connected with the resignation that need to be brought to the attention of the members. The notice of resignation must be deposited with the Companies Registry. If there is a statement made by the auditor relating to the circumstances of resignation this must be sent to all of the members.

3.4.3 Auditor's rights

The new CO enhances the rights of auditors. Pursuant to s. 412 of the new CO, auditors may require information and explanation for the performance of their duties from a **wider range of persons**, including persons holding or accountable for any accounting records of the company or a Hong Kong incorporated subsidiary of the company.

It also empowers auditors to require the company to obtain information and explanation for the performance of their duties from **persons holding or accountable for the accounting records** of a non-Hong Kong incorporated subsidiary.

3.5 Restructuring, including appointment of receivers and liquidators

Companies may alter their capital structure or make other arrangements to improve profitability or liquidity, increase efficiency or ultimately rescue the business. The law sets out to protect the members and outside parties in the event of these actions.

3.5.1 Restructuring

Restructuring is a common response to a change in business conditions. A company may restructure its financing arrangements, its assets or its operations in order to save money and achieve efficiencies.

Debt restructuring is the process where a company with cash flow problems restructures or renegotiates debts in order to improve or restore liquidity so that trading may continue.

Capital restructuring involves reallocating assets to improve liquidity. Certain assets are sold and replaced with alternative assets which can be better utilised to earn revenue and profits.

The overall motives of restructuring are reduced risk, reduced cost of capital and increased liquidity.

3.5.2 Liquidation

Key term

Liquidation is the "end of the road" for the company. It occurs when it is certain that the life of the company will come to an end. The process by which this occurs is called **winding up**. You can use the terms "liquidation" and "winding up" to mean broadly the same thing. However, the company does not have to be in financial difficulties to be wound up. The members of the company may decide at any time to take such action, and in some cases are obliged to do so (for example, if the company were set up to achieve a specific purpose and this has been fully achieved, there is no reason for the company to go on trading).

The **liquidator** is the person appointed to wind up the company and is an insolvency practitioner (usually an accountant or solicitor) with expertise in such matters. Where a company is insolvent, the liquidator is appointed by the **Official Receiver**, a civil servant acting on instructions from the court. The Official Receiver is sometimes called the **provisional liquidator**.

3.5.3 Receivership

A **receiver** is different to both a liquidator and the Official Receiver. A receiver is a person or firm appointed by creditors to act if a company has broken the conditions of a debenture, such as not making payments when contractually obliged to do so. The job of the receiver is to get the money back for the creditor. If he does so and the company can still survive, it does not mean that the receiver's actions will bring an end to the company.

The receiver is appointed under the provisions of the debenture. A receiver may also be appointed by the court or on the statutory basis provided by the Conveyancing and Property Ordinance:

> *"... there shall be implied in any legal charge or equitable mortgage by deed, where the money has become due, a power exercisable in writing by the mortgagee and any person entitled to give a receipt for the mortgage money on its repayment to appoint a receiver... to remove any receiver... and appoint another in his place."*

The court appoints a receiver if the security is in jeopardy.

When a receiver is appointed it is necessary to inform the Companies Registry within seven days of appointment. From this time, the company's letterhead must make specific reference to the receiver.

3.6 Financial statements requirements

Under the new CO, Hong Kong companies have a statutory duty to prepare financial statements and file these financial statements with the Companies Registry unless exempted. Some of the relevant Ordinance provisions are as follows:

- s.379 - a company's directors must prepare for each financial year financial statements that comply with the ordinance requirements, and directors must instead prepare for the financial year consolidated statements if the company is a holding company and not a wholly owned subsidiary of another corporate

- s.380(1) - the annual financial statements must give a true and fair view of the financial position of the company as at the end of the financial year and the financial performance of the company for the financial year

- s.380(2) - the annual consolidated statements must give a true and fair view of the financial position of the company and all the subsidiary undertakings as a whole as at the end of the financial year, and the financial performance of the company and all the subsidiary undertakings as a whole for the financial year

- s.380(3) – the financial statements for a financial year must comply with Part 1 and 2 of Schedule 4, depending on reporting exemption

- s.380(4) – the financial statements for a financial year must comply with any other requirements of the Ordinance in relation to the financial statements and the accounting standards applicable to the financial statements

- s.380(5) - the financial statements must contain all additional information necessary to give a true and fair view

- s.380(6) – the financial statements must contain the reasons for, and the particulars and effect of, the departure from the Ordinance requirements to give a true and fair view

- s.381 – the annual consolidated financial statements for a financial year must include all the subsidiary undertakings of the company, exclusion of one or more subsidiaries may be possible subject to reporting exemption or materiality

- s.387 - a statement of financial position that forms part of any financial statements must be approved by the directors and signed by 2 directors on the directors' behalf

The new CO defines accounting standards as statements of standard accounting practice issued or specified by a body prescribed by its Regulations. However, the definition of a true and fair view again is not provided.

Topic recap

Legal environment

Hong Kong Legal Framework

Types of organisation:
- Sole proprietor
- Partnerships
- Companies

A business licence to operate as a sole proprietor is applied for from the **Inland Revenue Department.**

Partnerships are formed by the **Hong Kong Partnerships Ordinance.**

A company is established under the provisions of the **Companies Ordinance.**

Joint ventures may be any type of legal structure.

Limited liability companies are **private or public.** Those which do not meet the conditions to remain private must register as public.

Corporate governance is the system by which companies are directed and controlled.

Directors and officers of a company

Directors' duties and responsibilities
- Fiduciary duties
- Duty to exercise skill and care
- Responsibilities in respect of financial reporting

Directors' powers and obligations:
- Power of directors – managing the company
- Directors' obligations – compliance with duties

The company secretary is the chief administrative officer. They:
- arrange board meetings
- arrange general meetings
- record meeting minutes
- maintain company records
- liaise with members
- deal with formal communications with the Companies Registry

Legal requirements

Share issues:
- Prospectus required where a public company seeks to raise capital from general public.

Debt & charges:
- Fixed charge: charge over single asset
- Floating charge: charge over group of assets.

Two registers of charges must be maintained.

Statutory reporting
A company must:
- maintain statutory registers
- prepare statements of financial position and comprehensive income.

Auditors
- New auditors appointed at AGM
- Removal of auditors by ordinary resolution
- Resignation at any time in writing

Restructuring
- Debt restructuring (renegotiate debts to improve liquidity)
- Capital restructuring (reallocate assets to improve liquidity)
- Liquidation (winding up the company)
- Receivership (recovery of money for creditors)

Exam practice

Preparing financial statements

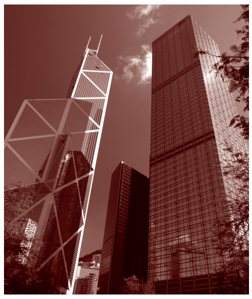
15 minutes

During an audit of the financial statements of a Hong Kong incorporated company listed on the Main Board of The Stock Exchange of Hong Kong Limited, the auditor reported to the Audit Committee of the company that no impairment assessment had been done by the management in respect of the goodwill arising on an acquisition of a subsidiary in the prior year under HKAS 36 *Impairment of Assets*. In a meeting with the directors of the company, one of the executive directors told the auditor that "We are not responsible for the preparation of financial statements. We have delegated this task to our financial controller. Please talk to him directly." The financial controller, being a professional accountant, responded that, "the financial statements will be approved by the Board of Directors instead of me; it is not my problem if the financial statements are not prepared in accordance with Hong Kong Financial Reporting Standards."

Required

Comment on the validity of the statements given by the executive director and the financial controller of the company in respect of their responsibilities in the preparation of the financial statements. **(8 marks)**

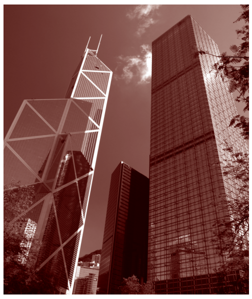
HKICPA May 2009



Part B

Financial reporting framework

The emphasis in this section is on an in-depth understanding of the financial reporting framework in Hong Kong. The purpose of this section is to develop your understanding about the financial reporting framework in Hong Kong, the role of accounting standards and the financial reporting requirements under Hong Kong Financial Reporting Standards.

chapter 2

Financial reporting framework

Topic list

1 Regulatory bodies and their impact on accounting
- 1.1 The role of the Hong Kong Institute of CPAs (HKICPA)
- 1.2 The role of the Stock Exchange of Hong Kong (SEHK) Ltd
- 1.3 Securities and Futures Commission (SFC)
- 1.4 Financial Reporting Council (FRC)
- 1.5 Hong Kong Insurance Authority (HKIA)
- 1.6 Hong Kong Monetary Authority (HKMA)

2 Financial reporting requirements under HKFRS

3 Hong Kong Financial Reporting Standards
- 3.1 The setting of HKFRS and due process
- 3.2 Current Hong Kong FRS
- 3.3 Scope of HKFRS
- 3.4 Accounting standards and choice

4 Other sources of financial reporting guidance
- 4.1 HK(IFRIC) Interpretations, Hong Kong Interpretations and HK(SIC) Interpretations
- 4.2 *Conceptual Framework for Financial Reporting* (the *Conceptual Framework)*
- 4.3 Accounting Guidelines and implementation guidance
- 4.4 Accounting Bulletins

5 Additional requirements for listed companies
- 5.1 Companies listed on the Main Board
- 5.2 Companies listed on GEM
- 5.3 Acceptance of Mainland Accounting and Auditing Standards

6 *Code of Ethics for Professional Accountants*
- 6.1 Fundamental principles
- 6.2 Obligation to comply with the *Code of Ethics*
- 6.3 Revision to *Code of Ethics*

7 Conceptual Framework and GAAP
- 7.1 A conceptual framework
- 7.2 Advantages and disadvantages of a conceptual framework
- 7.3 Generally Accepted Accounting Principles (GAAP)

8 The HKICPA's *Conceptual Framework*
- 8.1 Preface
- 8.2 Introduction
- 8.3 Purpose and status
- 8.4 Scope
- 8.5 Users and their information needs
- 8.6 The objective of financial statements
- 8.7 Information about economic resources, claims and changes in resources and claims
- 8.8 The reporting entity

9 Qualitative characteristics of financial information
- 9.1 Fundamental qualitative characteristics
- 9.2 Enhancing qualitative characteristics
- 9.3 The cost constraint on useful financial reporting
- 9.4 Underlying assumption

10 The elements of financial statements
- 10.1 Financial position
- 10.2 Performance
- 10.3 Capital maintenance
- 10.4 Section summary

11 Recognition of the elements of financial statements
- 11.1 Probability of future economic benefits
- 11.2 Reliability of measurement
- 11.3 Recognition of items

12 Measurement of the elements of financial statements

13 Fair presentation and compliance with HKFRS
- 13.1 Extreme case disclosures
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14 Management commentary
- 14.1 Purpose
- 14.2 Contents

15 Current developments
- 15.1 *Conceptual Framework*
- 15.2 Other IASB Projects

Learning focus

The content of the HKICPA's *Conceptual Framework* is vital as it underpins all HKFRS. Both in exams and in practice, when an accounting standard does not appear to provide guidance on a particular topic, you may be required to fall back on the basic principles of the *Conceptual Framework*.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
Describe the financial reporting framework in Hong Kong and the related implications for business activities		
2.01	**The role and setting of accounting standards**	2
2.01.01	Understand the role of accounting standards	
2.01.02	Understand the role of the HKICPA, Securities and Futures Commission (SFC), Financial Reporting Council (FRC), the Hong Kong Insurance Authority (HKIA), the Hong Kong Monetary Authority (HKMA) and the Hong Kong Stock Exchange (HKEx)	
2.02	**Hong Kong Financial Reporting Standards**	2
2.02.01	Describe how Hong Kong Financial Reporting Standards are set	
2.05	**Code of Ethics for Professional Accountants**	3
2.05.01	Explain the requirements of the Code of Ethics for Professional Accountants	
2.06	**Hong Kong (IFRIC) Interpretations, Hong Kong Interpretations and Hong Kong (SIC) Interpretations**	2
2.06.01	Describe the status of Hong Kong (IFRIC) Interpretations, Hong Kong Interpretations and Hong Kong (SIC) Interpretations	
2.07	**Other professional pronouncements and exposure drafts**	2
2.07.01	Identify other professional pronouncements and exposure drafts relevant to the financial reporting Conceptual Framework	
2.08	**Regulatory bodies and their impact on accounting**	2
2.08.01	Identify relevant regulatory bodies and their impact on accounting	
2.09	**Accounting principles and conceptual frameworks**	2
2.09.01	Explain what is meant by a conceptual framework and GAAP	
2.09.02	Identify the advantages and disadvantages of a conceptual framework	
2.09.03	Identify the components and requirements of the HKICPA's *Conceptual Framework*	
2.09.04	Explain those requirements of HKAS 1 *Presentation of Financial Statements* which overlap with the HKICPA's *Conceptual Framework*	
2.10	**Current developments**	2
2.10.01	Identify areas of accounting in which current developments are occurring	

1 Regulatory bodies and their impact on accounting

Topic highlights

The main regulatory bodies influencing accounting within Hong Kong are the Hong Kong Institute of Certified Public Accountants (HKICPA), and for listed companies, the Hong Kong Stock Exchange (HKEx). Other bodies include the Securities and Future Commissions (SFC), Financial Reporting Council (FRC), the Hong Kong Insurance Authority (HKIA) and the Hong Kong Monetary Authority (HKMA). Throughout this chapter we shall meet the regulations and requirements put in place by these bodies, but first, a brief introduction to each.

1.1 The role of the Hong Kong Institute of CPAs (HKICPA)

The HKICPA issues HKFRS and non-mandatory guidance documents including Accounting Guidelines and Accounting Bulletins.

The HKICPA is the only statutory accounting body in existence in Hong Kong responsible for the establishment of accounting and auditing standards and guidelines, as well as for the administration and regulation of the accounting profession in Hong Kong.

Pursuant to the Professional Accountants Ordinance (Chapter 50), the Council of the HKICPA (the Council) may, in relation to the practice of accountancy, issue or specify any standards of accounting practices required to be observed, maintained or otherwise applied by members of the Hong Kong Institute of CPAs. In this respect, the objectives of the Council are to:

(a) develop, in the public interest, a single set of high quality, understandable and enforceable accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the capital markets and other users of the information to make economic decisions

(b) promote the use and rigorous application of those standards

(c) promote, support and enforce compliance with those standards by members of the HKICPA whether as preparers or auditors of financial information

(d) bring about convergence of accounting standards with International Financial Reporting Standards (IFRS).

1.2 The role of the Stock Exchange of Hong Kong (SEHK) Ltd

The principal function of the SEHK is to provide a fair, orderly and efficient market for the trading of securities, under the Stock Exchange Unification Ordinance.

To enhance the competitiveness of the Hong Kong securities market so as to meet the challenge of an increasingly globalised market, there was a comprehensive market reform of the securities and futures market in March 2000, under which the SEHK, the Hong Kong Futures Exchange Ltd (HKFE) and the Hong Kong Securities Clearing Company Ltd (HKSCC) were amalgamated under a holding company, Hong Kong Exchanges and Clearing Ltd (HKEx).

Currently, there are two established exchanges under the SEHK, the Main Board and the Growth Enterprise Market (GEM) Board, on which companies are listed in Hong Kong.

Companies listed on the Main Board are required to comply with the Listing Rules whereas companies listed on the GEM Board are required to comply with the GEM Rules.

The SEHK regulates the financial reporting compliance of listed companies through a Regulatory Affairs Group and a GEM Department for companies listed on the Main Board and the GEM Board respectively.

1.3 Securities and Futures Commission (SFC)

Topic highlights

The Securities and Futures Commission (SFC) is an independent non-governmental statutory body, and is established by the Securities and Futures Commission Ordinance (SFCO). It is outside the civil service, responsible for regulating the securities and futures markets in Hong Kong.

The SFC is responsible for administering the laws governing the securities and futures markets in Hong Kong and facilitating and encouraging the development of these markets.

The statutory regulatory objectives as set out in the SFO are to:

- maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry;
- promote understanding by the public of the operation and functioning of the securities and futures industry;
- provide protection for members of the public investing in or holding financial products;
- minimise crime and misconduct in the securities and futures industry;
- reduce systemic risks in the securities and futures industry; and
- assist the Financial Secretary in maintaining the financial stability of Hong Kong by taking appropriate steps in relation to the securities and futures industry.

In carrying out their mission, the SFC aims to ensure Hong Kong's continued success and development as an international financial centre.

The SFC is divided into four operational divisions: Corporate Finance, Intermediaries and Investment Products, Enforcement, and Supervision of Markets. The Commission is supported by the Legal Services Division and Corporate Affairs Division.

1.3.1 Whom, what and how: SFC regulation

Areas of regulation	Methods
Licensed corporations and individuals carrying out the following regulated activities: • Dealing in securities • Dealing in futures contracts • Leveraged foreign exchange trading • Advising on securities • Advising on futures contracts • Advising on corporate finance • Providing automated trading services • Securities margin financing • Asset management	• Set licensing standards to ensure that all practitioners are fit and proper • Approve licenses and maintain a public register of licensees • Issue codes and guidelines to inform the industry of its expected standard of conduct • Monitor licensees' financial soundness and compliance with the Ordinance, codes, guidelines, rules and regulations • Handle misconduct complaints against licensees • Investigate and take action against misconduct

Areas of regulation	Methods
Investment products offered to the public	• Set standards for the authorisation and regulation of investment products • Authorise investment products offered to the public and their promotion (including advertisements and marketing materials)
Listed companies	• Approve changes to the Listing Rules • Monitor announcements and vet listing application materials under the Dual Filing regime • Administer the Codes on Takeovers and Mergers and Share Repurchases • Consider requests for exemptions from prospectus requirements under the Companies Ordinance • Enquire into listed companies' suspected prejudicial or fraudulent transactions or provision of false or misleading information to the public
Hong Kong Exchanges and Clearing Limited (HKEx)	• Oversee the performance of its role as the frontline regulator of listing related matters • Approve the creation of new markets, new products and changes to its rules and regulations • Monitor HKEx's own compliance with the Listing Rules • Monitor the trading of shares, options and futures on its markets • Oversee its systems and technology
Approved share registrars	• Approve the Federation of Share Registrars as an association whose members shall be approved share registrars • Require approved share registrars to comply with the requirements of the Code of Conduct for Share Registrars
Investor Compensation Company Limited (ICC)	• Recognise the ICC as an independent compensation company • Approve the rules and any amendment of rules of the ICC • Require the ICC to prepare and regularly submit financial statements, auditors' report and other documents to the SFC
All participants in trading activities	• Monitor unusual market movements and direct trade suspension of related stocks to maintain an informed and orderly market • Investigate and take action against market misconduct and other breaches of the law

1.4 Financial Reporting Council (FRC)

The FRC is an independent statutory body set up under the Financial Reporting Council Ordinance, which was enacted on 13 July 2006. The FRC was established on 1 December 2006. It became fully operational on 16 July 2007.

The **role of the FRC** is to:

- conduct independent investigations into possible auditing and reporting irregularities in relation to listed entities
- enquire into possible non-compliance with financial reporting requirements on the part of listed entities
- require listed entities to remove any non-compliance identified

The FRC may initiate investigations into a possible relevant irregularity or enquiries upon receipt of complaints or on its own initiative an enquiry into possible relevant non-compliance with financial reporting requirements on the part of listed entities.

Relevant irregularity means an auditing or reporting irregularity. It is defined in section 4 of the Financial Reporting Council Ordinance (the "FRC Ordinance").

Any auditing or reporting irregularity exists if an auditor in respect of the audit of the financial statements of a listed entity or a reporting accountant in respect of the preparation of an accountants' report required for a listing document:

(a) falsified or caused to be falsified a document;

(b) made a statement, in respect of a document, that was material and that he knew to be false or did not believe to be true;

(c) has been negligent in the conduct of his profession;

(d) has been guilty of professional misconduct;

(e) did or omitted to do something that would reasonably be regarded as bringing or likely to bring discredit upon the auditor or reporting accountant himself, the Hong Kong Institute of Certified Public Accountants (HKICPA) or the accountancy profession;

(f) failed to comply with a professional standard, i.e. any (a) statement of professional ethics; or (b) standard of accounting, auditing and assurance practices, as issued or specified by the council of the HKICPA from time to time;

(g) failed to comply with the provisions of any bylaw or rule made or any direction lawfully given by the council of the HKICPA.

A relevant non-compliance exists if a relevant financial report of a listed entity does not comply with a relevant requirement. A relevant non-compliance is defined in section 5 of the Financial Reporting Council Ordinance (the "FRC Ordinance").

A relevant requirement refers to accounting requirements as provided in:

- the Companies Ordinance;
- the standards of accounting practice issued or specified by the Council of the Hong Kong Institute of Certified Public Accountants (i.e. the Hong Kong Financial Reporting Standards);
- the International Financial Reporting Standards issued by the International Accounting Standards Board;
- the Listing Rules;
- any generally acceptable accounting principles allowed for usage under the Listing Rules; or
- the relevant SFC Codes or guidelines.

Any person who possesses information and/or evidence which suggest that there are or may be auditing and reporting irregularities or non-compliance with financial reporting requirements may lodge a complaint with the FRC.

Any auditing or reporting irregularities identified by the FRC will be referred to the HKICPA for follow-up action. Any non-compliance relevant to the Listing Rules will be referred to the Securities and Futures Commission or The Stock Exchange of Hong Kong Limited for follow-up action. The FRC is not empowered to discipline or prosecute.

1.5 Hong Kong Insurance Authority (HKIA)

The Office of the Commissioner of Insurance (OCI) is the regulatory body set up for the administration of the Insurance Companies Ordinance (Cap. 41) (ICO). The OCI was established in June 1990. The Office is headed by the Commissioner of Insurance who has been appointed as the Insurance Authority (IA) for administering the ICO.

The principal functions of the IA are to ensure that the interests of policy holders or potential policy holders are protected and to promote the general stability of the insurance industry. The IA has the following major duties and powers:

(a) **Authorisation**: Authorisation of insurers to carry on insurance business in or from Hong Kong. The IA has set out the criteria for authorisation which include, among other things, strong financial position, proper management, viable business plan and physical presence in Hong Kong in order to ensure that an adequate level of security is provided to the insuring public.

(b) **Regulation of insurers**: The regulatory objective of the IA is to ensure the financial soundness and integrity of the insurance market. The primary duty is to ensure that insurers conduct their activities in a prudent manner so that their obligations and policy holders' expectations will be met. Other operational aspects, such as setting of premium rates and policy terms and conditions, are largely left to self-regulation by the industry. Regulatory work is done primarily through the examination of the annual audited financial statements and business returns submitted by the insurers. Where causes for concern are identified in respect of an insurer, the IA is empowered under the ICO to take interventionary actions for protection of the interests of policy holders and potential policy holders.

(c) **Regulation of insurance intermediaries**: An insurance agent is required to be properly appointed by an insurer and registered with the Insurance Agents Registration Board (IARB), in accordance with the Code of Practice for the Administration of Insurance Agents issued by the Hong Kong Federation of Insurers. Under this central registration system, the IARB provides enquiry services to and handles complaints from the public relating to insurance agents.

An insurance broker may seek authorisation directly from the IA, or may apply to become a member of an approved body of insurance brokers, in order to carry on insurance broking business in or from Hong Kong. An approved body of insurance brokers is charged with the responsibilities of ensuring that its members comply with the statutory requirements and that the interests of policy holders and potential policy holders are properly protected. It also provides enquiry services to and handles complaints from the public relating to its members. An insurance broker who is directly authorised by the IA is subject to the same statutory requirements as applicable to a member of an approved body of insurance brokers.

(d) **Liaison with the insurance industry**: The IA believes in consultation and has worked closely with the representative bodies of the insurance industry in promoting self-regulation by the industry with the aim of enhancing the protection of policy holders. As one of the self-regulatory measures, the Insurance Claims Complaints Bureau (ICCB) was established in 1990. Any claimant who feels aggrieved that his claim under a personal policy is not fairly treated may lodge a complaint with the ICCB. The ICCB is empowered to make an award of up to $800,000 per case. The IA also reviews the guidelines and regulations developed within the system regularly to ensure that they are keeping up with market developments and provide adequate protection to the insuring public.

1.6 Hong Kong Monetary Authority (HKMA)

The Hong Kong Monetary Authority (HKMA) was established on 1 April 1993 by merging the Office of the Exchange Fund with the Office of the Commissioner of Banking. Its main functions and responsibilities are governed by the Exchange Fund Ordinance and the Banking Ordinance and it reports to the Financial Secretary.

The HKMA is the government authority in Hong Kong responsible for maintaining monetary and banking stability. Its main functions are:

- maintaining currency stability within the framework of the Linked Exchange Rate system
- promoting the stability and integrity of the financial system, including the banking system
- helping to maintain Hong Kong's status as an international financial centre, including the maintenance and development of Hong Kong's financial infrastructure
- managing the Exchange Fund.

2 Financial reporting requirements under HKFRS

Topic highlights

The Companies Ordinance provides the legal requirements for companies.

The financial reporting regulations and requirements currently in place in Hong Kong applicable to limited liability companies are derived from a number of sources, including those bodies mentioned above. Some are mandatory and some are advisory.

Those sources which are **mandatory** include:

(a) Legal requirements set out in the Companies Ordinance.

(b) Hong Kong Financial Reporting Standards (HKFRS, taken for the purpose of this Learning Pack to include both HKAS and HKFRS) and HKAS Interpretations (HKAS-Int) issued by the Hong Kong Institute of Certified Public Accountants (Hong Kong Institute of CPAs).

(c) For companies listed in Hong Kong, the requirements set out in the Rules Governing the Listing of Securities (the Listing Rules) and the Rules Governing the Listing of Securities on the Growth Enterprise Market (the GEM Rules), both issued by The Stock Exchange of Hong Kong Ltd (SEHK) pursuant to section 34 (1) of the Stock Exchanges Unification Ordinance (Cap. 361).

Those sources which are **advisory** in nature include:

(a) Accounting Guidelines (AGs) issued by the Hong Kong Institute of CPAs.

(b) Accounting Bulletins (ABs) issued by the Financial Accounting Standards Committee (FASC) of the Hong Kong Institute of CPAs.

(c) Pronouncements of the International Accounting Standards Board (IASB), formerly known as International Accounting Standards Committee (IASC), and leading national standard setting bodies such as those from Australia, Canada, New Zealand, the United Kingdom and the United States of America.

3 Hong Kong Financial Reporting Standards

HKFRS set out recognition, measurement, presentation and disclosure requirements dealing with transactions and events that are important in general purpose financial statements.

HKFRS are the most authoritative source of accounting principles generally accepted in Hong Kong (HK GAAP).

Although HKFRS do not have any statutory backing, their authority is ensured by the requirement of the Hong Kong Institute of CPAs that they should be observed by its members involved (either as preparers or as auditors) with financial statements intended to give a true and fair view, unless there are justifiable reasons for a departure in very exceptional circumstances.

For the purpose of this Learning Pack, the terms accounting standards, Standards and Interpretations, Hong Kong Accounting Standards and Hong Kong Financial Reporting Standards are used interchangeably and include all Hong Kong Financial Reporting Standards (HKFRS), Hong Kong Accounting Standards (HKAS) and HKAS Interpretations (HKAS-Int) approved by the Council and currently in issue unless otherwise specified.

3.1 The setting of HKFRS and due process

Topic highlights

The Financial Reporting Standards Committee (FRSC) of HKICPA has a mandate to develop financial reporting standards to achieve convergence with the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB).

Within this remit, the HKICPA Council permits the FRSC to work in whatever way it considers most effective and efficient and this may include forming advisory subcommittees or other forms of specialist advisory groups to give advice in preparing new and revised HKFRS. The process for the development of an HKFRS normally involves the following steps:

(a) Identifying and reviewing all the issues associated with an Exposure Draft or a draft Interpretation issued by the IASB for possible adoption in Hong Kong or any other topics and considering the application of the *Conceptual Framework* to the issues, if needed.

(b) Studying pronouncements of the IASB and other standard-setting bodies and accepted industry practices about the issues.

(c) Consulting the Standard Setting Steering Board of the HKICPA (SSSB) about the advisability of adding the topic to the FRSC's agenda.

(d) Forming an advisory group to give advice to the FRSC on the project.

(e) Publishing for public comment a discussion document. (In the case of the IASB issuing a discussion document, also issuing an invitation to comment in Hong Kong with an earlier deadline than that imposed by the IASB, so as to allow the FRSC a reasonable time to consider the comments before the Council makes a submission to the IASB.)

(f) Publishing for public comment an Exposure Draft or a draft Interpretation. (In the case of the IASB issuing an Exposure Draft or a draft Interpretation, issuing an invitation to comment in Hong Kong on that Exposure Draft or draft Interpretation with a request for comment before the comment deadline imposed by the IASB so as to allow the FRSC a reasonable time to consider the comments before the Council makes a submission to the IASB.)

(g) Publishing within an Exposure Draft a basis for conclusions.

(h) Considering all the comments received within the comment period on Discussion Papers and Documents, Exposure Drafts and draft Interpretations and those received in response to the Hong Kong invitation to comment on the IASB documents and, when appropriate, preparing a comment letter to the IASB.

(i) Following publication of the finalised IFRS or Interpretation of IFRS, considering the changes made, if any, by the IASB and adopting the finalised IFRS or Interpretation of IFRS in Hong Kong with the same effective date.

(j) Approving a standard or an Interpretation, including those converged with the equivalent IFRS or Interpretation of IFRS, by the Council.

(k) Publishing within a standard a basis for conclusions, if appropriate, explaining how the conclusions were reached and giving background information that may help users of HKFRS to apply them in practice or, in the case of a standard that is converged with IFRS, publishing within the standard the IASB Basis for Conclusions with an explanation of the extent to which the Council agrees with the IASB Basis for Conclusions so as to enable users to understand any changes made to the IFRS.

3.2 Current Hong Kong FRS

HKFRS set out recognition, measurement, presentation and disclosure requirements dealing with transactions and events that are important in general purpose financial statements.

The following table shows the list of Hong Kong Accounting Standards in issue as at 31 May 2013:

Hong Kong Accounting Standards	
HKAS 1 (Revised)	*Presentation of Financial Statements*
HKAS 2	*Inventories*
HKAS 7	*Statement of Cash Flows*
HKAS 8	*Accounting Policies, Changes in Accounting Estimates and Errors*
HKAS 10	*Events After the Reporting Period*
HKAS 11	*Construction Contracts*
HKAS 12	*Income Taxes*
HKAS 16	*Property, Plant and Equipment*
HKAS 17	*Leases*
HKAS 18	*Revenue*
HKAS 19 (Revised)	*Employee Benefits*
HKAS 20	*Accounting for Government Grants and Disclosure of Government Assistance*
HKAS 21	*The Effects of Changes in Foreign Exchange Rates*
HKAS 23 (Revised)	*Borrowing Costs*
HKAS 24 (Revised)	*Related Party Disclosures*
HKAS 26	*Accounting and Reporting by Retirement Benefit Plans*
HKAS 27 (2011)	*Separate Financial Statements*
HKAS 28 (2011)	*Investments in Associates and Joint Ventures*
HKAS 29	*Financial Reporting in Hyperinflationary Economies*
HKAS 32	*Financial Instruments: Presentation*
HKAS 33	*Earnings Per Share*
HKAS 34	*Interim Financial Reporting*
HKAS 36	*Impairment of Assets*
HKAS 37	*Provisions, Contingent Liabilities and Contingent Assets*
HKAS 38	*Intangible Assets*
HKAS 39	*Financial Instruments: Recognition and Measurement*

Hong Kong Accounting Standards	
HKAS 40	*Investment Property*
HKAS 41	*Agriculture*
HKFRS 1 (Revised)	*First-time Adoption of Hong Kong Financial Reporting Standards*
HKFRS 2	*Share-based Payment*
HKFRS 3 (Revised)	*Business Combinations*
HKFRS 4	*Insurance Contracts*
HKFRS 5	*Non-current Assets Held for Sale and Discontinued Operations*
HKFRS 6	*Exploration for and Evaluation of Mineral Resources*
HKFRS 7	*Financial Instruments: Disclosures*
HKFRS 8	*Operating Segments*
HKFRS 9	*Financial Instruments*
HKFRS 10	*Consolidated Financial Statements*
HKFRS 11	*Joint Arrangements*
HKFRS 12	*Disclosure of Interests in Other Entities*
HKFRS 13	*Fair Value Measurement*
HKFRS for PEs	*HKFRS for Private Entities*

You need to keep yourself up to date with Hong Kong Accounting Standards as they are issued or reviewed.

Various Exposure Drafts and Discussion Papers are currently at different stages within the HKFRS process, and by the end of your financial reporting studies, you should know *all* the Standards, Exposure Drafts and Discussion Papers.

3.3 Scope of HKFRS

Any limitation of the applicability of a specific HKFRS is made clear within that standard. HKFRS are **not intended to be applied to immaterial items, nor are they retrospective**. Each individual HKFRS lays out its scope at the beginning of the standard.

3.4 Accounting standards and choice

It is sometimes argued that companies should be given a choice in matters of financial reporting on the grounds that accounting standards are detrimental to the quality of such reporting. There are arguments on both sides.

In favour of accounting standards (both national and international), the following points can be made:

(a) They reduce or eliminate confusing variations in the methods used to prepare accounts.

(b) They provide a focal point for debate and discussions about accounting practice.

(c) They oblige companies to disclose the accounting policies used in the preparation of accounts.

(d) They are a less rigid alternative to enforcing conformity by means of legislation.

(e) They have obliged companies to **disclose more accounting information** than they would otherwise have done if accounting standards did not exist, for example HKAS 33 *Earnings Per Share*.

Many companies are reluctant to disclose information which is not required by national legislation. However, the following arguments may be put forward **against standardisation** and **in favour of choice**:

(a) A set of rules which give backing to one method of preparing accounts might be **inappropriate in some circumstances**. For example, HKAS 16 on depreciation is inappropriate for investment properties (properties not occupied by the entity but held solely for investment), which are covered by HKAS 40 on investment property.

(b) Standards may be subject to **lobbying or government pressure** (in the case of national standards). For example, in the USA, the accounting standard FAS 19 on the accounts of oil and gas companies led to a powerful lobby of oil companies, which persuaded the SEC (Securities and Exchange Commission) to step in. FAS 19 was then suspended.

(c) Many national standards are not based on a **conceptual framework of accounting**, although HKFRS are.

(d) There may be a **trend towards rigidity**, and away from flexibility in applying the rules.

You should be able to discuss:

- **due process** of the HKICPA
- **use and application** of HKFRS
- **future work** of the HKICPA

One of the competencies you are required to demonstrate is to recognise and apply the external legal and professional framework and regulations to financial reporting. The information in this chapter will give you knowledge to help you demonstrate this competence.

4 Other sources of financial reporting guidance

4.1 HK(IFRIC) Interpretations, Hong Kong Interpretations and HK(SIC) Interpretations

As well as HKFRS, you will also see reference to HK(IFRIC) Interpretations. IFRICs are the publications of the IFRS Interpretations Committee.

The IFRS Interpretations Committee is the interpretative body of the IASB. The mandate of the Interpretations Committee is to review on a timely basis widespread accounting issues that have arisen within the context of current IFRS and to provide authoritative guidance **(IFRICs)** on those issues.

IFRICs and their predecessors SICs are adopted in Hong Kong as HK(IFRIC) Interpretations and HK(SIC) Interpretations. A number of these interpretations are considered throughout this Learning Pack.

4.2 *Conceptual Framework for Financial Reporting* (the *Conceptual Framework*)

The *Conceptual Framework* sets out the concepts underlying the preparation and presentation of financial statements for external users. Its objectives are to:

(a) assist the Council in the development of future accounting standards and guidelines and in its review of existing accounting standards and guidelines;

(b) assist preparers of financial statements in applying accounting standards and guidelines and in dealing with topics that have yet to form the subject of an accounting standard or guideline;

(c) assist auditors in forming an opinion as to whether financial statements conform with accounting standards;

(d) assist users of financial statements in interpreting the information contained in financial statements prepared in conformity with accounting standards and guidelines; and

(e) provide those who are interested in the work of the Council with information about its approach to the formulation of accounting standards and guidelines.

The *Conceptual Framework* is discussed in more detail in sections 8 to 12 of this chapter.

4.3 Accounting Guidelines and implementation guidance

Accounting Guidelines (AGs) have effect as guidance statements and indicators of best practice. They are persuasive in intent. Unlike HKFRS, AGs are not mandatory, but are consistent with the purpose of HKFRS in that they help define accounting practice in the particular area or sector to which they refer. Therefore, they should normally be followed, and members of the Hong Kong Institute of CPAs should be prepared to explain departures if called upon to do so. Many AGs issued previously have already been superseded with the publication of a new HKFRS which addresses and sets out mandatory practice in relation to accounting issues which were previously the subject of an AG. The AGs in issue at the time of publication are:

AG 1 *Preparation and Presentation of Accounts from Incomplete Records*
AG 5 *Merger Accounting for Common Control Combinations*
AG 7 *Preparation of Pro Forma Financial Information for Inclusion in Investment Circulars*

In a number of HKFRS, e.g. HKAS 39, guidance on implementing the standard is included, either with the standard or in a separate document. *The Preface to Hong Kong Financial Reporting Standards* has not clarified the status of this guidance. For the purpose of this Learning Pack, this implementation guidance is considered as having the same status as the accounting guidelines. (Implementation guidance is not the same as application guidance, which is often an integral part of the HKFRS.)

4.4 Accounting Bulletins

Accounting Bulletins (ABs) are informative publications on subjects of topical interest and are intended to assist members or to stimulate debate on important accounting issues. They do not require the approval of the Council of the Hong Kong Institute of CPAs and they do not have the same authority as either HKFRS or AGs.

There are currently three ABs in issue:

AB 1 *Disclosure of Loans to Officers*
AB 3 *Guidance on Disclosure of Directors' Remuneration*
AB 4 *Guidance on the Determination of Realised Profits and Losses in the Context of Distribution under the Hong Kong Companies Ordinance*

5 Additional requirements for listed companies

Topic highlights

The SEHK requires listed companies to comply with its Listing Rules.

5.1 Companies listed on the Main Board

The disclosure requirements for companies listed on the Main Board, both in respect of annual financial reporting and interim financial reporting, are set out in the Appendix 16 of the Listing Rules.

Companies listed on the Main Board are required to send their annual reports and audited financial statements to every member and other holders of their listed securities within three months after the end of the reporting period, and not less than 21 days before the date of the annual general meeting. Note that the three-month limit for the release of the annual report relates to annual accounting periods ending on or after 31 December 2010. Prior to that the limit was four months.

The Listing Rules require certain financial information disclosures, other than those required by HKFRS or the Companies Ordinance, which are normally presented in the notes to financial statements. These disclosures include:

- analysis of the maturity profile of borrowings
- analysis of directors' remuneration by emolument bands; analysis of employees' emoluments by emolument bands; pension schemes
- credit policy and aged analysis of accounts receivable; and aged analysis of accounts payable

An entity which either meets the definition of a Financial Conglomerate or a Banking Company is subject to some additional disclosure requirements under the Listing Rules.

The Main Board requirement for paid announcements was abolished on 25 June 2007. Main Board issuers are required to publish their announcements on their own website as well as the HKEx website.

Any Main Board issuer that does not have its own website will be in breach of the Listing Rules.

5.1.1 Interim reports

A company listed on the Main Board is required to issue an interim report for the first six months of a financial year. This report must be published not later than two months after the end of that interim period.

Interim reports should contain the following financial information:

- Statement of profit or loss or statement of profit or loss and other comprehensive income.
- Balance sheet (statement of financial position).
- Cash flow statement (statement of cash flows).
- A statement of movements in equity other than those arising from capital transactions with shareholders and distributions to shareholders.
- Comparative figures, accounting policies and other notes to the financial statements.

Interim reports should comply with the requirements of HKAS 34 *Interim Financial Reporting*, or for companies reporting under international financial reporting standards, IAS 34.

The Listing Rules require that the interim reports should be reviewed by the entity's audit committee or, where such a committee has not been formed, by the external auditors.

5.2 Companies listed on the Growth Enterprise Market (GEM)

The disclosure requirements for companies listed on the GEM, both in respect of annual financial reporting and interim financial reporting, are principally set out in Chapter 18 Financial Information of the GEM Rules.

Companies listed on the GEM are subject to tighter reporting requirements. For example, they are required to publish annual reports within three months; and half-yearly reports and quarterly reports within 45 days after the end of each relevant financial period.

The disclosure requirements for annual reporting under the GEM Rules are in many ways similar to the Listing Rules though there are some specific disclosures which are only applicable under the GEM Rules. For instance, companies listed on GEM are subject to the following additional disclosure requirements:

(a) A comparison of actual business progress with business objectives stated in listing documents (for a few reporting periods after the year of listing only).

(b) Extension of the disclosure of directors' emoluments by showing the amount of emoluments by director on an anonymous basis.

(c) The interests (if any) of the sponsor, and its directors, employees and associates, and of the interests of the management shareholders of the issuer.

(d) As regards the compliance with corporate governance disclosure, specification of work undertaken by the audit committee and number of meetings held, and so on.

For companies listed on GEM, the principal means of information dissemination on GEM is publication on the Internet website operated by the SEHK. Companies listed on GEM are not generally required to issue paid announcements in the press.

A GEM issuer that does not have its own website will be in breach of the Listing Rules.

5.3 Acceptance of Mainland Accounting and Auditing Standards

In December 2010, the Hong Kong Stock Exchange issued its Consultation Conclusions on the Acceptance of Mainland Accounting and Auditing Standards and Mainland Audit Firms for Mainland Incorporated Companies Listed in Hong Kong. The amendments to the Listing Rules:

- allow Mainland incorporated issuers to prepare their financial statements using Mainland accounting standards; and
- allow Mainland audit firms vetted, nominated and endorsed by the Ministry of Finance of China and the China Securities Regulatory Commission to service these issuers using Mainland auditing standards.

Both Hong Kong Auditing Standards and Mainland Auditing Standards are allowed for Mainland incorporated companies listed in Hong Kong.

As a result of this change, it is expected that compliance costs will be reduced for Mainland companies listed in Hong Kong and market efficiency increased.

6 *Code of Ethics for Professional Accountants*

Topic highlights

Members of the HKICPA are bound by its *Code of Ethics*.

Certified public accountants in business owe certain legal duties towards their employers. Additionally, they have ethical duties towards the HKICPA. The Council of HKICPA requires members of the Institute (and therefore certified public accountants) to comply with the *Code of Ethics for Professional Accountants* (the *Code*). Apparent failures by certified public accountants to comply with the *Code* are liable to be enquired into by the appropriate committee established under the authority of the Institute, and disciplinary action may result. Disciplinary action may include an order that the name of the certified public accountant be removed from the Institute's membership register.

The *Code of Ethics* is likely to be taken into account when the work of a certified public accountant is being considered in a court of law or in other contested situations.

6.1 Fundamental principles

All certified public accountants, whether in business or in public practice, are required to comply with the following fundamental principles:

(a) **Integrity**: a certified public accountant should be straightforward and honest in all professional and business relationships. Integrity also implies fair dealing and truthfulness.

In particular, section 110 of the *Code of Ethics* requires that a certified accountant should not be associated with reports, returns, communications or other information where they believe that the information: (1) contains a materially false or misleading statement; (2) contains statements or information furnished recklessly; or (3) omits or obscures information required to be included where such omission or obscurity would be misleading. A certified public accountant should not be associated with such reports, returns, communications or other information unless the certified public accountant provides a modified report in respect of the above mentioned matters.

(b) **Objectivity**: a certified public accountant should not allow bias, conflict of interest or undue influence of others to override professional or business judgments.

In particular, section 120 of the *Code of Ethics* requires that all certified public accountants should not compromise their professional or business judgment because of bias, conflict of interest or the undue influence of others. Relationships that bias or unduly influence the professional judgment of the certified public accountant should be avoided.

A certified public accountant may be exposed to situations that may impair objectivity. It is, however, impracticable to define and prescribe all such situations.

(c) **Professional competence and due care**: a certified public accountant has a continuing duty to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques. A certified public accountant should act diligently and in accordance with applicable technical and professional standards when providing professional services.

(d) **Confidentiality**: a certified public accountant should respect the confidentiality of information acquired as a result of professional and business relationships and should not disclose any such information to third parties without proper and specific authority unless there is a legal or professional right or duty to disclose. Confidential information acquired as a result of professional and business relationships should not be used for the personal advantage of the certified public accountant or third parties.

(e) **Professional behaviour**: a certified public accountant should comply with relevant laws and regulations and should avoid any action that discredits the profession.

Ethics in accounting is of utmost importance to accounting professionals and those who rely on their services. Accounting professionals know that people who use their services, especially decision makers using financial statements, expect them to be highly competent, reliable, and objective. Those who work in the field of accounting must not only be well qualified but must also possess a high degree of professional integrity. A professional's good reputation is one of his or her most important assets.

There is a very fine line between acceptable accounting practice and management's deliberate misrepresentation in the financial statements.

The financial statements must meet the following criteria:

(a) **Technical compliance**: a transaction must be recorded in accordance with generally accepted accounting principles (GAAP).

(b) **Economic substance**: the resulting financial statements must represent the economic substance of the event that has occurred.

(c) **Full disclosure and transparency**: sufficient disclosure must be made so that the effects of transactions are transparent to the reader of the financial statements.

Accounting plays a critical function in society. It affects human behaviour especially when pay or compensation is impacted, and to deliberately mask the nature of accounting transactions could be deemed as unethical behaviour.

Example: Shepherd Co.

The finance director of Shepherd Co., a CPA, has carried out the following actions in June 20X9:

(a) Employed his brother's cleaning company to clean Shepherd Co.'s offices every week

(b) Used information that he acquired while at work to recommend to his sister that she buys shares in Shepherd Co.'s parent company

(c) Approved the monthly management accounts of the company by signing his name, even though he had not looked at them.

Has the finance director contravened any of the fundamental principles of the *Code of Ethics for Professional Accountants*?

Solution

(a) contravenes the principle of objectivity
(b) contravenes the principle of confidentiality
(c) contravenes the principle of integrity

6.2 Obligation to comply with the *Code of Ethics*

Professional accountants have obligations to comply with the *Code of Ethics*. Compliance is monitored by employers and the HKICPA.

Disciplinary actions may be taken by HKICPA for non-compliance with the *Code of Ethics*, including removal from the Institute's membership register.

6.3 Revision to *Code of Ethics*

The *Code of Ethics for Professional Accountants* (the *Code*) was revised in 2010 so as to maintain convergence with the revised Code of Ethics for Professional Accountants issued by the IESBA in July 2009. The revisions clarify requirements for all professional accountants and significantly strengthen the independence requirements of auditors. The revised *Code* came into effect from 1 January 2011.

In addition to the IESBA Code, the Hong Kong Code contains additional local requirements in Part D, such as the Prevention of Bribery Ordinance. These form an integral part of the *Code*, and members should ensure that they are aware of the additional requirements and comply with them.

7 Conceptual Framework and GAAP

Topic highlights

A **conceptual framework** is a statement of generally accepted theoretical principles which form the frame of reference for financial reporting. There are advantages and disadvantages to having a conceptual framework.

7.1 A conceptual framework

A **conceptual framework** is a statement of generally accepted theoretical principles which form the frame of reference for financial reporting. In other words, a conceptual framework will form the basis for determining which events should be accounted for, how they should be measured and how they should be communicated to the user. It is used to aid the development of new accounting standards and the evaluation of those already in existence, and although theoretical in nature, a conceptual framework for financial reporting has highly practical final aims.

Where a conceptual framework does not exist, standards tend to be produced in a haphazard fashion, generally in response to an accounting issue that has arisen. Inconsistencies and contradictions may therefore appear and, in turn, ambiguity which affects the true and fair concept of reporting. This *ad hoc* approach is avoided where a framework exists, and the specific rules within standards are based on sound basic principles, so ensuring a consistency of approach.

Another problem with the lack of a conceptual framework has become apparent in the USA. The large number of **highly detailed standards** produced by the Financial Accounting Standards Board (FASB) has created a financial reporting environment governed by specific rules rather than general principles. However, accounting scandals such as Enron in the US have exposed the weaknesses of this approach.

7.2 Advantages and disadvantages of a conceptual framework

Advantages

(a) Standards do not have to be developed on a haphazard, reactive basis, concentrating resources on combating a problem that has been identified in practice, rather than developing a **consistent suite of standards** that cover all problems.

(b) The standard-setting process in many countries in the past has been subject to **political interference**, where interested parties have tried to influence the setting of standards in their favour. For example, pharmaceutical companies may argue for the costs of research and development to be capitalised in all situations, regardless of the likely recoverability of the cost. A standard-setter should be better able to stand firm against pressure, if standards can be seen to be deriving from a published conceptual framework.

(c) In the past, some standards seem to have concentrated on the **income statement** (the calculation of profit or loss), while others have concentrated on the **statement of financial position** (the valuation of net assets).

Disadvantages

(a) Financial statements are drawn up to serve the interests of a **variety of user groups**, and it is not clear that a single conceptual framework can be devised that will satisfy the information needs of all users.

(b) It can be argued that different accounting statements should be drawn up to achieve different purposes. For example inventory might be of most use when measured at marginal cost in a decision-making statement, and at full absorption cost in a financial reporting statement.

(c) The experience in countries that have issued conceptual frameworks is that **little notice is taken of them** by standard-setting bodies when deciding on new standards.

Prior to a review of the HKICPA's attempt to bring forth the conceptual framework, it is important to consider the generally accepted accounting principles (or practice) or GAAP.

7.3 Generally Accepted Accounting Principles (GAAP)

GAAP signifies all the rules, from whatever source, which govern accounting.

In individual countries this is seen as a **combination** of:

- national company law
- national accounting standards
- local stock exchange requirements

Although the above sources form the basis for the GAAP of individual countries, the effects of other **non-mandatory** sources in a particular country are also included in the concept, such as:

- International Accounting Standards
- statutory requirements in other countries
- long-standing accounting practices in areas not subject to a standard

Unlike countries such as the USA, GAAP does not have any statutory dominance or meaning in many countries, such as the UK. The term, if mentioned in legislation, is only to a limited extent.

There are different views of GAAP in different countries. One view, held in most of Europe, is that GAAP is a dynamic concept with accounting practices constantly changing in response to circumstances. The term applies to those practices which the accounting profession regards as permissible and legitimate in the circumstances in which it has been applied.

However, not all the countries share the same view. In the USA, the equivalent of a "true and fair view" is "fair presentation in accordance with GAAP". Generally Accepted Accounting Principles are viewed as having "substantial authoritative support". The adoption of accounting principles that do not have substantial authoritative support in the preparation of accounts is presumed to be misleading or inaccurate.

The above leads to the effect that "new" or "different" accounting principles are not acceptable unless they have been adopted by the mainstream accounting profession, usually the standard-setting bodies and/or professional accountancy bodies.

A **conceptual framework** for financial reporting can be defined as an attempt to codify existing GAAP in order to reappraise current accounting standards and to produce new standards.

7.3.1 Mandatory and advisory sources

In Hong Kong, there are both mandatory and advisory sources of generally accepted accounting principles (GAAP).

Mandatory sources are the following:

(a) **Companies Ordinance.** Legal requirements include maintenance of accounting records, content of financial statements, and audits of companies incorporated in Hong Kong. The new Hong Kong Companies Ordinance was issued in 2012, is being enacted by subsidiary legislation and will become effective during 2014. Further detail on some of the sections relevant to Module A was provided in Chapter 1.

(b) **Hong Kong Financial Reporting Standards (HKFRS).** The term HKFRS includes both Standards (HKFRS and HKAS) and Interpretations (HK(IFRIC)-Ints, HK(SIC)-Ints, and HK-Ints).

    (i) Standards and Interpretations are developed by the Financial Accounting Standards Committee of the Hong Kong Institute of Certified Public Accountants (HKICPA).

    (ii) Standards and Interpretations are virtually identical to their international equivalents (International Financial Reporting Standards) except for three Hong Kong Interpretations (HK-Ints) which have been developed locally by the HKICPA.

(c) **Listing Rules.** The Stock Exchange of Hong Kong Limited (SEHK) has adopted rules governing the listing of securities on its Main Board (the Listing Rules) and on its Growth Enterprise Market (the GEM Rules). These include some accounting and disclosure requirements.

Other sources of GAAP

Hong Kong Accounting Standard 8 *Accounting Policies, Changes in Accounting Estimates and Errors* (HKAS 8, which is identical to IAS 8) states:

10. In the absence of a HKFRS that specifically applies to a transaction, other event or condition, management shall use its judgment in developing and applying an accounting policy that results in information that is:

(a) relevant to the economic decision-making needs of users; and

(b) reliable, in that the financial statements:

- **(i) represent faithfully the financial position, financial performance and cash flows of the entity;**
- **(ii) reflect the economic substance of transactions, other events and conditions, and not merely the legal form;**
- **(iii) are neutral, i.e. free from bias;**
- **(iv) are prudent; and**
- **(v) are complete in all material respects.**

11. In making the judgment described in paragraph 10, management shall refer to, and consider the applicability of, the following sources in descending order:

(a) the requirements and guidance in HKFRS dealing with similar and related issues; and

(b) the definitions, recognition criteria and measurement concepts for assets, liabilities, income and expenses in the *Conceptual Framework*.

12. In making the judgment described in paragraph 10, management may also consider the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards, other accounting literature* and accepted industry practices, to the extent that these do not conflict with the sources in paragraph 11.

*In the context of Hong Kong, other accounting literature includes Accounting Guidelines and Accounting Bulletins.

The Accounting Guidelines and Accounting Bulletins referred to in the footnote to paragraph 12 of HKAS 8 (above) are "best practice" guidance documents that have been published by the HKICPA to assist its members in applying HKFRS. Accounting Guidelines, and Industry Accounting Guidelines, are persuasive in intent and, while not mandatory, should normally be followed. Accounting Bulletins are intended to assist members of the HKICPA in dealing with accounting issues and to stimulate debate on subjects of topical interest.

TechWatch is a monthly publication prepared by the HKICPA to alert HKICPA members to topics and issues that impact on accountants and their working environment. It is intended for general guidance only.

7.3.2 GAAP for Small and Medium-sized Entities

The HKICPA released its own *Small and Medium-sized Entity Financial Reporting Framework and Financial Reporting Standard* (SME-FRF & FRS) in August 2005. The SME-FRF and FRS became effective for optional use by a qualifying entity's first financial statements that cover a period beginning on or after 1 January 2005. Entities that qualify include Hong Kong incorporated companies that meet certain legal requirements and overseas companies that have no public accountability, meet size requirements and where the owners agree to use the SME-FRF and FRS.

Those entities which do not meet the criteria to use the SME-FRF and FRS may be able to use the *HKFRS for Private Entities*, issued in 2010. Both of these options are discussed in more detail in the next chapter.

8 The HKICPA's *Conceptual Framework*

Topic highlights

The *Conceptual Framework* provides the basis for the development of HKFRS / HKAS.

In June 1997 the HKICPA produced a document, *Framework for the Preparation and Presentation of Financial Statements* (the *Framework*). This is, in effect, the **conceptual framework** upon which all HKFRS are based and hence it determines how financial statements are prepared and the information they contain.

The *Framework* is currently being revised with the project taking place in several stages and Exposure Drafts being issued as each progress stage approaches completion. The first amendments to the *Framework* were issued in October 2010, and the HKICPA has decided to amend the *Framework* on a piecemeal basis, so the revised parts of the *Framework* sit alongside the old *Framework*. The *Framework* has been renamed the *Conceptual Framework for Financial Reporting.*

The revised *Conceptual Framework for Financial Reporting* consists of several sections or chapters, following on after a preface and introduction. These chapters are as follows:

- The objective of general purpose financial reporting (issued October 2010)
- The reporting entity (not yet issued)
- Qualitative characteristics of useful financial information (issued October 2010)
- The Framework (1997): The Remaining Text
  - Underlying assumption
  - The elements of financial statements
  - Recognition of the elements of financial statements
  - Measurement of the elements of financial statements
  - Concepts of capital and capital maintenance

Much of the content of the chapters is also included in HKAS 1 (revised), and covered in sections 10 to 12 of this chapter. As you read through them, think about the impact the *Conceptual Framework* has had on HKFRS, particularly the definitions.

8.1 Preface

Financial statements are prepared and presented for external users worldwide, and although they may appear similar, differences are caused by social, economic and legal circumstances.

The HKICPA wishes to narrow these differences by **harmonising** all aspects of financial statements, including the regulations governing their accounting standards and their preparation and presentation.

The HKICPA believes that financial statements prepared for the purpose of providing information that is useful in making economic decisions meet the common needs of most users. The types of economic decisions for which financial statements are likely to be used include the following:

- Decisions to buy, hold or sell equity investments
- Assessment of management stewardship and accountability
- Assessment of the entity's ability to pay employees
- Assessment of the security of amounts lent to the entity
- Determination of taxation policies
- Determination of distributable profits and dividends
- Inclusion in national income statistics
- Regulations of the activities of entities

Any additional requirements imposed by **national governments** for their own purposes should not affect financial statements produced for the benefit of other users.

The *Conceptual Framework* recognises that financial statements can be prepared using a **variety of models**. Although the most common is based on historical cost and a nominal unit of currency (such as the Hong Kong dollar), the *Conceptual Framework* can be applied to financial statements prepared under a range of models.

8.2 Introduction

The introduction to the *Conceptual Framework* lays out the purpose, status and scope of the document. It then looks at different users of financial statements and their information needs.

8.3 Purpose and status

The introduction gives a list of the purposes of the *Conceptual Framework*.

(a) To give guidance to the Council of HKICPA in developing new financial reporting standards and reviewing existing standards. Accounting standards will be more consistent and logical if they are developed from an orderly set of concepts.

(b) To assist preparers of financial statements in applying HKFRS. The concepts guide preparers in their broader fulfilment of GAAP.

(c) To assist auditors in forming an opinion as to whether financial statements conform with HKFRS. An independent review by the auditor of the recognition and measurement decisions by preparers relating to revenues, expenses, assets and liabilities in the financial statements can be undertaken by reference to the details about primary elements.

(d) To assist users of financial statements in interpreting the information. The quality of disclosures can be judged by users against the list of qualitative characteristics.

(e) To provide those who are interested in the work of the Council with information about its approach to the formulation of HKFRS. The process of communication between the Council of HKICPA and its constituents can be enhanced because the conceptual underpinnings of proposed accounting standards will be more apparent.

The *Conceptual Framework* is not an HKFRS and so does not overrule any individual HKFRS. In a limited number of cases there may be a conflict between an HKFRS and the *Conceptual Framework*; here, the **HKFRS will prevail**. The number of such cases will diminish over time as the *Conceptual Framework* is used as a guide in the production of new HKFRS. The *Conceptual Framework* itself will be revised occasionally depending on the experience of the HKICPA in using it.

8.4 Scope

The *Conceptual Framework* deals with the following:

(a) The **objective** of financial reporting.

(b) The **qualitative characteristics** of useful information.

(c) The **definition, recognition and measurement** of the elements from which financial statements are constructed.

(d) Concepts of **capital and capital maintenance**.

The *Conceptual Framework* is concerned with **"general purpose" financial statements** (that is, a normal set of annual statements), but it can be applied to other types of accounts. A complete set of financial statements includes:

(a) a statement of financial position
(b) a statement of profit or loss and other comprehensive income
(c) a statement of changes in financial position (e.g. a statement of cash flows)
(d) notes, other statements and explanatory material

Supplementary information may be included, but some items are not included in the financial statements themselves, namely commentaries and reports by the directors, the chairman, management and so on.

All types of financial reporting entities are included whether commercial, industrial, business; public or private sector.

Key term

A **reporting entity** is an entity for which there are users who rely on the financial statements as their major source of financial information about the entity. *(Conceptual Framework)*

CF.OB5

8.5 Users and their information needs

Users of financial statements include investors, employees, lenders, suppliers and other trade creditors, customers, government and their agencies and the public.

The *Conceptual Framework* places particular emphasis on existing and potential investors, lenders and other creditors. It states that other users of financial statements may find general purpose financial statements useful, however those reports are not primarily directed towards those other groups.

Self-test question 1

What are the information needs of the users of financial information? Your answer should not be restricted to the groups of users identified by the *Conceptual Framework* as the primary users.

(The answer is at the end of the chapter)

CF.OB2-12

8.6 The objective of financial statements

Topic highlights

The *Conceptual Framework* states that:

"The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity."

This section of the *Conceptual Framework* was amended in September 2010. As a result of the amendments, there is a new emphasis on specific users of accounts, namely investors, potential investors, lenders and creditors. They require information which is useful in making decisions about buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit.

The type of information required by investors, creditors and lenders is that which provides an indication of **potential future net cash inflows**. Such information includes that relating to:

- the resources of the entity
- claims against the entity
- how efficiently and effectively the management have used the entity's resources, protected the entity's resources from the unfavourable effects of factors such as price changes and ensured that the entity complies with applicable laws and regulations.

Most investors, creditors and lenders cannot require entities to provide information directly to them, and therefore rely on general purpose financial statements. Although such financial statements do include a large amount of information, the *Conceptual Framework* states that general purpose financial statements do not and they cannot provide **all** of the information that investors, lenders and other creditors need. Therefore, these users must also consider information from other sources, such as general economic conditions and expectations, political events and political climate, and industry and company outlooks.

This section of the *Conceptual Framework* also clarifies that:

- general purpose financial statements are not designed to show the value of an entity, although information contained within them may aid a valuation
- the management of an entity need not rely on general purpose financial statements as they can obtain necessary financial information internally
- other parties such as regulators and members of the public may also find general purpose financial reports useful, however, these reports are not primarily directed to these groups.

8.7 Information about economic resources, claims and changes in resources and claims

General purpose financial reports provide information about the financial position of a reporting entity, which is information about:

- the entity's economic resources, and
- claims against the reporting entity.

Financial reports also provide information about the effects of transactions and other events that change a reporting entity's economic resources and claims. Both types of information provide useful input for decisions about providing resources to an entity.

CF.OB13-14

8.7.1 Economic resources and claims

Information about the nature and amounts of a reporting entity's economic resources and claims can help users to identify the reporting entity's financial strengths and weaknesses. That information can help users to assess:

- the reporting entity's liquidity and solvency,
- its needs for additional financing, and
- how successful it is likely to be in obtaining that financing.

Information about priorities and payment requirements of existing claims helps users to predict how future cash flows will be distributed among those with a claim against the reporting entity.

CF.OB15-21

8.7.2 Changes in economic resources and claims

Changes in a reporting entity's economic resources and claims result from:

(a) an entity's financial performance, and
(b) other events or transactions such as issuing debt or equity instruments.

To properly assess the prospects for future cash flows from the reporting entity, users need to be able to distinguish between both of these changes.

8.8 The reporting entity

This section of the *Conceptual Framework* has not yet been issued. An Exposure Draft was issued in 2010 in which a reporting entity is defined as follows:

> *"A reporting entity is a circumscribed area of economic activities whose financial information has the potential to be useful to existing and potential equity investors, lenders, and other creditors who cannot directly obtain the information they need in making decisions about providing resources to the entity and in assessing whether the management and the governing board of that entity have made efficient and effective use of the resources provided."*

A reporting entity has three features:

(a) Economic activities of an entity are being conducted, have been conducted, or will be conducted

(b) Those economic activities can be objectively distinguished from those of other entities and from the economic environment in which the entity exists

(c) Financial information about the economic activities of that entity has the potential to be useful in making decisions about providing resources to the entity and in assessing whether the management and the governing board have made efficient and effective use of the resources provided.

These features are necessary but not always sufficient to identify a reporting entity.

During the course of 2013 a discussion paper relating to all remaining phases of the *Conceptual Framework* project, including 'the reporting entity' will be issued and the IASB aims to complete the project by 2015.

9 Qualitative characteristics of financial information

Topic highlights

The *Conceptual Framework* states that qualitative characteristics are the attributes that make the information provided in financial statements useful to existing and potential investors, lenders and creditors. The two fundamental qualitative characteristics are relevance and faithful representation. These are supported by four enhancing qualitative characteristics of comparability, verifiability, timeliness and understandability.

This section of the *Conceptual Framework* was revised in September 2010 and as a result, two fundamental and four enhancing qualitative characteristics replace the previous qualitative characteristics of relevance, reliability, comparability and understandability.

The two fundamental qualitative characteristics are relevance and faithful representation; the four enhancing characteristics are comparability, verifiability, timeliness and understandability.

If financial information is to be useful, it must be relevant and faithfully represent what it purports to represent. The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable.

The revised *Conceptual Framework* states that the qualitative characteristics of useful financial information apply not only to financial information provided in financial statements, but also to financial information provided in other ways.

CF.QC5-16

9.1 Fundamental qualitative characteristics

The fundamental qualitative characteristics are relevance and faithful representation.

9.1.1 Relevance

Relevant financial information is capable of making a difference in the decisions made by users. Information may be capable of making a difference in a decision even if some users choose not to take advantage of it or are already aware of it from other sources. Financial information is capable of making a difference in decisions if it has predictive value, confirmatory value or both. Financial information has a confirmatory value if it confirms or changes previous evaluations.

Materiality

Materiality is related to relevance. Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity. Materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report. It is impossible to specify a quantitative threshold for materiality or predetermine what could be material in a particular situation as it depends on the individual entity.

9.1.2 Faithful representation

To be useful, in addition to being relevant, financial information must also faithfully represent the phenomena that it purports to represent. To be a perfectly faithful representation, a depiction would have three characteristics – it would be complete, neutral and free from error.

Faithful representation does not mean accurate in all respects. Information that is complete means all necessary information is included for the user to understand the item being depicted. Neutral information is prepared without bias in the selection or presentation of the information. Free from error means there are no errors or omissions in the description of the item, and the process used to produce the reported information has been selected and applied with no errors in the process.

CF.QC17-18

9.1.3 Application of the fundamental qualitative characteristics

Useful information must be both relevant and faithfully represented; neither a faithful representation of an irrelevant phenomenon nor an unfaithful representation of a relevant phenomenon helps users to make good decisions.

The most efficient and effective process for applying the fundamental qualitative characteristics would usually be as follows:

(a) Identify an economic phenomenon that has the potential to be useful to users of an entity's financial information

(b) Identify the type of information about that phenomenon that would be most relevant, if available and can be faithfully represented

(c) Determine whether that information is available and can be faithfully represented

(d) If so, the process of satisfying the fundamental qualitative characteristics ends; if not, the process is repeated with the next most relevant type of information.

CF.QC19-32

9.2 Enhancing qualitative characteristics

Comparability, verifiability, timeliness and understandability are qualitative characteristics that enhance the usefulness of information that is relevant and faithfully represented.

9.2.1 Comparability

Users' decisions involve choosing between alternatives, for example, selling or holding an investment, or investing in one reporting entity or another. Consequently, information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or another date.

Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items. Unlike the other qualitative characteristics, comparability does not relate to a single item. A comparison requires at least two items.

Consistency, although related to comparability, is not the same. Consistency refers to the use of the same methods for the same items, either from period to period within a reporting entity or in a single period across entities. Comparability is the goal; consistency helps to achieve that goal.

9.2.2 Verifiability

Verifiability helps assure users that information faithfully represents the economic phenomena it purports to represent. Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation.

Verification can be direct or indirect. Direct verification means verifying an amount through direct observation, for example, by counting cash. Indirect verification means checking the inputs to a model, formula or other technique and recalculating the outputs using the same methodology.

9.2.3 Timeliness

Timeliness means having information available to decision-makers in time to be capable of influencing their decisions. Generally, the older the information is the less useful it is. However, some information may continue to be timely long after the end of a reporting period because, for example, some users may need to identify and assess trends.

9.2.4 Understandability

Classifying, characterising and presenting information clearly and concisely makes it understandable.

Some transactions are inherently complex and cannot be made easy to understand. While excluding information about those transactions from financial reports might make the information in those financial reports easier to understand, this may mean that information would be incomplete and therefore potentially misleading.

The revised *Conceptual Framework* states that financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently. At times, even the well-informed, diligent users may need to seek the aid of an adviser to understand information about complex economic phenomena.

CF.QC33-34

9.2.5 Application of the enhancing qualitative characteristics

Enhancing qualitative characteristics should be maximised to the extent possible. However, the enhancing qualitative characteristics, either individually or as a group, cannot make information useful if that information is irrelevant or not faithfully represented.

CF.QC35-39

9.3 The cost constraint on useful financial reporting

Cost is a constraint on the information that can be provided by financial reporting. Reporting financial information imposes costs, and it is important that those costs are justified by the benefits of reporting that information. There are several types of costs and benefits to consider.

Providers of financial information expend most of the effort involved in collecting, processing, verifying and disseminating financial information, but users ultimately bear those costs in the form of reduced returns. Users of financial information also incur costs of analysing and interpreting the information provided. If needed information is not provided, users incur additional costs to obtain that information elsewhere or to estimate it.

Reporting financial information that is relevant and faithfully represents what it purports to represent helps users to make decisions with more confidence.

CF.4.1

9.4 Underlying assumption

The *Conceptual Framework* identifies going concern as an underlying assumption in preparing financial statements.

The financial statements are normally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed.

10 The elements of financial statements

Topic highlights

Transactions and other events are grouped together in broad **classes** according to their economic characteristics. These broad classes are the **elements** of financial statements: assets, liabilities, equity, income and expenses.

This chapter of the *Conceptual Framework* is taken from the 1997 *Framework.* It lays out these elements as follows:

Elements of financial statements

- Measurement of financial position in the statement of financial position
  - Assets
  - Liabilities
  - Equity
- Measurement of performance in the statement of profit or loss and other comprehensive income
  - Income
  - Expenses

A process of **sub-classification** then takes place for presentation in the financial statements, e.g. assets are classified by their nature or function in the business to show information in the best way for users to take economic decisions.

CF.4.4 – 4.7

10.1 Financial position

The elements related to the measurement of financial position are assets, liabilities and equity.

Key terms

- **Asset**. A resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity.
- **Liability**. A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.
- **Equity**. The residual interest in the assets of the entity after deducting all its liabilities.

(Conceptual Framework)

These definitions are important, but they do not cover the **criteria for recognition** of any of these items, which are discussed in the next section of this chapter. This means that the definitions may include items which would not actually be recognised in the statement of financial position because they fail to satisfy recognition criteria particularly, as we will see below, the **probable flow of any economic benefit** to or from the business.

Whether an item satisfies any of the definitions above will depend on the **substance and economic reality** of the transaction, not merely its legal form. For example, consider finance leases (see Chapter 9).

CF.4.8-4.14

10.1.1 Assets

Key term

Future economic benefit. The potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity. The potential may be a productive one that is part of the operating activities of the entity. It may also take the form of convertibility into cash or cash equivalents or a capability to reduce cash outflows, such as when an alternative manufacturing process lowers the cost of production. *(Conceptual Framework)*

Assets are usually employed to produce goods or services for customers; customers will then pay for these and so contribute to the cash flow of the entity.

The existence of an asset is not reliant on:

- **physical form** or
- **legal ownership**

Non-physical items such as patents are assets provided that they are controlled and provide probable future economic benefits; similarly non-owned items, such as machinery obtained under a finance lease are assets, provided that they are controlled and provide probable future economic benefits.

Transactions or events **in the past** give rise to assets; those expected to occur in the future do not in themselves give rise to assets. For example, an intention to purchase a non-current asset does not, in itself, meet the definition of an asset.

CF.4.15-4.18

10.1.2 Liabilities

An essential characteristic of a liability is that the entity has a **present obligation**.

Key term

Obligation. A duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. Obligations also arise, however, from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner. *(Conceptual Framework)*

It is important to distinguish between a present obligation and a **future commitment**. A management decision to purchase assets in the future does not, in itself, give rise to a present obligation.

Settlement of a present obligation will involve the entity giving up resources embodying economic benefits in order to satisfy the claim of the other party. This may be done in various ways, not just by payment of cash.

Liabilities must arise from **past transactions or events**. In the case of, say, recognition of future rebates to customers based on annual purchases, the sale of goods in the past is the transaction that gives rise to the liability.

CF.4.19

10.1.3 Provisions

Some liabilities can be measured only with a degree of estimation for example payments to be made under existing warranties. These liabilities are known as provisions.

Key term

Provision. A present obligation which satisfies the rest of the definition of a liability, even if the amount of the obligation has to be estimated. *(Conceptual Framework)*

Self-test question 2

Consider the following situations. In each case, do we have an asset or liability within the definitions given by the *Conceptual Framework?* Give reasons for your answer.

(a) Manu Co. has purchased a patent for $20,000. The patent gives the company sole use of a particular manufacturing process which will save $3,000 a year for the next five years.

(b) Hirecar Co. paid Michael Wood $10,000 to set up a car repair shop, on condition that priority treatment is given to cars from the company's fleet.

(c) Sellcar Co. provides a warranty with every car sold.

(The answer is at the end of the chapter)

CF.4.20-4.23

10.1.4 Equity

Equity is defined above as a **residual**, but it may be sub-classified in the statement of financial position. This is relevant to the decision-making needs of the users as it will indicate legal or other restrictions on the ability of the entity to distribute or otherwise apply its equity. Some reserves are required by statute or other law, e.g. for the future protection of creditors. The amount shown for equity depends on the **measurement of assets and liabilities**. It has nothing to do with the market value of the entity's shares.

CF.4.24-4.28

10.2 Performance

Profit is used as a **measure of performance**, or as a basis for other measures (eg earnings per share).

It depends directly on the measurement of income and expenses, which in turn depend (in part) on the concepts of capital and capital maintenance adopted.

The elements of income and expense are therefore defined.

Key terms

- **Income**. Increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.
- **Expenses**. Decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants. *(Conceptual Framework)*

Income and expenses can be **presented in different ways** in the statement of profit or loss and other comprehensive income, to provide information relevant for economic decision-making. For example, distinguish between income and expenses which relate to continuing operations and those which do not.

Items of income and expense can be **distinguished** from each other or **combined** with each other.

CF.4.29-4.32

10.2.1 Income

Both **revenue** and **gains** are included in the definition of income. **Revenue** arises in the course of ordinary activities of an entity and may be referred to by names including sales, fees, interest, dividends rent or royalties.

Key term

Gains. Increases in economic benefits. As such they are no different in nature from revenue. *(Conceptual Framework)*

Gains include those arising on the disposal of non-current assets. The definition of income also includes **unrealised gains**, for example, on revaluation of marketable securities.

CF.4.33-4.35

10.2.2 Expenses

As with income, the definition of expenses includes losses as well as those expenses that arise in the course of ordinary activities of an entity.

Key term

Losses. Decreases in economic benefits. As such they are no different in nature from other expenses. *(Conceptual Framework)*

Losses will include those arising on the disposal of non-current assets. The definition of expenses will also include **unrealised losses**, for example, exchange rate effects on borrowings.

10.3 Capital maintenance

Capital maintenance refers to the concept that profits can only be made when the capital of an organisation is restored to, or maintained at the level that it was at the start of an accounting period. The concept is commonly separated into two types: physical and financial capital maintenance.

Under the physical capital maintenance concept, a profit is earned only when the operating capability of an organisation at the end of a period exceeds the operating capability at the start of the period.

Under the financial capital maintenance concept, a profit is earned when the money value of net assets at the end of a period exceeds their money value at the start of the period.

CF.4.36

10.3.1 Capital maintenance adjustments

A **revaluation** gives rise to an increase or decrease in equity.

Key term

Revaluation. Restatement of assets and liabilities. *(Conceptual Framework)*

These increases and decreases meet the definitions of income and expenses. They are **not included** in the statement of profit or loss under certain concepts of capital maintenance, however, but rather in equity.

10.4 Section summary

Make sure you learn the important definitions.

- Financial position:
  - Assets
  - Liabilities
  - Equity
- Financial performance:
  - Income
  - Expenses

11 Recognition of the elements of financial statements

CF.4.37-4.39

Topic highlights

Items which meet the definition of assets or liabilities may still not be recognised in financial statements because they must also meet certain **recognition criteria**.

Key term

Recognition. The process of incorporating in the statement of financial position or statement of profit or loss and other comprehensive income an item that meets the definition of an element and satisfies the following criteria for recognition:

(a) It is probable that any future economic benefit associated with the item will flow to or from the entity.

(b) The item has a cost or value that can be measured with reliability. *(Conceptual Framework)*

Regard must be given to **materiality** (see above).

CF.4.40

11.1 Probability of future economic benefits

Probability here means the **degree of uncertainty** that the future economic benefits associated with an item will flow to or from the entity. This must be judged on the basis of the **characteristics of the entity's environment** and the **evidence available** when the financial statements are prepared.

CF.4.41-4.43

11.2 Reliability of measurement

The cost or value of an item, in many cases, **must be estimated**. The *Conceptual Framework* states, however, that the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. Where no reasonable estimate can be made, the item should not be recognised, although its existence should be disclosed in the notes, or other explanatory material.

Items may still qualify for recognition **at a later date** due to changes in circumstances or subsequent events.

CF.4.44-4.53

11.3 Recognition of items

We can summarise the recognition criteria for assets, liabilities, income and expenses, based on the definition of recognition given above.

Statement of financial position

- An **asset** is recognised when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably.
- A **liability** is recognised when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably.

Statement of profit or loss and other comprehensive income

- **Income** is recognised when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably.
- An **expense** is recognised when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably.

12 Measurement of the elements of financial statements

CF.4.54-4.56

Topic highlights

A number of different measurement bases are used in financial statements. They include:

- historical cost
- current cost
- realisable (settlement) value
- present value of future cash flows

Key term

Measurement. The process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the statement of financial position and statement of profit or loss and other comprehensive income. *(Conceptual Framework)*

This involves the selection of a particular **basis of measurement**. A number of these are used to different degrees and in varying combinations in financial statements. They include the following:

Key terms

Historical cost. Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

Current cost. Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently.

Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

Realisable (settlement) value.

- **Realisable value**. The amount of cash or cash equivalents that could currently be obtained by selling an asset in an orderly disposal.
- **Settlement value**. The undiscounted amounts of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business.

Present value. The present discounted value of the future net cash flows in the normal course of business. *(Conceptual Framework)*

Historical cost is the most commonly adopted measurement basis, but this is usually combined with other bases, e.g. inventory is carried at the lower of cost and net realisable value.

13 Fair presentation and compliance with HKFRS

Topic highlights

HKAS 1.15,16,18-20

Compliance with HKFRS is presumed to result in financial statements that achieve a fair presentation.

Most importantly, financial statements should **present a true and fair view** of the financial position, financial performance and cash flows of an entity. **Compliance with HKFRS** is presumed to result in financial statements that achieve a fair presentation and true and fair view.

The following points made by HKAS 1 expand on this principle:

(a) Financial statements should be prepared using the **accrual basis**, i.e. income and expenses are recognised as they arise rather than when the related cash is received or paid.

(b) Financial statements should be prepared on a **going concern basis** unless it is planned for the entity to cease trading.

(c) **Compliance with HKFRS** should be disclosed.

(d) **All relevant HKFRS** must be followed if compliance with HKFRS is disclosed.

(e) Use of an **inappropriate accounting treatment** cannot be rectified either by disclosure of accounting policies or notes/explanatory material.

There may be (very rare) circumstances when management decides that compliance with a requirement of an HKFRS would be misleading. **Departure from the HKFRS** is therefore required to achieve a fair presentation.

The following should be disclosed in such an event:

(a) Management confirmation that the financial statements fairly present the entity's financial position, performance and cash flows.

(b) Statement that all HKFRS have been complied with *except* departure from one HKFRS to achieve a fair presentation.

(c) Details of the nature of the departure, why the HKFRS treatment would be misleading, and the treatment adopted.

(d) Financial impact of the departure.

This is usually referred to as the "**true and fair override**".

HKAS 1.17,23

13.1 Extreme case disclosures

In very rare circumstances, management may conclude that compliance with a requirement in a standard or interpretation may be so **misleading** that it would **conflict with the objective** of financial statements set out in the *Conceptual Framework*, but the relevant regulatory framework prohibits departure from the requirements.

In such cases the entity needs to reduce the perceived misleading aspects of compliance by **disclosing**:

(a) the title of the standard, the nature of the requirement and the reason why management has reached its conclusion.

(b) for each period, the adjustment to each item in the financial statements that would be necessary to achieve fair presentation.

HKAS 1 states what is required for a fair presentation:

(a) Selection and application of **accounting policies**.

(b) **Presentation of information** in a manner which provides relevant, reliable, comparable and understandable information.

(c) **Additional disclosures** where required.

HKAS 1.25,26

13.2 Break-up basis accounts

HKAS 1 requires that, when preparing financial statements, management should assess the ability of an entity to continue as a going concern.

Financial statements should be prepared on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so.

In assessing whether an entity is a going concern, management must take into account all available information about the future, being at least 12 months from the end of the reporting period. They may consider current and expected profitability, debt repayment schedules and potential sources of replacement financing.

Where an entity is not a going concern, the financial statements are prepared on a basis other than that of a going concern, most commonly the break-up basis.

13.2.1 Content of break-up basis accounts

The term break-up basis is not defined in accounting standards and may be interpreted differently by different people.

If the accounts are prepared on a basis other than that of a going concern, it does not automatically mean that all assets are written down to their scrap value, nor that provision is made for all the costs of winding up the business. All of the normal rules of accounting still apply, other than that of going concern. The recognition, measurement and presentation of assets and liabilities will be affected as follows.

Assets

(a) Non-current assets should be assessed for impairment, and written down to their recoverable amount if this is less than their carrying amount.

As we shall see later in the Learning Pack, recoverable amount is the higher of net realisable value and value in use.

- Realisable value was defined in section 12 as the amount of cash or cash equivalents that could currently be obtained by selling the asset.
- Value in use is the present value of the future cash flows associated with the asset.

It should be remembered that the value in use is likely to be lower than previously expected since the time frame for use will be shorter than if the company were a going concern.

Therefore, realisable value will often be taken as the recoverable amount.

(b) In addition, inventories will continue to be measured at the lower of cost and net realisable value, however when an entity is not a going concern, it becomes more likely that cost will exceed net realisable value.

(c) Amounts receivable are stated at their realisable value i.e. the cash expected to be recovered. Practically this will be equal to gross receivables net of irrecoverable debts and an allowance for receivables as usual, however in the context of a company which is not a going concern the identification of irrecoverable debts and calculation of an allowance may require additional consideration.

(d) Monetary items, such as cash are stated at their face value.

(e) It is sometimes said that all non-current assets should be reclassified as current assets in break-up basis accounts. This would only be the case, however, if their use had changed. If they were still held for use within the business (if only for a short time) then they are still non-current assets.

Liabilities

(a) Liabilities are normally only recognised where an obligation exists at the reporting date and the normal rules in HKAS 37 have been met. Therefore, legal and other costs related to an insolvency are only recognised when incurred.

(b) Some non-current liabilities will be reclassified as current. A common example of this is where the company is in breach of loan covenants at the year end meaning that the loan facility will be withdrawn and so repayment is required in the short term.

13.2.2 Disclosure

When management is aware of material uncertainties related to events or conditions that may cast significant doubt upon an entity's ability to continue as a going concern, the entity should disclose those uncertainties.

Where an entity does not prepare financial statements on a going concern basis, it must disclose that fact together with the basis on which it prepared the financial statements and the reason why the entity is not regarded as a going concern.

14 Management commentary

A management commentary (known as management discussion and analysis in Hong Kong) is a narrative report that accompanies financial statements as part of an entity's financial reporting. It explains the main trends and factors underlying the development, performance and position of the entity's business during the period covered by the financial statements. It also explains the main trends and factors that are likely to affect the entity's future development, performance and position.

An IFRS Practice Statement was issued on *Management Commentary* in December 2010. This is a broad, non-binding framework for the presentation of narrative reporting to accompany financial statements prepared in accordance with IFRS.

The Practice Statement is not an IFRS. Therefore, entities applying IFRS are not required to comply with the Practice Statement, unless specifically required by their jurisdiction.

14.1 Purpose

The purpose of management commentary is to help investors to:

(a) interpret and assess the related financial statements in the context of the environment in which the entity operates.

(b) assess what management views as the most important issues facing the entity and how it intends to manage those issues.

(c) assess the strategies adopted by the entity and the potential for those strategies to succeed.

14.2 Contents

A number of principles and qualitative characteristics should underlie the preparation and presentation of the management commentary.

In particular, the management commentary should:

- supplement and complement financial statement information.
- provide an analysis of the entity through the eyes of management.
- have an orientation to the future.
- possess the fundamental characteristics of relevance and faithful representation and maximise the enhancing characteristics of comparability, verifiability, timeliness and understandability.

15 Current developments

15.1 *Conceptual Framework*

As we saw earlier in this chapter, the IASB and FASB completed the first phase of their joint project to develop a common *Conceptual Framework for Financial Reporting* in 2010*.* As a result, they have issued a *Conceptual Framework* which includes new chapters on the objective of financial statements and qualitative characteristics together with the remaining chapters from the old *Framework.* This revised *Conceptual Framework* has been adopted by the HKICPA.

The remaining phases of the project relate to:

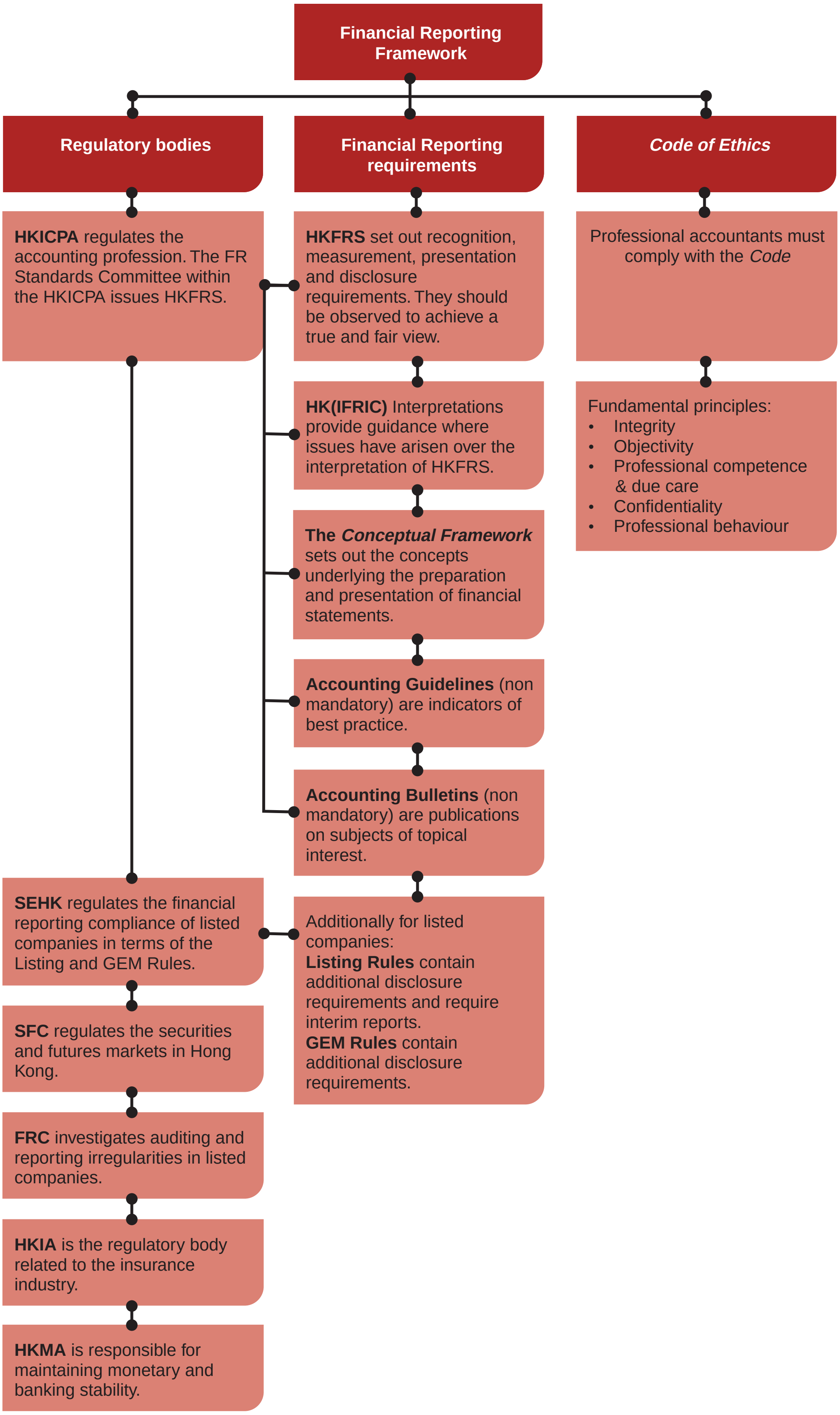
- elements and recognition
- measurement
- the reporting entity
- presentation and disclosure

Subsequent to the completion of phase 1 of the project in 2010, remaining work was deferred. In late 2012, however, the project was reactivated as an IASB-only project. The IASB is currently working towards a discussion paper covering all remaining phases of the project and this is expected to be issued during the course of 2013. The IASB aims to complete the project by 2015.

15.2 Other IASB projects

The IASB is engaged in a number of ongoing projects. These are discussed in more detail in the relevant chapters of this Learning Pack.

Topic recap


Financial Reporting Framework
Regulatory bodies
Financial Reporting requirements
Code of Ethics
HKICPA regulates the accounting profession. The FR Standards Committee within the HKICPA issues HKFRS.
HKFRS set out recognition, measurement, presentation and disclosure requirements. They should be observed to achieve a true and fair view.
Professional accountants must comply with the *Code*
HK(IFRIC) Interpretations provide guidance where issues have arisen over the interpretation of HKFRS.
Fundamental principles:
• Integrity
• Objectivity
• Professional competence & due care
• Confidentiality
• Professional behaviour
The *Conceptual Framework* sets out the concepts underlying the preparation and presentation of financial statements.
Accounting Guidelines (non mandatory) are indicators of best practice.
Accounting Bulletins (non mandatory) are publications on subjects of topical interest.
SEHK regulates the financial reporting compliance of listed companies in terms of the Listing and GEM Rules.
Additionally for listed companies:
Listing Rules contain additional disclosure requirements and require interim reports.
GEM Rules contain additional disclosure requirements.
SFC regulates the securities and futures markets in Hong Kong.
FRC investigates auditing and reporting irregularities in listed companies.
HKIA is the regulatory body related to the insurance industry.
HKMA is responsible for maintaining monetary and banking stability.

Conceptual Framework

A statement of generally accepted theoretical principles which form the frame of reference for financial reporting.

The HKICPA's *Conceptual Framework*

Purpose of the *Conceptual Framework*:
- Aid development of new standards/review of existing standards
- Assist application of HKFRS
- Assist auditors in forming opinion
- Assist users to interpret financial information

Conceptual framework

To provide financial information that is useful to investors and creditors in making decisions. This includes information about:
- economic resources
- economic claims
- changes in economic resources and claims

Underlying assumption: going concern otherwise break-up basis accounts.

Qualitative characteristics

Fundamental:
- Relevance
- Faithful representation

Enhancing:
- Comparability
- Verifiability
- Timeliness
- Understandability

Elements of FS

Financial position:
- Assets
- Liabilities
- Equity

Financial performance:
- Income
- Expenses

Recognise when:
- it is probable future economic benefit will flow to/from the entity
- cost or value can be measured reliably

Measure at:
- historical cost
- current cost
- realisable (settlement) value
- PV of future cash flows

Fair presentation
- Presumed to be achieved by compliance with HKFRS
- Departure from HKFRS is allowed if necessary to achieve fair presentation
- "True and fair override" disclosures are necessary in the case of a departure

Management commentary (Management discussion and analysis)
- Narrative report to accompany financial statements
- IFRS Practice Statement issued 2010

Answers to self-test questions

Answer 1

(a) **Investors** are the providers of risk capital.

- (i) Information is required to help make a decision about buying or selling shares, taking up a rights issue and voting.
- (ii) Investors must have information about the level of dividend, past, present and future and any changes in share price.
- (iii) Investors will also need to know whether the management has been running the company efficiently.
- (iv) As well as the position indicated by the statement of profit or loss and other comprehensive income, statement of financial position and earnings per share (EPS), investors will want to know about the liquidity position of the company, the company's future prospects, and how the company's shares compare with those of its competitors.

(b) **Employees** need information about the security of employment and future prospects for jobs in the company, and to help with collective pay bargaining.

(c) **Lenders** need information to help them decide whether to lend to a company. They will also need to check that the value of any security remains adequate, that the interest repayments are secure, that the cash is available for redemption at the appropriate time and that any financial restrictions (such as maximum debt/equity ratios) have not been breached.

(d) **Suppliers** need to know whether the company will be a good customer and pay its debts.

(e) **Customers** need to know whether the company will be able to continue producing and supplying goods.

(f) **Government's** interest in a company may be one of creditor or customer, as well as being specifically concerned with compliance with tax and company law, ability to pay tax and the general contribution of the company to the economy.

(g) The **public** at large would wish to have information for all the reasons mentioned above, but it could be suggested that it would be impossible to provide general purpose accounting information which was specifically designed for the needs of the public.

Answer 2

(a) This is an asset, albeit an intangible one. There is a past event, control and future economic benefit (through cost savings).

(b) This cannot be classified as an asset. Hirecar Co. has no control over the car repair shop and it is difficult to argue that there are "future economic benefits".

(c) The warranty claims in total constitute a liability; the business has taken on an obligation. It would be recognised when the warranty is issued rather than when a claim is made.

Exam practice

Fair presentation

11 minutes

"Financial statements should be prepared on a going concern basis and measured with historical cost in order to present fairly the financial position of an entity." **Comment on this statement.**

(6 marks)

HKICPA June 2012

Mr. Kong

9 minutes

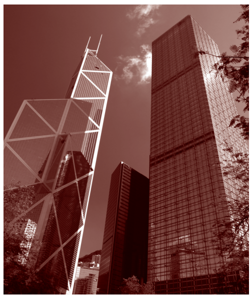
Mr. Kong, a member of Hong Kong Institute of Certified Public Accountants (the "Institute"), is the Chief Financial Controller of a company. At the end of the financial period, the company has certain old and obsolete inventories kept in the warehouse. In order to avoid recognising an impairment loss in the financial statements, Mr. Kong has asked the accounting manager Ms. Yuen, who is also a member of the Institute, to create a forged purchase order from an existing customer for the inventories at a selling price above the cost, with a delivery date six months later. He has asked her to provide a copy to the auditor as evidence that the inventory does not require writing down to net realisable value. Mr. Kong has also threatened Ms. Yuen with dismissal if she is not willing to comply with his wishes.

Required

Discuss the behaviour of Mr. Kong and what Ms. Yuen should do in accordance with the Code of Ethics for Professional Accountants.

(5 marks)

HKICPA June 2011

chapter 3

Small company reporting

Topic list

Learning focus

The *HKFRS for Private Entities* was issued in April 2010. It provides an option for non-publicly accountable entities which do not qualify for the SME-FRS to use simplified accounting and disclosure rules.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
LO2.03	**Small and Medium-sized Entity Financial Reporting Framework and Financial Reporting Standard:**	2
	2.03.01 Identify the conditions under which an entity may adopt the *SME Financial Reporting Framework and Financial Reporting Standard*	
	2.03.02 Describe the requirements of the *SME Financial Reporting Framework* and *Financial Reporting Standard*	
LO2.04	**Hong Kong Financial Reporting Standard for Private Entities**	2
	2.04.01 Identify the conditions under which an entity may adopt the *HKFRS for Private Entities*	
	2.04.02 Describe the requirements of the *HKFRS for Private Entities*	

1 Background

Topic highlights

The SME-FRF and SME-FRS provide a framework for simplified reporting for smaller companies in Hong Kong.

The *HKFRS for Private Entities* was issued in April 2010 and is based on the IASB's *International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs)*.

The objective of financial statements is to provide information about the financial position and performance of an entity that is useful to users of such information. Financial statements show the results of management's stewardship of, and accountability for, the resources entrusted to it.

For small and medium-sized entities (SMEs), the most significant users are likely to be owners, government and creditors, who may have the power to obtain information additional to that contained in the financial statements. These users do not generally require the detailed disclosures required by full HKFRS, and indeed the preparing entities generally find the provision of such disclosures onerous in terms of the time and cost of preparation.

In Hong Kong, there are therefore two options for simplified reporting for smaller, non-listed entities:

1 the SME-FRF and SME-FRS
2 the new *HKFRS for Private Entities*.

This chapter considers each of these options, including who can use them and what simplifications are made compared to the use of full HKFRS.

2 Financial Reporting in Hong Kong

Topic highlights

Until recently, two financial reporting options existed in Hong Kong: the SME-FRS was applicable to most small and medium-sized entities and full HKFRS to all others. The introduction of the *HKFRS for Private Entities* adds a third, middle tier, which can be adopted by unlisted entities.

2.1 Three financial reporting options

As a result of the introduction of the *HKFRS for Private Entities*, Hong Kong now has three financial reporting options:

1 The SME-FRF & FRS which **can only** be applied by **certain unlisted entities** (see section 3)

2 The new *HKFRS for Private Entities* which can be applied by any **private entity** (see section 4.2)

3 Full HKFRS which **must** be applied by **publicly listed entities** and **may** be applied by any private entity.

The options available to each type of entity are summarised in the following table:

	Can apply:
Non-listed companies which meet the criteria to use the SME-FRF & FRS	– **SME-FRF & FRS** – ***HKFRS for Private Entities* (meet the criteria to use *HKFRS for Private Entities*)** – **Full HKFRS**
Non-listed companies which do not meet the criteria to use the SME-FRF & FRS	– ***HKFRS for Private Entities* (meet the criteria to use *HKFRS for Private Entities*)** – **Full HKFRS**
Publicly listed companies	– **Full HKFRS**

3 SME-FRF and SME-FRS

Topic highlights

The SME-FRF and SME-FRS can only be applied by certain unlisted entities. The SME-FRF provides a conceptual framework for small company reporting and the SME-FRS sets out recognition, measurement, presentation and disclosure requirements for companies reporting under it.

SME-FRF sets out the conceptual basis and qualifying criteria for the preparation of financial statements in accordance with the *Small and Medium-sized Entity Financial Reporting Standard* (SME-FRS).

SME-FRS sets out the recognition, measurement, presentation and disclosure requirements for an entity that prepares and presents the financial statements in accordance with the SME-FRS.

SME-FRS 16

3.1 Companies which qualify for reporting under the SME-FRF and SME-FRS

Both Hong Kong incorporated and overseas unlisted companies may qualify for reporting under the SME-FRF and preparing financial statements in accordance with the SME-FRS.

3.1.1 Qualifying Hong Kong companies

Those companies which satisfy the criteria set out in Part 9 Division 2 section 359 of the new CO qualify for reporting under the SME-FRF and so can apply the SME-FRS in preparing their financial statements. Reporting under this regime is not, however, a requirement for such companies, but a choice.

A company applying s.359 above should obtain agreement from all of the shareholders of the company in writing that the financial statements are properly prepared. Thus the interests of the minority shareholders are protected.

Section 359 does not apply to:

- a private company which is itself a holding company of subsidiaries
- a private company which is a subsidiary of another company formed and registered under the Companies Ordinance.

A Hong Kong company which has a controlled investment in the PRC which does not meet the legal definition of a subsidiary does, however, satisfy the criteria for reporting under s.359 and therefore can apply the SME-FRS.

Part 9 ("Accounts and Audit") of the new CO, contains the accounting and auditing provisions in relation to the keeping of accounting records, the preparation and circulation of annual financial statements, directors' and auditor's reports and the appointment and rights of auditors.

New provisions are introduced to make it easier and more efficient for SMEs to be able to use simplified accounting and reporting requirements, to require public and large companies to include an analytical business review in directors' reports, and to enhance auditors' right to information. This Part also introduces new sanctions relating to the contents of auditor's reports.

3.1.2 Facilitating Simplified Reporting

It becomes easier for SMEs to prepare simplified financial and directors' reports in the following ways:

- a private company (with the exception of a bank/deposit-taking company, an insurance company or a stockbroker) will automatically qualify for simplified reporting if it qualifies as a "small private company".
- Small private company (defined in new CO Schedule 3 section 1)

If it meets any two of the following size criteria for two consecutive periods:

annual revenue	≤	HK$100 million
total assets	≤	HK$100 million
employees	≤	100 employees

For example, a company with a property valued at more than HK$100 million can still apply to use the SME-FRS if its annual revenue is less than HK$100 million and it has less than 100 employees.

- the holding company of a group of companies that qualifies as a "group of small private companies" will also qualify for simplified reporting (Part 9 Division 2 section 365).
- a private company that is not a member of a corporate group may adopt simplified reporting with the agreement of all the members.

Allowing small guarantee companies and groups of small guarantee companies, which have a total annual revenue of not more than $25 million, to qualify for simplified reporting (Part 9 Division 2 sections 363 and 366).

A private company or a group of private companies which is not qualified as a "small private company" or a "group of small private companies" respectively may prepare simplified reports if it meets a higher size criteria and if the members holding 75% of the voting rights so resolve and no member objects.

Making the summary financial reporting provisions more user-friendly and extending their application to companies in general (rather than confining them to listed companies, as in the current Companies Ordinance).

SME-FRS 17, 22-24

3.1.3 Overseas companies

A company incorporated outside Hong Kong is not bound by the new CO and should prepare its separate financial statements in accordance with the requirements imposed by the law in its place of incorporation. Provided that the specific requirements of the place of incorporation are met, these companies may report under the SME-FRF and apply the SME-FRS if:

1 They have no public accountability. An entity has public accountability for the purposes of the SME-FRF if:

   (a) at any time during the current or preceding reporting period, the entity (whether in the public or private sector) is an issuer of securities, that is, its equity or debt securities are publicly traded or it is in the process of issuing publicly traded equity or debt securities;

   (b) the entity is an institution authorised under the Banking Ordinance;

   (c) the entity is an insurer authorised under the Insurance Companies Ordinance; or

(d) the entity is a corporation which is granted a licence under the Securities and Futures Ordinance to carry on business in a regulated activity in Hong Kong.

2 They meet any two of the following size criteria for two consecutive periods:

annual revenue	≤	HK$50 million
total assets	≤	HK$50 million
employees	≤	50 employees

For example, a company with a property valued at more than HK$50 million can still apply to use the SME-FRS if its annual revenue is less than HK$50 million and it has less than 50 employees. (Note that the size criteria for overseas companies are different from the requirement applicable to Hong Kong companies as stated in Section 3.1.1 of this Learning Pack.)

3 All owners agree to apply the SME-FRS. (A shareholder agreement should be signed every year.)

These qualifying conditions are applicable to all overseas companies, including a subsidiary or an intermediate holding company of a listed entity.

SME-FRS 20

When a company has not been considered to be an SME in terms of its size under section 3.1.2 point 2 above and subsequently becomes an SME, the company will not qualify for reporting under the SME-FRF until the company has been determined to be an SME for two consecutive reporting periods.

Now the Companies Ordinance, Part 16 ("Non-Hong Kong Companies") deals with companies incorporated outside Hong Kong which have established a place of business in Hong Kong.

There is no fundamental change to the current rules.

Example

An overseas company meets the size criteria for reporting under the SME-FRF as follows:

Year ended	Company A
31 December 20X5	Criteria not met
31 December 20X6	Criteria met
31 December 20X7	Criteria met
31 December 20X8	Criteria met

In what period(s), if any, may the company report under the SME-FRF?

Solution

- In 20X5 the company does not satisfy the criteria and so cannot report under the SME-FRF.
- In 20X6 and 20X7, the company does meet the criteria, however will not have been determined to be an SME for two consecutive reporting periods and so cannot report under the SME-FRF.
- In 20X8 the company satisfies the criteria for two consecutive reporting periods and so qualifies for reporting under the SME-FRF.

SME-FRS 21

Where a company has previously qualified for reporting under the SME-FRF in terms of section 3.1.2, the company will no longer qualify for reporting under the SME-FRF in terms of size criteria set in section 3.1.2 point 2 above until the company is no longer an SME for two consecutive reporting periods.

Example

An overseas company, Company B, previously qualified as an SME and reported under the SME-FRF with the following changes:

Year ended	Company B
31 December 20X5	Criteria continue to be met
31 December 20X6	Criteria not met
31 December 20X7	Criteria not met
31 December 20X8	Criteria not met

May Company B qualify to report under the SME-FRF for the year ending 31 December 20X6 and onwards?

Solution

- In 20X6 and 20X7 Company B continues to qualify for reporting under the SME-FRF until Company B is no longer an SME for two consecutive reporting periods.
- In 20X8 Company B is no longer an SME for three consecutive reporting periods and should transfer to HKFRS for its financial statements starting from the year ending 31 December 20X8.

For an entity that qualifies for reporting under the SME-FRF, the appropriate application of the SME-FRS, with additional disclosure when necessary, would result in financial statements that achieve a proper presentation appropriate for SMEs.

For a company applying s.141D of the Hong Kong Companies Ordinance, compliance with the SME-FRF and SME-FRS is necessary in order for financial statements to give a true and correct view.

3.2 The requirements of the SME-FRF and SME-FRS

Sections 1 to 17 of SME-FRS set out detailed financial reporting requirements for entities reporting under SME-FRF and SME-FRS. You should refer to the original text of SME-FRF and SME-FRS when it is necessary.

The SME FRS is in the most part a simplified version of the full HKFRS regime, However, the SME-FRS differs from the full HKFRS regime in certain key areas, which include the following:

(a) There is no requirement to include a cash flow statement in a set of SME-FRS financial statements (FRS 1.1).

(b) Changes in equity may be disclosed in a note rather than in a separate primary statement (FRS 1.29).

(c) Leasehold interests in land from the Government of the HKSAR, or elsewhere with similar features, are accounted for as property, plant and equipment (FRS 3.13).

(d) There is no separate category of "investment property". Instead, the definition of property, plant and equipment includes properties held for rental purposes or investment potential (FRS section on definitions & FRS 3.1)

(e) The recognition of deferred tax is prohibited (FRS 14.4). Instead the only tax expense recognised is that calculated based on profits assessed for tax purposes for the period i.e. as is payable to the taxation authorities in respect of that period.

(f) Investments cannot be carried at fair value. Instead, all held-to-maturity securities are stated at amortised cost, other current investments are stated at the lower of cost and net realisable value and other long-term investments are stated at cost less accumulated impairment losses (FRS 6.7 & 6.8).

(g) Entities can decide whether or not to use a discounting technique in the impairment test and in estimating any provisions (FRS 9.8 and 10.3).

(h) The SME-FRS does not have specific section dealing with employee benefits, and therefore does not have specific requirements covering the matters within the scope of HKAS 19, Employee benefits, and HKFRS 2, Share based payment . Instead, example 5 of Appendix 1 to the SME-FRS indicates that provisions for long service pay and for other post employment retirement schemes would fall under section 10 "Provisions, contingent liabilities and contingent assets" of the SME-FRS.

(i) The rules on accounting for speculative and non-speculative forward foreign exchange contracts (FRS 15.6-15.8) appear to have been drafted based on SSAP 11, Foreign currency translation , and therefore still refer to calculating "discounts and premiums" on the contracts, as well as "gains and losses"

4 Introduction to the *HKFRS for Private Entities*

Topic highlights

On 30 April 2010, the HKICPA issued the *HKFRS for Private Entities*. This new standard became applicable immediately, and provided a new reporting option for those private companies which did not meet the criteria to use the SME-FRS & FRF and were therefore previously forced to apply full HKFRS.

4.1 Development of the *HKFRS for Private Entities*

The *HKFRS for Private Entities* is based on the *International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs)*, which was issued in July 2009. Despite its name, this IFRS for SMEs was developed by the IASB to apply to entities which are **not publicly accountable and publish general purpose financial statements for external users**, (rather than those which meet certain size definitions).

The Council considered that a variation of the IFRS for SMEs should be adopted in Hong Kong as a reporting **option** for eligible non-listed companies, and as a result issued the HKFRS for Private Entities.

4.1.1 Amendments made to the IFRS for SMEs in developing the *HKFRS for Private Entities*

The *HKFRS for Private Entities* is based on the IASB's IFRS for SMEs, however the following amendments are made to make the standard more relevant to Hong Kong:

(a) *The term "SMEs" is replaced by "Private Entities"*

The term SMEs is widely used in Hong Kong and associated with the locally developed SME-FRF & FRS. For clarity and differentiation, this HKFRS which is based on the "IFRS for SMEs" is called "Hong Kong Financial Reporting Standard for Private Entities" (*HKFRS for Private Entities*).

(b) *The recognition and measurement principles in section 29 Income Tax of the IFRS for SMEs is replaced by the extant version of HKAS 12 Income Taxes*

The Council considers that it is more appropriate to include the recognition and measurement principles contained in the extant version of HKAS 12 *Income Taxes* in the new HKFRS. The relevant disclosures contained in the IFRS for SMEs are, however, retained.

(c) *The measurement of deferred tax liabilities associated with an investment property measured at fair value is capped at the amount of tax that would be payable on its sale to an unrelated market participant at fair value at the end of the reporting period*

This amendment will restrict the amount of deferred taxation recognised in relation to revaluation gains of investment properties as such tax is in practice never paid in Hong Kong. This provision removes an anomaly currently in HKAS 12 *Income Taxes.*

4.2 Eligibility to use the *HKFRS for Private Entities*

Council has approved the adoption of the *HKFRS for Private Entities* as a **financial reporting option** for companies that:

(a) do not have public accountability; and
(b) publish general purpose financial statements for external users.

4.2.1 Public accountability

An entity is defined as having public accountability (and so may **not** use the new standard) if:

- its debt or equity instruments are traded in a public market (or it is in the process of issuing its debt or equity instruments for trading in a public market), or
- it holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses.

A public market means any domestic or foreign stock exchange market, or an over-the-counter market.

In general, an entity that holds assets in a fiduciary capacity as one of its primary businesses may be a bank, insurance company, securities broker/dealer, mutual fund or investment bank.

If an entity holds assets in a fiduciary capacity for a broad group of outsiders for reasons that are incidental to its primary business, it is not considered to have public accountability. Such entities may include schools, travel agents and charities.

4.2.2 General purpose financial statements

HKFRS are designed to apply to the general purpose financial statements of profit-oriented entities. General purpose financial statements are directed towards the common information needs of a wide range of users, for example, shareholders, creditors, employees and the public at large. The objective of financial statements is to provide information about the **financial position**, **performance** and **cash flows** of an entity that is useful to those users in making economic decisions.

4.2.3 Subsidiaries

A subsidiary of a group which applies full HKFRS may use the *HKFRS for Private Entities* provided that the subsidiary itself meets the eligibility criteria.

5 Contents of the *HKFRS for Private Entities*

5.1 Overview

Topic highlights

The *HKFRS for Private Entities* is a self-contained standard incorporating accounting principles that are based on full HKFRS, but which have been simplified to suit the private entities within its scope.

It includes simplifications that reflect the needs of users of private companies' financial statements and the cost-benefit considerations of preparers. It facilitates financial reporting by unlisted entities by:

- simplifying requirements for recognition and measurement;
- eliminating topics and disclosure requirements that are not generally applicable to private entities;
- removing certain accounting treatments permitted under full HKFRS.

Note that entities are **not** permitted to mix and match the requirements of the *HKFRS for Private Entities* and full HKFRS, except for the option to apply the recognition and measurement rules of HKAS 39 (HKFRS 9) with regard to financial instruments.

The *HKFRS for Private Entities* became effective immediately upon its issuance on 30 April 2010. Eligible entities are permitted to use *HKFRS for Private Entities* to prepare financial statements for prior period(s) where the relevant financial statements have not been finalised and approved.

5.1.1 Cost-benefit considerations

In order to provide additional relief to preparers of financial statements under the *HKFRS for Private Entities*, an "undue cost or effort" principle has been introduced in some sections of the standard to replace the "impracticability" relief criterion in the full HKFRS (a requirement is considered "impracticable" if an entity cannot apply it after making every reasonable effort to do so).

Although the notion of "undue cost or effort" is not defined, it focuses on the concept of balancing costs and benefits, which might in turn require management's judgment of when a cost is considered excessive. In other words, the "undue cost or effort" principle implies that cost is always considered.

5.2 Simplified accounting

The H*KFRS for Private Entities* simplifies certain recognition and measurement principles in full HKFRS. The more useful simplifications are highlighted below.

(a) **Research and development costs and borrowing costs** must be expensed immediately.

(b) **Financial instruments**

Financial instruments meeting specified criteria are measured at cost or amortised cost. All others are measured at fair value through profit or loss.

In addition, a simplified principle is established for derecognition and hedge accounting requirements are simplified and tailored to private entities.

(c) **Property, plant and equipment and intangibles**

Only the cost model is allowed. There is no need to review residual value, useful life and depreciation method unless there is an indication that they have changed since the most recent reporting date.

(d) **Goodwill and other indefinite-life intangibles**

An impairment test is performed only if there are indications of impairment (rather than annually). Goodwill is measured at cost less accumulated amortisation and impairment losses. All intangible assets are considered to have a finite useful life. If a reliable estimate of goodwill or intangible assets cannot be made, it is presumed to be ten years.

(e) **Investments in associates and jointly-controlled entities**

The cost model, equity model and fair value model are permitted as an accounting policy choice that should be applied to the whole class of associates or jointly-controlled entities. An entity using the cost model must measure an investment for which there is a published price using the fair value model.

(f) **Exchange differences**

An exchange difference that is recognised initially in other comprehensive income is not reclassified in profit or loss on disposal of the investment in a foreign subsidiary. This treatment is less burdensome than that required under full HKFRS because it eliminates the need for tracking exchange differences after initial recognition.

(g) **Non-current assets held for sale**

There is no separate held-for-sale classification; instead holding an asset or group of assets for sale is an indicator of impairment.

(h) **Equity-settled share-based payment**

If observable market prices are not available to measure the fair value of an equity-settled share-based payment, the directors' best estimate is used.

(i) **Defined benefit plans**

All actuarial gains and losses are recognised immediately (in profit or loss or other comprehensive income). All past service costs are to be recognised immediately in profit or loss. To measure the defined benefit obligation, the projected unit credit method should be used only if it can be applied without undue cost or effort. (**Note**. HKAS 19 has been revised and has incorporated these simplifications.)

(j) **Biological assets**

The cost-depreciation-impairment model is used unless the fair value is readily determinable without undue cost or effort. In this case, the fair value through profit or loss model should be applied.

(k) **Borrowing costs**

All borrowing costs are expensed immediately.

(l) **Government grants**

Government grants are recognised in income (at fair value) when the performance conditions are met.

(m) **Investment property**

If an entity can measure the fair value of an item of investment property reliably, without undue cost or effort, it must use fair value. Otherwise the cost model is applied.

5.3 Simplified presentation

In order to reduce costs for preparers, while still meeting the needs of users, the *HKFRS for Private Entities* has simplified financial statement presentation requirements as follows:

(a) An entity is not required to present a statement of financial position at the beginning of the earliest comparative period when the entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements as required under HKAS 1.

(b) An entity is permitted to present a single statement of income and retained earnings in place of separate statements of comprehensive income and changes in equity if the only changes to its equity during the periods for which financial statements are presented, arise from profit or loss, payment of dividends, corrections of prior period errors, and changes in accounting policy.

(c) All deferred tax assets and liabilities are classified as non-current assets or liabilities.

5.4 Omitted topics

The *HKFRS for Private Entities* does not address the following topics that are covered in full HKFRS, because these topics are not generally considered to be relevant to private entities:

- Earnings per share
- Interim financial reporting
- Segment reporting
- Classification for non-current assets (or disposal groups) as held for sale

5.5 Examples of options in full HKFRS not included in the *HKFRS for Private Entities*

The *HKFRS for Private Entities* does not allow the following accounting treatments available under full HKFRS. This is generally because a simplified treatment is available instead (see section 5.2 above):

	Treatment disallowed in *HKFRS for Private Entities*:
Property, plant and equipment and intangible assets	Revaluation model
Borrowing costs	Capitalisation of borrowing costs
Defined pension plans	Deferral of actuarial gains and losses
Financial instruments*	Available-for-sale and held-to-maturity classifications are not available
Government grants	Various accounting options excluded
Investment property	Accounting policy choice
Consolidation	Measurement of the non-controlling interest at fair value

***** **Note.** Entities are permitted to choose to apply HKAS 39 *Financial Instruments: Recognition and Measurement* in its entirety rather than the financial instruments section of the *HKFRS for Private Entities*. Note also that full HKFRS no longer allow these categories (HKFRS 9) and no longer allows deferred recognition (HKAS 19).

5.6 Simplified disclosure

A number of disclosure requirements contained in full HKFRS have been omitted from the *HKFRS for Private Entities* for the following reasons:

- They relate to topics covered in full HKFRS but omitted from the *HKFRS for Private Entities*.
- They relate to recognition and measurement principles contained in full HKFRS that have been replaced by simplifications.
- They relate to options in full HKFRS that are not included in the *HKFRS for Private Entities*.
- Some disclosures are not included on the basis of users' needs or cost-benefit considerations.

Examples of simplified and reduced disclosure requirements include the following:

- There is no requirement to disclose the fair value of the carrying amount for property, plant and equipment and investment property.
- The vast majority of the disclosure requirements of HKFRS 7 *Financial Instruments: Disclosures* are not required.

- There is no requirement to disclose estimates used to measure the recoverable amount of cash generating units containing goodwill.
- In relation to income taxes, entities are only required to provide an explanation of the significant differences in amounts reported in the statement of profit or loss and other comprehensive income and amounts reported to tax authorities.
- In relation to investments in associates, the following disclosures are omitted:
  – Summarised financial information relating to assets, liabilities, revenues and profit or loss.
  – Share of contingent liabilities and the nature and extent of any significant restrictions on the ability of associates to transfer funds to the investor, if any.

5.7 Updates and amendments to the *HKFRS for Private Entities*

The HKICPA expects to undertake a review of *HKFRS for Private Entities* in accordance with the IASB timetable to review its IFRS for SMEs. The IASB is currently in the middle of a comprehensive post-implementation review of user entities' experience in applying the IFRS for SMEs. A Request for Information was issued in 2012 and the Board is currently discussing responses. It will consider whether to amend the IFRS for SMEs for:

1 issues identified in the review
2 new and amended full IFRS adopted since the IFRS for SMEs was issued.

Beyond this, the IASB anticipate that the standard will be amended approximately once every three years, with proposed changes issued in one go within an ‘omnibus Exposure Draft’.

Therefore, the number and frequency of amendments is reduced compared to those made to full standards, and so the burden on companies to keep up to date is also reduced.

6 Impact of the *HKFRS for Private Entities*

Topic highlights

The *HKFRS for Private Entities* affects many companies, whether at an individual entity level, or subsidiaries in larger groups. Similar to full HKFRS, the *HKFRS for Private Entities* enables a true and fair view to be given on the financial statements.

6.1 Key concerns

A key area of concern for all businesses, especially individual companies in Hong Kong, is to ensure that the benefits of application of the *HKFRS for Private Entities* outweigh the costs associated with doing so.

The principal issue is therefore to ensure that the financial costs of preparation do not increase and the needs of stakeholders are still met.

The HKFRS addresses this concern, ensuring that

- financial statements are based on the same conceptual framework as full HKFRS, condensed and specifically tailored for private entities; and
- the burden of preparing financial statements in accordance with full HKFRS is reduced.

6.2 Comparison with full HKFRS

6.2.1 The omitted topics

The following topics have been omitted completely from the *HKFRS for Private Entities* (compare to full HKFRS), because they are not expected to be relevant for majority of entities which meet the criteria of choosing *HKFRS for Private Entities* (PEs):

- Earnings per share
- Interim financial reporting
- Segment reporting
- Special accounting for assets held for sale

6.2.2 Not an option

The *HKFRS for Private Entities* does not include the following options, because it is considered that PEs will choose to follow the simpler options as they will generally be less costly, require less expertise and achieve greater comparability with their peers.

If a PE feels strongly about using one or more of the complex options, it could elect to follow the full HKFRS rather than the *HKFRS for Private Entities*.

Property, plant and equipment

- The revaluation model is not an option.
- Property, plant and equipment carried at cost less accumulated depreciation and impairment.

Intangible assets

- The revaluation model is not an option.
- Intangible assets carried at cost less accumulated amortisation and impairment.

Borrowing costs

- The capitalisation model is not allowed.
- All borrowing costs should be expensed.

Government grants

- Various options excluded.
- Only single simplified method retained, that is, recognition in income (at fair value) when the performance conditions are met.

Investment property

- Measurement is driven by circumstances rather than allowing an accounting policy choice between the cost and fair value models.

Financial instruments

- Available-for-sale and held-to-maturity categories are not available.

Note. The above are just some of the differences between full HKFRS and the HKFRS for Private Entities.

6.2.3 Considerations prior to adopting the *HKFRS for Private Entities*

The *HKFRS for Private Entities* aims to simplify and reduce the potentially ever-increasing reporting requirements of the full HKFRS. However, in determining whether to adopt the *HKFRS for Private Entities*, management is advised to consider the facts and circumstances of the PE, including but not limited to the following matters.

Must all PEs apply the *HKFRS for Private Entities*?

No. The adoption of the *HKFRS for Private Entities* is an option for PEs. If compliance with the full HKFRS is required, desired or preferred by a PE, the PE may continue using or adopt the full HKFRS and need not adopt the *HKFRS for Private Entities*.

Will the financial statements of a PE meet the needs of users?

PEs will have to consider whether financial statements prepared under the *HKFRS for Private Entities* meet the needs of their own specific users. The financial statements of PEs generally are not widely circulated, and the needs of individual users of those financial statements tend to be specific, but not necessarily the same.

The *HKFRS for Private Entities* is based on the same framework as the full HKFRS. In developing the IFRS for SMEs, the IASB attempted to consider the needs of users of the financial statements of an SME. However, due to the specific needs of individual users, careful assessment will be needed by each SME to determine whether the IFRS for SMEs will meet their needs. The IFRS for SMEs concentrates on items such as short-term cash flows, liquidity, and balance sheet strength. The IASB concluded that the full IFRS at times provided too much information for the needs of an SME user, while in other situations other needs were not being met by the full IFRSs.

The HKICPA has held meetings with the Inland Revenue Department of the HKSAR Government and representatives of Hong Kong Association of Banks since the issuance of the IFRS for SMEs. Both parties acknowledged the standard setting role of the HKICPA and have no objection in principle to relieving PEs from complying with the full HKFRS in the preparation of financial statements.

Are there any long-term considerations that should be taken into account?

The PE's long-term plans need to be considered; where such plans include becoming publicly accountable or a possible listing of debt or equity instruments, this could affect the choices made by the PE. A PE with such plans would be precluded from using the *HKFRS for Private Entities* in the future, as it would fail to meet the definition of a PE. This would then force the PE into a second conversion to the full HKFRS.

Another consideration is whether a PE's holding company reports (or will report) under the full HKFRS. In such cases, it may be easier for that PE to also report under the full HKFRS in order to facilitate the consolidation process in its parent company – thereby avoiding the need for dual reporting.

Topic recap

Small company reporting

Financial reporting options in Hong Kong

Full HKFRS

Must be applied by publicly listed entities; may be applied by private entities

HKFRS for Private Entities

May be applied by entities which:
1. have no public accountability
2. prepare general purpose financial statements

Based on the IASB's IFRS for SMEs this is a self-contained standard

Compared to full HKFRS, provides:
- simplified accounting eg all R&D costs expensed as incurred.
- simplified presentation eg all deferred tax balances classified as non-current
- omitted topics eg EPS
- simplified disclosure eg most HKFRS 7 disclosures not required

SME-FRF & FRS

May be applied by private entities meeting set criteria:
- HK entities applying s.141D of Companies Ordinance
- Overseas entities with no public accountability which meet the size test and where all owners agree to apply the SME-FRS

Conceptual basis and qualifying criteria set out in SME-FRF

Recognition, measurement, presentation and disclosure requirements provided in SME-FRS

Exam practice

HKFRS for Private Entities

16 minutes

Sigma Technology Limited (STL) was established in the Macau Special Administration Region (MSAR) in 2008 by Mr. Ong and is engaged in trading computer hardware. More than 50 staff are employed by the company. STL has prepared its financial statements in accordance with the Small and Medium-sized Entity Financial Reporting Framework (SME-FRF) since it was established for both internal and external users. For the three years ended 31 December 20X1, STL reported the following data in its management accounts:

	20W9	*20X0*	*20X1*
	HK$'000	HK$'000	HK$'000
Revenue	43,528	53,456	48,621
Profit for the year	8,602	11,731	8,980
Total assets	20,984	32,327	28,489
Total liabilities	13,729	16,341	14,201

Required

(a) Explain whether STL can report under the SME-FRF for the years ended 31 December 20X0 and 31 December 20X1. **(3 marks)**

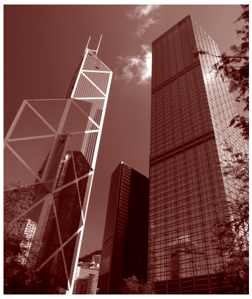
(b) Explain whether STL can report under the Hong Kong Financial Reporting Standard for Private Entities (HKFRS for Private Entities) for the year ended 31 December 20X1. **(2 marks)**

(c) "Revaluation and impairment of property, plant and equipment are prohibited under HKFRS for Private Entities". Explain whether this statement is correct. **(2 marks)**

(d) Assuming that Mr. Ong plans to list STL on the Growth Enterprise Market of The Stock Exchange of Hong Kong Limited and is considering incorporating the financial information of the entity for each of the two years ended 31 December 20X1 and 6 months ended 30 June 20X2 in the prospectus, explain whether STL can report the historical financial information in its prospectus under the SME-FRF or the HKFRS for Private Entities. **(2 marks)**

(Total = 9 marks)

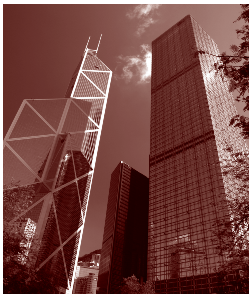
HKICPA December 2012 (amended)


Part C

Accounting for business transactions

The emphasis in this section is on an in-depth understanding of each accounting standard relating to transactions. The purpose of this section is to develop your knowledge about different accounting standards categorised into three areas: Statements of Financial Position and Comprehensive Income, Statements of Cash Flows, and Disclosure and Reporting. You should be able to identify and apply relevant accounting standards in resolving the accounting issues to be faced in the examination and the business world.


chapter 4

Non-current assets held for sale and discontinued operations

Topic list

Learning focus

The measurement requirements for non-current assets and disposal groups held for sale are particularly important both for exam and practical purposes.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
Account for transactions in accordance with Hong Kong Financial Reporting Standards		
3.21	**Non-current assets held for sale and discontinued operations**	3
3.21.01	Define non-current assets (or disposal groups) held for sale or held for distribution to owners and discontinued operations within the scope of HKFRS 5	
3.21.02	Explain what assets are within the measurement provision of HKFRS 5	
3.21.03	Determine when a sale is highly probable	
3.21.04	Measure non-current assets held for sale and discontinued operations including initial measurement, subsequent measurement and change of plan	
3.21.05	How to account for impairment loss and subsequent reversals	
3.21.06	Present the non-current asset held for sale and discontinued operation in the financial statements (including the prior year restatement)	

1 HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*

Topic highlights

HKFRS 5 requires assets and disposal groups "held for sale" to be presented separately in the statement of financial position.

The results of discontinued operations should be presented separately in the statement of profit or loss and other comprehensive income.

HKFRS 5, Appendix A

1.1 Introduction and definitions

HKFRS 5 requires assets and groups of assets ("disposal groups") that are "held for sale" to be presented separately in the statement of financial position.

It also requires that the results of discontinued operations are presented separately in the statement of profit or loss and other comprehensive income.

These requirements ensure that users of financial statements are better able to make projections about the financial position, profits and cash flows of the entity.

Key terms

Disposal group. A group of assets to be disposed of, by sale or otherwise, together as a group in a single transaction, and liabilities directly associated with those assets that will be transferred in the transaction. (In practice, a disposal group could be a subsidiary, a cash-generating unit or a single operation within an entity.)

Discontinued operation. A component of an entity that either has been disposed of or is classified as held for sale and:

(a) represents a separate major line of business or geographical area of operations

(b) is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations or

(c) is a subsidiary acquired exclusively with a view to resale.

(HKFRS 5)

HKFRS 5.2,5,5A

1.2 Scope

The classification and presentation requirements of HKFRS 5 (sections 2 and 4) apply to all recognised non-current assets and to all disposal groups.

The measurement requirements of the HKFRS (section 3) apply to all recognised non-current assets other than those listed below, which continue to be measured in accordance with the relevant HKFRS noted:

(a) Deferred tax assets (HKAS 12)
(b) Assets arising from employee benefits (HKAS 19)
(c) Financial assets (HKAS 39/HKFRS 9)
(d) Investment properties accounted for in accordance with the fair value model (HKAS 40)
(e) Agricultural and biological assets that are measured at fair value less costs to sell (HKAS 41)
(f) Insurance contracts (HKFRS 4)

The measurement requirements of the standard also apply to all disposal groups and such a group may include any assets and liabilities including current assets, current liabilities and those assets listed above which are excluded from the scope of the standard on an individual basis.

Where a non-current asset forms part of a disposal group, the measurement requirements of HKFRS 5 are applied to the group as a whole rather than to each asset within it on an individual basis.

The classification, presentation and measurement requirements in this HKFRS applicable to a non-current asset (or disposal group) that is classified as held for sale apply also to a non-current asset (or disposal group) that is classified as held for distribution to owners acting in their capacity as owners (held for distribution to owners).

2 Classification of assets held for sale or for distribution to owners

HKFRS 5.6,7

Topic highlights

A non-current asset (or disposal group) should be classified as held for sale **if its carrying amount will be recovered principally through a sale transaction rather than through continuing use**.

In order for this to be the case:

(a) the asset must be available for immediate sale in its present condition, and
(b) its sale must be highly probable (i.e., significantly more likely than not).

HKFRS 5.8,8A,9,11

2.1 Highly probable sale

For an asset to qualify as being held for sale, the sale must be "highly probable". The following must apply:

(a) Management must be **committed** to a plan to sell the asset.

(b) There must be an active programme to **locate a buyer**.

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

(d) The sale should be expected to take place **within one year** from the date of classification.

(e) It is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

The probability of shareholders' approval (if required in the jurisdiction) should be considered as part of the assessment of whether the sale is highly probable.

An entity that is committed to a sale plan involving loss of control of a subsidiary shall classify all the assets and liabilities of that subsidiary as held for sale when the criteria are met, regardless of whether the entity will retain a non-controlling interest in its former subsidiary after the sale.

If an asset (or disposal group) is not sold within one year, it can still be classified as held for sale only when the delay has been **caused by events or circumstances beyond the entity's control**. The entity is required to produce sufficient evidence to show its commitment to sell the asset or disposal group, otherwise it must cease to classify the asset as held for resale.

When a disposal group (e.g., a subsidiary) is acquired solely with a view to its subsequent disposal, an entity is allowed to classify it as an asset held for sale only if the sale is expected to occur within a year and it is highly probable that all the criteria mentioned above will be satisfied within a short period (normally three months) after the acquisition of the disposal group.

HKFRS 5.12A

2.2 Assets held for distribution to owners

A non-current asset (or disposal group) is classified as held for distribution to owners when the entity is committed to distribute the asset (or disposal group) to the owners.

For this to be the case:

- the assets must be available for immediate distribution in their present condition, and
- the distribution must be highly probable.

In order for the distribution to be considered highly probable:

1 actions to complete the distribution should have been initiated

2 these actions should be expected to be completed within 12 months of the date of classification.

Actions required to complete the distribution should indicate that it is unlikely that significant changes to the distribution will be made or that the distribution will be withdrawn. The probability of shareholders' approval (if required in the jurisdiction) should be considered as part of the assessment of whether the distribution is highly probable.

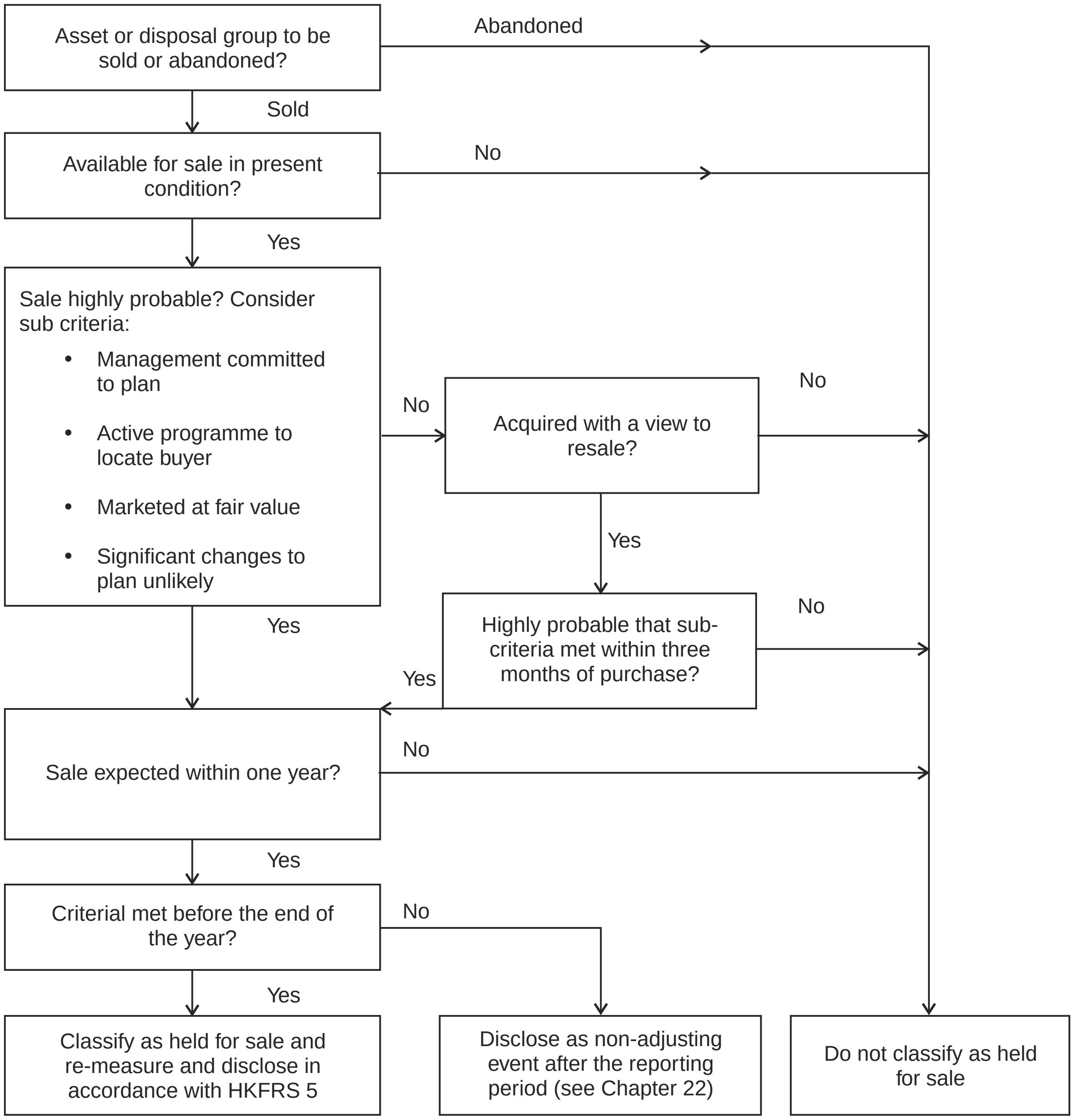
HKFRS 5.13

2.3 Assets to be abandoned

An asset that is to be **abandoned** should **not** be classified as held for sale. Since its carrying amount is to be recovered principally through continuing use rather than sale, it should not be classified as held for sale. However separate disclosure may be required (see section 5 below) when a disposal group to be abandoned meets the definition of a **discontinued operation**.

2.4 Summary decision tree

The following decision tree will help you to make a decision as to whether an asset or disposal group should be classified as held for sale:



Self-test question 1

Should the following be classified as held for sale at a 31 December 20X1 year end?

1 Lawnmo is committed to a plan to sell a manufacturing facility in its present condition and classifies the facility as held for sale at 31 March 20X1. After a firm purchase commitment is obtained, the buyer's inspection of the property identifies environmental damage not previously known to exist. Lawnmo is required by the buyer to make good the damage, and this is likely to mean that the sale will not be completed until the end of August 20X2. Lawnmo has initiated actions to make good the damage, and satisfactory rectification of the damage is highly probable.

2 Ficus is committed to a plan to sell its head office building and has engaged the services of an agent to locate a buyer. Ficus will use the building until the completion of its new premises, currently under construction. The existing head office will not be transferred to a buyer until such time as Ficus vacates the property.

(The answer is at the end of the chapter)

3 Measurement of assets held for sale

HKFRS 5 Appendix A

Key terms

Fair value. The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Costs to sell. The incremental costs directly attributable to the disposal of an asset (or disposal group), excluding finance costs and income tax expense.

Recoverable amount. The higher of an asset's fair value less costs to sell and its value in use.

Value in use. The present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life. *(HKFRS 5)*

HKFRS 5.15,15A

3.1 Initial measurement

On transfer to the held for sale category, a non-current asset (or the net assets of a disposal group) should be measured at the **lower of carrying amount** and **fair value less costs to sell**.

An entity shall measure a non-current asset (or disposal group) classified as held for distribution to owners at the **lower of its carrying amount** and **fair value less costs to distribute**.

HKFRS 5.16

3.1.1 Carrying amount

HKFRS 5 clarifies that the carrying amount is that amount at which the asset or disposal group would have been included in the financial statements had the classification to the held for sale category not occurred. This carrying amount is measured in accordance with applicable HKFRS.

HKFRS 5.17

3.1.2 Fair value less costs to sell

Fair value less costs to sell is equivalent to net realisable value. When the sale is expected to occur beyond one year, the standard specifies that costs to sell should be measured at present value. Any increase in the present value arising from the passage of time is recognised in profit or loss as a financing cost.

HKFRS 5.19,25

3.2 Subsequent measurement

Once classified as held for sale (or part of a disposal group held for sale), a non-current asset is not depreciated or amortised. Interest attributable to the liabilities of a disposal group does however continue to be recognised.

On subsequent measurement of a disposal group, the carrying amount of those assets which are part of the disposal group but individually outside the scope of HKFRS 5 (see section 1.2) should be re-measured in accordance with the relevant HKFRS before the fair value less costs to sell of the disposal group is re-measured.

HKFRS 5.20

3.3 Impairment losses

Assets held for sale are outside the scope of HKAS 36 and the guidance on impairments provided within HKFRS 5 applies instead.

Where fair value less costs to sell is lower than carrying amount, the asset or disposal group held for sale is impaired, and the difference between carrying amount and fair value less costs to sell must be recognised as an impairment loss.

Example: Tang Co.

Tang Co. has owned a printing machine for several years. The machine cost $400,000 and is being depreciated over a period of 10 years. At 1 October 20X8, the machine is carried in the statement of financial position at $280,000. On 31 March 20X9 the management of Tang Co. decided to sell the machine and immediately instructed a specialist selling agency to market the machine. The current market value of such a machine is $270,000 and Tang Co. has agreed to pay a 5% commission to the specialist selling agency.

At what value should the machine be included in the statement of financial position at 30 September 20X9, assuming that it has not yet been sold and that fair values remain unchanged since classification as held for sale?

Solution

At the date of transfer to held for sale the carrying amount was:

$280,000 – ($400,000/10 years × 6/12) = $260,000

The fair value less costs to sell was:

$270,000 × 95% = $256,500

On transfer to the held for sale category an impairment of $3,500 is recognised. Thereafter no depreciation is charged, meaning that the asset held for sale is included in the statement of financial position at 30 September 20X9 as a current asset carried at $256,500.

HKFRS 5.23

3.3.1 Impairment losses and disposal groups

An impairment loss recognised for a disposal group reduces the carrying amount of the non-current assets of the disposal group that are within the scope of HKFRS 5 in the following order:

1 Any goodwill within the disposal group
2 Other assets on a pro rata basis.

Example: Random Co.

Random Co. makes the decision to dispose of a division of its business on 15 February 20X9 and immediately begins an active programme to find a buyer. The assets of this division make up a disposal group, and are measured as follows:

	Carrying amount at 15 February 20X9 $'000
Goodwill	450
Intangible asset	1,000
Property, plant and equipment	2,000
Inventory	1,300
Other current assets	900
Total	5,650

The fair value of the disposal group is $5.4 million and costs to sell are $290,000.

An impairment loss is therefore recognised on transfer of the disposal group to held for sale of $540,000, and this is allocated to the non-current assets which fall within the scope of the measurement provisions of HKFRS 5. Therefore, no impairment loss is allocated to inventory or the other current assets.

The loss is allocated in the first place to goodwill and thereafter to other non-current assets on a pro-rata basis:

	Carrying amount at 15 February 20X9	*Impairment loss*	*Carrying amount after allocation of impairment loss*
	$'000	$'000	$'000
Goodwill	450	(450)	–
Intangible asset	1,000	(30)	970
Property, plant and equipment	2,000	(60)	1,940
Inventory	1,300	–	1,300
Other current assets	900		900
Total	5,650	540	5,110

HKFRS 5.21

3.4 Reversal of impairment losses

Where an asset or disposal group held for sale is measured at fair value less costs to sell, any subsequent increase in fair value less costs to sell is recognised, however not in excess of cumulative impairment losses recognised in accordance with HKFRS 5 or HKAS 36.

HKFRS 5.27

3.5 Measurement where assets are no longer classified as held for sale

A non-current asset (or disposal group) that is **no longer classified as held for sale** (for example, because the sale has not taken place within one year) is measured at the **lower of**:

(a) its **carrying amount** before it was classified as held for sale, adjusted for any depreciation, amortisation or revaluations that would have been charged had the asset not been classified as held for sale

(b) its **recoverable amount** at the date of the decision not to sell.

4 Presentation of assets held for sale

HKFRS 5.38-40

4.1 Presentation of a non-current asset or disposal group classified as held for sale

Separate classifications are to be presented in the statement of financial position for non-current assets and disposal groups. Likewise separate disclosure is also required for the liabilities of a disposal group in the statement of financial position.

(a) Assets and liabilities held for sale **should not be offset**.

(b) The **major classes** of assets and liabilities held for sale should be **separately disclosed** either in the statement of financial position or in the notes.

If the disposal group is a newly acquired subsidiary that meets the criteria to be classified as held for sale on acquisition, disclosure of the major classes of assets and liabilities is **not** required.

Re-presentation of prior year comparatives is not required to reflect those assets classified as held for sale only in the current year.

Example: Colway Co.

At the end of 20X9, Colway Co. decides to dispose of a machine and Division D of its business. Division D is a disposal group. Both of these intended disposals meet the criteria to be classified as held for sale, and their carrying amount after this classification is:

	$'000
Machine	15
Non-current assets of Division D	340
Current assets of Division D	120
Liabilities of Division D	260

Presentation in the statement of financial position of Colway Co. is therefore as follows:

	$'000	$'000
Non-current assets	X	X
Current assets	X	X
Non-current assets classified as held for sale	475	X
Total assets	X	X
Equity	X	X
Non-current liabilities	X	X
Current liabilities	X	X
Liabilities associated with non-current assets classified as held for sale	260	X
Total equity and liabilities	X	X

HKFRS 5.41,42

4.2 Additional disclosures

The following disclosures are required when a non-current asset (or disposal group) is either classified as held for sale or sold during a reporting period:

(a) A **description** of the non-current asset (or disposal group)

(b) A description of the **facts and circumstances** of the disposal

(c) Any **gain or loss** recognised when the item was classified as held for sale

(d) If applicable, the reportable **segment** in which the non-current asset (or disposal group) is presented in accordance with HKFRS 8 *Operating Segments*

When an entity reclassifies an asset as **no longer held for sale**, it should disclose the facts and circumstances leading to the decision and its resultant effect.

5 Discontinued operations

HKFRS 5.32

5.1 Definition of discontinued operations

A discontinued operation was defined at the start of this chapter as a component of an entity that has either been disposed of, or is classified as held for sale, and:

(a) represents a separate major line of business or geographical area of operations

(b) is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations, or

(c) is a subsidiary acquired exclusively with a view to resale

A component of an entity comprises operations and cash flows that can be clearly distinguished from the rest of the entity, both operationally and for financial reporting purposes.

HKFRS 5 requires that the results of a discontinued operation are disclosed separately in order to enable users of the financial statements to evaluate the financial effects of discontinued operations.

Self-test question 2

Discuss whether these situations meet the definition of discontinued operations in HKFRS 5.

(i) Wong Co. had used two factories to manufacture office equipment. A general slump in the economy has resulted in a reduced demand for such equipment and the company has decided to move all the production facilities to one of the factories but keep the now empty factory in the hope that there will be an upturn in demand and require the return to two factory output.

(ii) In addition to the manufacture of office equipment, Wong Co. supplied office stationery to private education establishments. In order to raise much needed cash the office stationery supply business was sold. The office stationery supply business was operated separately from the manufacturing activities.

(The answer is at the end of the chapter)

HKFRS 5.33-35,37

5.2 Presentation of discontinued operations

An entity should disclose a **single amount** in the **statement of profit or loss and other comprehensive income** comprising the total of:

(a) the **post-tax profit or loss** of discontinued operations and

(b) the post-tax gain or loss recognised on the **measurement to fair value less costs to sell** or on the disposal of the assets or disposal group(s) constituting the discontinued operation.

An entity should also disclose an **analysis** of the above single amount into:

(a) the revenue, expenses and pre-tax profit or loss of discontinued operations

(b) the related income tax expense

(c) the gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or the discontinued operation

(d) the related income tax expense

The analysis may be shown separately from continuing operations, in a section identified as discontinued operations, in the statement of profit or loss and other comprehensive income. As an alternative, it may also be presented in the notes to the financial statements. Such disclosure is not necessary where the discontinued operation relates to a newly acquired subsidiary that has been classified as held for sale.

Disclosures relating to the **net cash flows** attributable to the operating, investing and financing activities of the discontinued operations may be presented on the face of the statement of cash flows. Alternatively, they may be shown in the notes.

The required disclosures must be re-presented for prior periods presented in the financial statements so that the disclosures relate to all operations that have been discontinued by the most recent reporting date.

Any current year adjustments made to amounts previously presented in discontinued operations and directly related to the disposal of a discontinued operation in a prior period are classified separately in discontinued operations.

The gains or losses arising from the reassessment of a disposal group, which is held for sale and is not a discontinued operation, should be incorporated in the profit or loss from continuing operations.

Illustration

The following illustration is taken from the implementation guidance to HKFRS 5. Profit for the year from discontinued operations would be analysed in the notes.

Smart Group
STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X9

	20X9	*20X8*
	$'000	$'000
Continuing operations		
Revenue	X	X
Cost of sales	(X)	(X)
Gross profit	X	X
Other income	X	X
Distribution costs	(X)	(X)
Administrative expenses	(X)	(X)
Other expenses	(X)	(X)
Finance costs	(X)	(X)
Share of profit of associates	X	X
Profit before tax	X	X
Income tax expense	(X)	(X)
Profit for the year from continuing operations	X	X
Discontinued operations		
Profit for the year from discontinued operations	X	X
Profit for the year	X	X
Period attributable to:		
Owners of the parent	X	X
Non-controlling interest	X	X
	X	X

The analysis of the profit from discontinued operations may also be presented in a separate column in the statement of profit or loss and other comprehensive income.

Self-test question 3

A&Z

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X1

	20X1	*20X0*
	$'000	$'000
Revenue	3,000	2,200
Cost of sales	(1,000)	(700)
Gross profit	2,000	1,500
Distribution costs	(400)	(300)
Administrative expenses	(900)	(800)
Profit before tax	700	400
Income tax expense	(210)	(120)
Profit for the year	490	280
Other comprehensive income for the year, net of tax	40	30
Total comprehensive income for the year	530	310

During the year the company ran down a material business operation with all activities ceasing on 26 December 20X1. The results of the operation for 20X0 and 20X1 were as follows:

	20X1	*20X0*
	$'000	$'000
Revenue	320	400
Cost of sales	(150)	(190)
Gross profit	170	210
Distribution costs	(120)	(130)
Administrative expenses	(100)	(90)
Loss before tax	(50)	(10)
Income tax expense	15	3
Loss for the year	(35)	(7)
Other comprehensive income for the year, net of tax	5	4
Total comprehensive income for the year	(30)	(3)

The company recognised a loss of $30,000 on initial classification of the assets of the discontinued operation as held for sale, followed by a subsequent gain of $120,000 on their disposal in 20X1. These have been netted against administrative expenses. The income tax rate applicable to profits on continuing operations and tax savings on the discontinued operation's losses is 30%.

Required

Prepare the statement of profit or loss and other comprehensive income for the year ended 31 December 20X1 for A&Z complying with the provisions of HKFRS 5.

(The answer is at the end of the chapter)

Topic recap

HKFRS 5 Non-Current Assets Held for Sale and Discontinued Operations

Non-current assets/disposal groups held for sale

Non-current asset/disposal group is classified as held for sale if:

- available for immediate sale in present condition, and
- the sale is highly probable:
  - Management committed to sale plan;
  - Active programme to locate buyer;
  - Marketed at reasonable price;
  - Sale expected to take place < 12 months
  - Unlikely that sale plan will be changed.

Measurement

Lower of carrying amount and fair value less costs to sell.

If FV less costs to sell < carrying amount recognise impairment loss. In disposal group set against:

1. goodwill
2. other assets on pro rata basis

No further depreciation/amortisation

Disclosure

- Disclose separately as current assets / current liabilities held for sale without offsetting
- Disclose separate classes of assets / liabilities held for sale

Discontinued operations

Operation which is disposed of or held for sale and:

- represents a separate major business/geographical area
- is part of a plan to dispose of a separate major business/geographical area
- is a subsidiary acquired with a view to resale

Disclosure

Disclose single amount in statement of profit or loss and other comprehensive income comprising:

- post tax profit or loss of the discontinued operations and
- post tax gain or loss on disposal/measurement to fair value less costs to sell.

Disclose further analysis of the single amount in the SPLOCI or notes.

Disclose net cash operating, investing and financing cash flows of the discontinued operation.

Answers to self-test questions

Answer 1

1 The manufacturing facility should be classified as held for sale. Although the sale will not be completed within 12 months of classification, the delay is caused by circumstances beyond Lawnmo's control and Lawnmo is clearly committed to the sale.

2 The building should not be classified as held for sale. The delay in transferring the building to a buyer demonstrates that it is not available for immediate sale. This is the case even if a firm purchase commitment were obtained.

Answer 2

(i) The closure of the factory does not result in the disposal of a separate major line of business or geographical area of operation nor is the factory being held for sale. The closure therefore does not appear to result in a need to classify any of the performance of Wong Co. as discontinued in these circumstances. Nothing has been discontinued, merely production reduced to a more competitive level until demand returns.

(ii) The office stationery supply business will probably be considered to represent a separate major line of business and should therefore be classified as a discontinued operation with separate disclosure of its activities in the statement of profit or loss as required by HKFRS 5. Its disposal will probably have been a single co-ordinated plan, further confirming the business as a discontinued operation.

Answer 3

A&Z

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X1

	20X1	*20X0*
	$'000	$'000
Revenue (3,000 – 320)/(2,200 – 400)	2,680	1,800
Cost of sales (1,000 – 150)/(700 – 190)	(850)	(510)
Gross profit	1,830	1,290
Distribution costs (400 – 120)/(300 – 130)	(280)	(170)
Administrative expenses (900 – 100)/(800 – 90)	(800)	(710)
Profit before tax	750	410
Income tax expense (210 + 15)/(120 + 3)	(225)	(123)
Profit for the year from continuing operations	525	287
Loss for the year from discontinued operations	(35)	(7)
Profit for the year	490	280
Other comprehensive income for the year, net of tax	40	30
Total comprehensive income for the year	530	310

Note. Discontinued operations

During the year the company ran down a material business operation with all activities ceasing on 26 December 20X1. The results of the operation were as follows:

	20X1	*20X0*
	$'000	$'000
Revenue	320	400
Cost of sales	(150)	(190)
Gross profit	170	210
Distribution costs	(120)	(130)
Administrative expenses (100 + 90)	(190)	(90)
Loss before tax	(140)	(10)
Income tax expense (15 + (90 × 30%))	42	3
Loss after tax	(98)	(7)
Post-tax gain on remeasurement and subsequent disposal of assets classified as held for sale (90 × 70%)	63	–
Loss for the year	(35)	(7)
Other comprehensive income for the year, net of tax	5	4
Total comprehensive income for the year	(30)	(3)

Exam practice

Disposal Groups

22 minutes

Super Shoes Limited ("SS") is the holding company of Rocket Running Limited ("RR") and Soft Walking Limited ("SW"). At the board meeting of SS on 30 June 20X9, the management decided to dispose of all the assets of RR to an independent third party and close down the retailing operation of SW by the end of October 20X9. The assets of RR and SW as at 30 June 20X9 are measured in the consolidated financial statements before classification as held for sale and / or adjustment for impairment as a result of sales / closure of operation, if applicable, as follows:

	RR	*SW*
	HK$'000	HK$'000
Goodwill	2,400	2,700
Intangible assets	12,500	-
Property, plant and equipment	48,300	18,800
Inventories	16,600	6,400
Trade receivables	4,500	1,300
Financial assets held for trading	8,000	-
TOTAL	92,300	29,200

Taking into consideration the range of the price offered by the potential buyer, the management estimates that the fair value less costs to sell of the group of assets of RR amounts to HK$85,000,000.

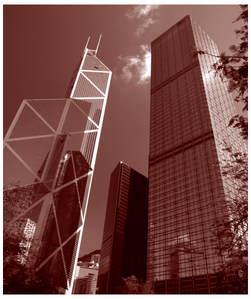
Almost all of the property, plant and equipment of SW are leasehold improvement of retailing shops located at premises rented under operating leases which would be abandoned upon the early termination of the lease terms. No proceeds are expected to be received even upon disposal. SW would continue to sell its inventories but at an estimated discount of 40% of the cost. The trade receivables are expected to be fully recovered.

Required

Explain and calculate the impairment loss to be made to each of the assets of RR and SW.

(12 marks)

HKICPA February 2010


chapter 5

Property, plant and equipment

Topic list

1 HKAS 16 *Property, Plant and Equipment*

1.1 Scope
1.2 Definitions
1.3 Recognition of non-current assets
1.4 Measurement
1.5 Depreciation
1.6 Revaluations
1.7 Impairment
1.8 Retirements and disposals
1.9 Disclosure
1.10 Current developments

Learning focus

Non-current assets form a large part of many entities' statements of financial position. Accounting for them is not necessarily straightforward and you may need to think critically and deal with controversial issues. This chapter deals with property, plant and equipment; how to account for transactions involving them, and the principles and methods of depreciation.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
Account for transactions in accordance with Hong Kong Financial Reporting Standards		
3.08	**Property, plant and equipment**	3
3.08.01	Identify the non-current assets which fall within or outside the scope of HKAS 16	
3.08.02	State and apply the recognition rules in respect of property, plant and equipment	
3.08.03	Determine the initial measurement of property, plant and equipment, including assets acquired by exchange or transfer	
3.08.04	Determine the accounting treatment of subsequent expenditure on property, plant and equipment	
3.08.05	Determine the available methods to measure property, plant and equipment subsequent to initial recognition	
3.08.06	Account for the revaluation of property, plant and equipment	
3.08.07	Define "useful life" and allocate an appropriate useful life for an asset in a straightforward scenario	
3.08.08	Explain the different methods of depreciation: straight line and diminishing balance, and calculate the depreciation amount in respect of different types of asset	
3.08.09	Account for the disposal of property, plant and equipment	
3.08.10	Disclose relevant information relating to property, plant and equipment in the financial statements	

1 HKAS 16 *Property, Plant and Equipment*

Topic highlights

HKAS 16 covers all aspects of accounting for property, plant and equipment. This represents the bulk of items which are "**tangible" non-current assets**.

HKAS 16.2,3

1.1 Scope

HKAS 16 should be followed when accounting for property, plant and equipment *unless* another accounting standard requires a **different treatment**.

HKAS 16 **does not apply** to the following:

(a) Property, plant and equipment classified as held for sale in accordance with HKFRS 5
(b) Biological assets related to agricultural activity
(c) The recognition and measurement of exploration and evaluation assets
(d) Mineral rights and mineral reserves, such as oil, gas and other non-regenerative resources.

However, the standard applies to property, plant and equipment used to develop the assets described in (b) and (d).

HKAS 16.6

1.2 Definitions

The standard gives a large number of definitions.

Key terms

Property, plant and equipment are tangible items that are:

- held for use in the production or supply of goods or services, for rental to others, or for administrative purposes
- expected to be used during more than one period

Cost is the amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction.

Residual value is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

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

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Carrying amount is the amount at which an asset is recognised after deducting any accumulated depreciation and accumulated impairment losses.

An **impairment loss** is the amount by which the carrying amount of an asset exceeds its recoverable amount.

Recoverable amount is the higher of an asset's fair value less costs to sell and its value in use.

(HKAS 16)

HKAS 16.7

1.3 Recognition of non-current assets

An item of property, plant and equipment should be recognised in the statement of financial position as an asset when:

(a) it is probable that **future economic benefits** associated with the asset will flow to the entity.
(b) the cost of the asset to the entity can be **measured reliably**.

1.3.1 First criterion: Future economic benefits

The **degree of certainty** attached to the flow of future economic benefits must be assessed. This should be based on the evidence available at the date of initial recognition (usually the date of purchase). The entity should thus be assured that it will receive the rewards attached to the asset and it will incur the associated risks, which will only generally be the case when the rewards and risks have actually passed to the entity. Until then, the asset should not be recognised.

1.3.2 Second criterion: Cost measured reliably

It is generally easy to measure the cost of an asset as the **transfer amount on purchase**, i.e. what was paid for it. **Self-constructed assets** can also be measured easily by adding together the purchase price of all the constituent parts (labour, materials and so on) paid to external parties.

HKAS 16.8,9,11,13,14

1.3.3 Application to specific types of asset

Small separate assets

Smaller items, such as tools, dies and moulds, are sometimes classified as consumables and written off as an expense. Where these are classified as property, plant and equipment, it is usual to aggregate similar items together and treat them as one.

Spare parts and stand-by equipment

Spare parts, stand-by equipment and servicing equipment are recognised as property, plant and equipment when they meet the definition of property, plant and equipment. Otherwise they are classified as inventory.

Safety and environmental equipment

When items of safety and environmental equipment are acquired they will qualify for recognition where they enable the entity to **obtain future economic benefits** from related assets in excess of those it would obtain otherwise. The recognition will only be to the extent that the carrying amount of the asset and related assets does not exceed the total recoverable amount of these assets.

Complex assets

For very large and specialised items, an apparently single asset should be broken down into its composite parts. This occurs where the different parts have different useful lives and different depreciation rates are applied to each part, e.g. an aircraft, where the body and engines are separated as they have different useful lives. Expenditure incurred in replacing or renewing a component of an item of property, plant and equipment must be recognised in the carrying amount of the item (and then depreciated to the next replacement date).

Inspections and overhauls

Certain assets require periodic overhauls or inspections in order to operate. The cost of these overhauls/inspections should be included in the carrying amount of the relevant asset and depreciated as a separate element of the asset to the date of the next overhaul/inspection.

HKAS 16.12

1.3.4 Subsequent expenditure

Subsequent expenditure on a non-current asset may be capitalised where the expenditure enhances the economic benefits of the asset beyond its current standard or performance. This may be achieved through extension of the asset's life, improved quality of output or an increased operating capacity. Day to day servicing costs, repairs and maintenance do not meet this criteria and therefore must be expensed to profit or loss.

1.4 Measurement

HKAS 16.15-22

1.4.1 Initial measurement

Once an item of property, plant and equipment qualifies for recognition as an asset, it will initially be **measured at cost**.

The standard lists the components of the cost of an item of property, plant and equipment.

(a) **Purchase price**, less any trade discount or rebate

(b) **Import duties** and non-refundable purchase taxes

(c) **Directly attributable costs** of bringing the asset to working condition for its intended use, for example:

 (i) The cost of site preparation
 (ii) Initial delivery and handling costs
 (iii) Installation costs
 (iv) Testing
 (v) Professional fees (architects, engineers)

(d) Initial estimate of the unavoidable cost of dismantling and removing the asset and restoring the site on which it is located (**HKAS 37** *Provisions, Contingent Liabilities and Contingent Assets*).

(e) Any borrowing costs incurred related to building the asset may be capitalised within the assets too (**HKAS 23** *Borrowing Costs*).

Additional guidance is provided on directly attributable costs included in the cost of an item of property, plant and equipment.

(a) These costs bring the asset to the location and working conditions necessary for it to be capable of operating in the manner intended by management, including those costs to test whether the asset is functioning properly.

(b) They are determined after deducting the net proceeds from selling any items produced when bringing the asset to its location and condition.

The standard also states that income and related expenses of operations that are **incidental** to the construction or development of an item of property, plant and equipment should be **recognised** in profit or loss. These include:

- costs of opening a new facility
- costs of introducing a new product or service
- costs of conducting business in a new location or with a new class of customer
- administration and other general overhead costs

In addition, the capitalisation of costs must cease when an asset is in the location and condition necessary for it to be capable of normal operation. Therefore, the following **may not** be capitalised:

- Costs incurred when an item is capable of normal use however is operating at less than full capacity
- Initial operating losses
- The costs of relocating or reorganising the entity's operations.

All of these will be recognised as an **expense** rather than an asset.

In the case of **self-constructed assets**, the same principles are applied as for acquired assets. If the entity makes similar assets during the normal course of business for sale externally, then the cost of the asset will be the cost of its production under **HKAS 2** *Inventories*. This also means that abnormal costs (wasted material, labour or other resources) are excluded from the cost of the asset. An example of a self-constructed asset is when a building company builds its own head office.

HKAS 16.24

1.4.2 Exchanges of assets

HKAS 16 specifies that exchange of items of property, plant and equipment, regardless of whether the assets are similar, are measured at **fair value**, **unless the exchange transaction lacks commercial substance** or the fair value of neither of the assets exchanged can be **measured reliably**. If the acquired item is not measured at fair value, its cost is measured at the carrying amount of the asset given up.

Example: Exchange of assets

A ship owner has properties with a carrying value of $10m. He is going to exchange his properties for a ship which has a market value of $20m by paying an additional sum of cash of $5m.

Solution

The ship owner shall capitalise the ship at a value of $20m. The properties are deemed to be disposed of at $15m ($20m – $5m), thus a gain of $5m ($15m – $10m) is recognised on disposal of the properties.

Expressed as journal entries, we can see:

		$m	$m
DEBIT	Property, plant and equipment (Ship)	20	
CREDIT	Gain on disposal		5
	Property, plant and equipment (Properties)		10
	Cash		5

HKAS 16.30,31

1.4.3 Measurement subsequent to initial recognition

HKAS 16 offers two possible treatments here, requiring you to choose between keeping an asset recorded at **cost** or revaluing it to **fair value**.

(a) **Cost model**. Carry the asset at its cost less any accumulated depreciation and any accumulated impairment losses.

(b) **Revaluation model**. Carry the asset at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. HKAS 16 makes clear that the **revaluation model is available only if the fair value of the item can be measured reliably**.

Depreciation, revaluation and impairment are discussed in more detail in the next three sections of the chapter.

1.5 Depreciation

Topic highlights

Where assets held by an entity have a limited useful life to that entity it is necessary to apportion the value of an asset over its useful life.

With the exception of land held on freehold or very long leasehold, **every non-current asset eventually wears out over time**. Machines, cars and other vehicles, fixtures and fittings, and even buildings do not last for ever. When a business acquires a non-current asset, it will have some idea about how long its useful life will be, and it might decide what to do with it.

(a) Keep on using the non-current asset until it becomes **completely worn out**, useless, and worthless.

(b) **Sell off** the non-current asset at the end of its useful life, either by selling it as a second-hand item or as scrap.

Since a non-current asset has a cost, and a limited useful life, and its value eventually declines, it follows that a charge should be made in profit or loss to reflect the use that is made of the asset by the business. This charge is called **depreciation**.

Depreciation must be charged even where an asset appears to be increasing in value over time. Other than assets classified as held for sale, to which HKFRS 5 applies, the only type of asset for which non-depreciation is permissible is freehold land.

HKAS 16.6

Key terms

Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life.

Depreciable assets are assets which:

- are expected to be used during more than one accounting period
- have a limited useful life
- are held by an entity for use in the production or supply of goods and services, for rental to others, or for administrative purposes.

Useful life is one of two things:

- The period over which an asset is expected to be available for use by an entity.
- The number of production or similar units expected to be obtained from the asset by an entity.

Depreciable amount is the cost of an asset, or other amount substituted for cost, less its residual value.

HKAS 16.48,50,55, 58,60

1.5.1 The mechanics of depreciation

The standard states the following:

(a) The **depreciable amount** of an item of property, plant and equipment should be allocated on a systematic basis over its useful life.

(b) The **depreciation method** used should reflect the pattern in which the asset's economic benefits are consumed by the entity.

(c) The **depreciation charge** for each period should be recognised as an expense unless it is included in the carrying amount of another asset.

Land and buildings are dealt with separately even when they are acquired together because land use right normally is considered as a lease and accounted for in accordance with the requirements under **HKAS 17**. Buildings do have a limited life and must be depreciated. Any increase in the value of land on which a building is standing will have no impact on the determination of the building's useful life.

Depreciation is usually treated as an **expense**, but not where it is absorbed by the entity in the process of producing other assets. For example, depreciation of plant and machinery can be incurred in the production of goods for sale (inventory items). In such circumstances, the depreciation is included in the cost of the new assets produced.

Depreciation should commence when an asset is available for use. In other words it is in the location and condition necessary for ordinary use.

HKAS 16.56,57

1.5.2 Useful life

The useful life of a depreciable asset is estimated based on the following factors:

- Expected **physical wear and tear**
- **Obsolescence**
- Legal or other **limits** on the use of the assets

The judgment on useful life is based on the entity's past experience with similar assets or classes of assets. The task of estimating the useful life will be much more onerous when an entirely new type of asset is acquired (i.e. through technological advancement or through use in producing a brand new product or service).

It is indicated in the standard that the useful life of an asset might be shorter than its physical life. The physical wear and tear the asset is likely to endure is one of the key factors that we need to look at. It is affected by circumstances such as the entity's repair and maintenance programme and number of shifts for which the asset will be used, and so on. Other factors such as obsolescence (due to technological advance, improvements in production, reduction in demand for the product or service produced by the asset) and legal restrictions, for example, the length of a related lease, also play a role in determining the useful life of an asset.

HKAS 16.53

1.5.3 Residual value

The residual value of an asset is **likely to be immaterial** in most instances. However, if the residual value is expected to be significant, it must then be estimated at the date of acquisition or at any subsequent revaluation. The residual value should be estimated based on the current situation with other similar assets, used in the same way, which are now at the end of their useful lives. Any future cost relating to the disposal should be netted off against the gross residual value.

HKAS 16.60,62

1.5.4 Depreciation methods

HKAS 16 requires the depreciation method used to reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity. A variety of methods are available and these include the straight line method, the diminishing balance method and the units of production method.

Straight line depreciation results in a constant annual depreciation charge. This method simply spreads the depreciable amount evenly over the useful life.

Diminishing balance depreciation results in a higher depreciation charge in the earlier years of an asset's useful life and a lower charge in later years. It is calculated as a constant percentage of an asset's carrying amount.

The **units of production** method results in a charge based on expected output. The charge is therefore higher in periods of higher output and lower when there is a lower output.

Consistency is important. The depreciation method selected should be applied consistently from period to period unless altered circumstances justify a change. When the method *is* changed, the effect should be quantified and disclosed and the reason for the change should be stated. Change of policy is not allowed simply because of the profitability situation of the entity.

Self-test question 1

A computer system cost $20,000 and is being depreciated at 10% using the diminishing balance method. How does this asset appear in the statement of financial position in the first and second year of ownership?

Why is the diminishing balance method more appropriate for such an asset?

(The answer is at the end of the chapter)

Self-test question 2

DSyne Co acquired an item of plant for $1.8m on 1 January 20X1. It identified that the asset had three major components as follows:

Component	*Useful life*	*Cost*
		$'000
1	15 years	900
2	5 years	650
3	10 years	250

Under the terms of the 15-year licence agreement for the use of the plant, component 1 (but not the other components) was to be dismantled at the end of the licence period.

Dismantling costs were initially estimated at a total cost of $280,000 payable in 15 years' time. DSyne's discount rate appropriate to the risk specific to this liability is 7% per annum.

Component 1 developed a fault on 1 January 20X2 and had to be sold for scrap for $140,000. A replacement was purchased at a cost of $910,000 on 1 January 20X2, for use until the end of the licence period, when dismantling costs on this component estimated at $250,000 would be payable.

At a rate of 7% per annum the present value of $1 payable in 15 years' time is 0.3624 and of $1 payable in 14 years' time is 0.3878.

Required

Calculate

(a) the carrying amount of the machinery at 31 December 20X1
(b) the profit/loss on the disposal of the faulty component
(c) the carrying amount of the machinery at 31 December 20X2

(The answer is at the end of the chapter)

HKAS 16.51

1.5.5 Review of useful life and residual value

A review of the **useful life and residual value** of property, plant and equipment should be carried out **at least at each financial year end** and the depreciation charge for the current and future periods should be adjusted if expectations have changed significantly from previous estimates. Changes to the useful life or residual value are treated as changes in accounting estimates and are accounted for prospectively as adjustments to future depreciation.

Example: Review of useful life

A machine costs $100,000 and has a useful life of 10 years since its acquisition in 20X7. At the end of the second year of use, the asset is assessed to have a remaining useful life of five years. The company adopts the straight line depreciation method.

What will be the depreciation charge for 20X9?

Solution

	$
Original cost	100,000
Depreciation 20X7 – 20X8 (100,000 × $^2/_{10}$)	(20,000)
Carrying amount at 1 January 20X9	80,000

Remaining life = 5 years

Depreciation charge years 20X9 – 20Y3 $\frac{80,000}{5}$ = $16,000

HKAS 16.61

1.5.6 Review of depreciation method

The **depreciation method** should also be reviewed **at least at each financial year end** and, if there has been a significant change in the expected pattern of economic benefits from those assets, the method should be changed to suit this changed pattern. When such a change in depreciation method takes place the change should be accounted for as a **change in accounting estimate** and the depreciation charge for the current and future periods should be adjusted.

Example: Review of depreciation method

Using the same data as above, assume that at the end of the second year the company changes from the straight line method to the diminishing balance method of depreciation, at a rate of 25% per annum.

The carrying amount of $80,000 is therefore written off from 20X9 onwards using the diminishing balance method over its remaining useful life.

The depreciation charge for 20X9 is therefore $20,000 (25% × $80,000).

HKAS 16.31

1.6 Revaluations

Where an entity chooses to apply the revaluation model to property, plant and equipment, the revalued assets are carried at a revalued amount less subsequent depreciation and impairment losses. Revalued amount is the fair value of the asset at the date of revaluation.

HKFRS 13.9-33,76,81,86

1.6.1 Fair value

HKFRS 13, issued in May 2011, amended the definition of fair value contained within HKAS 16 to "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date".

HKFRS 13 also deleted the HKAS 16 guidance on establishing fair value and replaced this with a requirement to instead refer to the requirements of HKFRS 13 *Fair Value Measurement*.

This standard requires that the following are considered in determining fair value:

1. The asset being measured.
2. The principal market (i.e. that where the most activity takes place) or where there is no principal market, the most advantageous market (i.e. that in which the best price could be achieved) in which an orderly transaction would take place for the asset.
3. The highest and best use of the asset and whether it is used on a standalone basis or in conjunction with other assets.
4. Assumptions that market participants would use when pricing the asset.

Having considered these factors, HKFRS 13 provides a hierarchy of inputs for arriving at fair value. It requires that level 1 inputs are used where possible:

Level 1 Quoted prices in active markets for identical assets that the entity can access at the measurement date.

Level 2 Inputs other than quoted prices that are directly or indirectly observable for the asset.

Level 3 Unobservable inputs for the asset.

HKAS 16.34

1.6.2 Frequency of revaluations

Valuations must be kept up to date so that the carrying amount of a revalued asset does not differ materially from its fair value. In some cases annual revaluation is necessary, whereas in others it may be necessary to revalue the item only every three or five years.

HKAS 16.36,38

1.6.3 Consistency of revaluation

When an item of property, plant and equipment is revalued, **the whole class of assets to which it belongs should be revalued**.

All items within a class should be revalued simultaneously. In this way, selective revaluation of certain assets and disclosure of a mixture of costs and values from different dates in the financial statements can be avoided. Entities are permitted to have revaluation on a rolling basis if the revaluations are kept up to date and the revaluation of the entire class is accomplished in a short period of time.

HKAS 16.39,40

1.6.4 Accounting for a revaluation

How should any **increase in value** be treated when a revaluation takes place? The debit will be the increase in value in the statement of financial position, but what about the credit? HKAS 16 requires the increase to be credited to other comprehensive income and accumulated in a **revaluation surplus** (i.e. part of owners' equity), *unless* the increase is reversing a previous decrease which was recognised as an expense. Where this is the case, the increase is recognised as income to the extent of the previous expense; any excess is then taken to the revaluation surplus.

A **decrease in value** is recognised in the same way as an impairment loss (see section 1.7 below).

Example: Revaluation

Paddington has acquired numerous buildings and accounts for these using the revaluation model.

One particular piece of land is carried in Paddington's statement of financial position at $560,000 at 1 January 20X1. At 31 December 20X1, further to a revaluation exercise, a fair value of $710,000 is identified in respect of this building.

How is this revaluation accounted for assuming that

(a) the buildings have only ever risen in value

(b) further to an economic downturn, at the time of the last revaluation exercise, an impairment of $80,000 was identified and recognised in profit.

Ignore depreciation.

Solution

(a) The double entry is:

		$	$
DEBIT	Buildings	150,000	
CREDIT	Other comprehensive income (revaluation surplus)		150,000

(b) The double entry is:

		$	$
DEBIT	Buildings	150,000	
CREDIT	Administrative expenses (profit or loss)		80,000
	Other comprehensive income (revaluation surplus)		70,000

Note. The line item for the credit to profit or loss is not specified in the standard, but it is generally made to the same account as any depreciation and other costs relating to the buildings.

The case is similar for a **decrease in value** on revaluation. Any decrease should be recognised as an expense, except where it offsets a previous increase taken as a revaluation surplus in owners' equity. Any decrease greater than the previous upwards increase in value must be taken as an expense in profit or loss.

Example: Revaluation decrease

Rupert Co. acquired a building for an original cost of $3.5 million at the start of 20X1. It was revalued upwards to $3.8 million in January 20X3. The value has now fallen to $3 million at 31 December 20X3.

How should the decrease in value be recorded at 31 December 20X3?

Solution

The double entry is:

		$	$
DEBIT	Other comprehensive income (revaluation surplus)	300,000	
	Administrative expenses (profit or loss)	500,000	
CREDIT	Building		800,000

1.6.5 Depreciation of revalued assets

Where a depreciated asset is revalued, future depreciation is calculated based on the revalued amount. One effect of an upwards revaluation is therefore an increase to the depreciation charge.

Normally, a revaluation surplus is only realised when the asset is sold, but when it is being depreciated, part of that surplus is being realised as the asset is used. The amount of the surplus realised is the difference between depreciation charged on the revalued amount and the (lower) depreciation which would have been charged on the asset's original cost. **This amount can be transferred to retained (i.e. realised) earnings**. This transfer is effected in the statement of changes in equity; it is not reflected in the statement of profit or loss and other comprehensive income.

Example: Revaluation and depreciation

Roosevelt Co. purchased a property on 1 January 20X1. Details are as follows:

- Cost $9million
- Useful life 50 years

On 1 January 20X6 the property was revalued to $8.5million, with the useful life unchanged.

(a) Account for the revaluation.

(b) Calculate depreciation for the year ended 31 December 20X6 and the amount that may be transferred to retained earnings from the revaluation surplus in that year.

Solution

(a) On 1 January 20X6 the carrying value of the property is $9m – (5 × $9m ÷ 50) = $8.1m. For the revaluation:

		$	$
DEBIT	Asset value	400,000	
CREDIT	Other comprehensive income (revaluation surplus)		400,000

(b) The depreciation for the year ended 31 December 20X6 will be $8.5m ÷ 45 = $188,889, compared to depreciation on cost of $9m ÷ 50 = $180,000. So each year, the extra $8,889 can be treated as part of the surplus which has become realised:

		$	$
DEBIT	Revaluation surplus	8,889	
CREDIT	Retained earnings		8,889

This is a movement on owners' equity only, disclosed in the statement of changes in equity.

1.7 Impairment

An **impairment loss** should be treated in the same way as a **revaluation decrease** i.e. the decrease should be **recognised as an expense**. However, a revaluation decrease (or impairment loss) should be charged directly against any related revaluation surplus to the extent that the decrease does not exceed the amount held in the revaluation surplus in respect of that same asset.

A **reversal of an impairment** loss should be treated in the same way as a **revaluation increase**, i.e. a revaluation increase should be recognised as income to the extent that it reverses a revaluation decrease or an impairment loss of the same asset previously recognised as an expense.

HKAS 16.68

1.8 Retirements and disposals

When an asset is permanently **withdrawn from use, or sold or scrapped**, and no future economic benefits are expected from its disposal, it should be withdrawn from the statement of financial position.

Gains or losses are the difference between the estimated net disposal proceeds and the carrying amount of the asset. They should be recognised as income or expense in profit or loss.

HKAS 16.67,68,68A

1.8.1 Derecognition

An entity is required to **derecognise the carrying amount** of an item of property, plant or equipment that it disposes of on the date the **criteria for the sale of goods** in **HKAS 18** *Revenue* would be met. This also applies to parts of an asset.

An entity cannot classify as revenue a gain it realises on the disposal of an item of property, plant and equipment.

However, an entity that, in the course of its ordinary activities, routinely sells items of property, plant and equipment that it has held for rental to others shall transfer such assets to inventories at their carrying amount when they cease to be rented and become held for sale. The proceeds from the sale of such assets shall be recognised as revenue in accordance with HKAS 18 *Revenue*. HKFRS 5 does not apply when assets that are held for sale in the ordinary course of business are transferred to inventories.

Example: Derecognition

A property was purchased at a cost of $10m and has a useful life of 50 years. At the end of Year 20, the property was revalued to $30m and its useful life remains unchanged. The property was sold at the beginning of Year 22 for $33m.

Solution

Accounting entries:

At the end of **Year 20**, the following accounting entries reflect the revaluation:

		$m	$m
DEBIT	Property ($30m – ($^{30}/_{50} \times$ $10m))	24	
CREDIT	Revaluation surplus		24

In **Year 21**, the following adjustments are to be made:

	$m
Depreciation based on revalued amount ($30m $\times$ $^{1}/_{30}$)	1.0
Depreciation based on original cost ($10m $\times$ $^{1}/_{50}$)	0.2
Depreciation increase related to revaluation surplus is regarded as realised	0.8

DEBIT	Revaluation surplus	0.8	
CREDIT	Retained profits		0.8

Being realisation of part of revaluation reserve due to additional depreciation provided on revaluation surplus.

In **Year 22**, the following adjustments are to be made:

		$m	$m
DEBIT	Bank (disposal proceeds)	33	
	Accumulated depreciation	1	
CREDIT	Property		30
	Gain on disposal (in profit or loss)		4

Being revalued property disposed of at a profit

DEBIT	Revaluation reserve ($24m – $0.8m)	23.2	
CREDIT	Retained profit		23.2

Being realisation of revaluation reserve upon disposal of asset.

The following analysis shows that the distributable profits remain the same, whether the property is revalued or not:

	$m
Without revaluation of the asset	
Cost	10.0
Less: Accumulated depreciation ($0.2 × 21 years)	(4.2)
Carrying amount	5.8
Disposal proceeds	(33.0)
Profit realised on disposal	27.2

	$m
With revaluation of the asset	
Gain on disposal (as above)	4.0
Revaluation surplus transferred to retained profits	23.2
	27.2

Self-test question 3

A business purchased two rivet making machines on 1 January 20X5 at a cost of $15,000 each. Each had an estimated life of five years and a nil residual value. The straight line method of depreciation is used.

Owing to an unforeseen slump in market demand for rivets, the business decided to reduce its output of rivets, and switch to making other products instead. On 31 March 20X7, one rivet making machine was sold (on credit) to a buyer for $8,000.

Later in the year, however, it was decided to abandon production of rivets altogether, and the second machine was sold on 1 December 20X7 for $2,500 cash.

Required

Prepare the machinery account, provision for depreciation of machinery account and disposal of machinery account for the accounting year to 31 December 20X7.

(The answer is at the end of the chapter)

HKAS 16.73,74,77, 79

1.9 Disclosure

The standard has a long list of disclosure requirements, for each class of property, plant and equipment.

(a) **Measurement bases** for determining the gross carrying amount (if more than one, the gross carrying amount for that basis in each category).

(b) **Depreciation methods** used.

(c) **Useful lives** or depreciation rates used.

(d) **Gross carrying amount** and accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period.

(e) **Reconciliation** of the carrying amount at the beginning and end of the period showing:

  (i) Additions
  (ii) Disposals
  (iii) Acquisitions through business combinations (see Chapter 27)
  (iv) Increases/decreases during the period from revaluations and from impairment losses
  (v) Impairment losses recognised in profit or loss
  (vi) Impairment losses reversed in profit or loss
  (vii) Depreciation
  (viii) Net exchange differences (from translation of statements of foreign entity)
  (ix) Any other movements.

The financial statements should also disclose the following:

(a) Any recoverable amounts of property, plant and equipment
(b) Existence and amounts of **restrictions on title**, and items pledged as security for liabilities
(c) Accounting policy for **the estimated costs of restoring the site**
(d) Amount of expenditures on account of **items in the course of construction**
(e) Amount of commitments to **acquisitions**

Revalued assets require further disclosures, in addition to those required by HKFRS 13 *Fair Value Measurement*:

(a) Basis used to revalue the assets

(b) Effective date of the revaluation

(c) Whether an independent valuer was involved

(d) Carrying amount of each class of property, plant and equipment that would have been included in the financial statements had the assets been carried at cost less accumulated depreciation and accumulated impairment losses

(e) Revaluation surplus, indicating the movement for the period and any restrictions on the distribution of the balance to shareholders

The standard also **encourages disclosure** of additional information, which the users of financial statements may find useful.

(a) The carrying amount of temporarily idle property, plant and equipment

(b) The gross carrying amount of any fully depreciated property, plant and equipment that is still in use

(c) The carrying amount of property, plant and equipment retired from active use and held for disposal

(d) The fair value of property, plant and equipment when this is materially different from the carrying amount

The following format (with notional figures) is commonly used to disclose non-current assets movements:

	Land and buildings	*Plant and equipment*	*Total*
	$	$	$
Cost or valuation			
At 1 January 20X8	40,000	10,000	50,000
Revaluation surplus	12,000	–	12,000
Additions in year	–	4,000	4,000
Disposals in year	–	(1,000)	(1,000)
At 31 December 20X8	52,000	13,000	65,000
Depreciation			
At 1 January 20X8	10,000	6,000	16,000
Charge for year	1,000	3,000	4,000
Eliminated on disposals	–	(500)	(500)
At 31 December 20X8	11,000	8,500	19,500
Carrying amount			
At 31 December 20X8	41,000	4,500	45,500
At 1 January 20X8	30,000	4,000	34,000

1.10 Current developments

The IASB proposed amendments to IAS 16 in December 2012. As HKAS 16 is converged with IAS 16, these will also affect HKAS 16. The amendments would clarify that depreciation methods must reflect a pattern of **consumption** of economic benefits from an asset rather than a pattern of **generation** of economic benefits by an asset. Therefore a revenue-based method of depreciation is not allowed.

A revenue-based method of depreciation is a method whereby the depreciation charge in a given year is calculated based on the revenue earned in that year as a proportion of total revenues expected to be generated by the asset over its useful life.

Comments on the Exposure Draft are due by 2 April 2013. Finalised amendments are expected in the fourth quarter of 2013.

Topic recap

HKAS 16 Property, Plant and Equipment

Recognise an asset when:

1. it is probable that future economic benefits associated with the asset will flow to the entity and
2. the cost of the asset can be measured reliably.

Subsequent expenditure is recognised as an asset only where it enhances the benefits of the asset.

Initial measurement

Measured at cost including:

- purchase price
- duties and taxes
- directly attributable costs
- dismantling costs (HKAS 37)
- borrowing costs (HKAS 23)

Subsequent measurement

Cost model

Carrying amount = cost – accumulated depreciation – accumulated impairment losses.

Revaluation model

Carrying amount = revalued amount – accumulated depreciation – accumulated impairment losses.

Rules:
Valuations must be kept up to date.

Model must be applied to the whole class of asset.

Upwards revaluation recognised as other comprehensive income in revaluation surplus.

Downwards revaluation charged to revaluation surplus to the extent it exists in respect of the asset then as an expense.

Depreciation

Allocate depreciable amount (revalued amount) less residual value over useful life.

Land usually not depreciated.

Review useful life, residual value and depreciation method at least each financial year.

Changes accounted for prospectively.

Disclosure requirements:

- Measurement bases
- Depreciation methods and estimations
- Reconciliation of cost/revalued amount and accumulated depreciation b/f to the same amounts c/f
- Recoverable amounts
- Restrictions on title
- Estimated costs of restoring site
- Expenditure on assets under construction
- Capital commitments
- Additional disclosure for revalued assets

Answers to self-test questions

Answer 1

	First year	*Second year*
	$	$
Cost	20,000	20,000
Accumulated depreciation		
Yr 1 ($20,000 × 10%)	(2,000)	(2,000)
Yr 2 ($18,000 × 10%)	–	(1,800)
Carrying amount	18,000	16,200

The diminishing balance method of depreciation is used instead of the straight line method when it is considered fair to allocate a greater proportion of the total depreciable amount to the earlier years and a lower proportion to the later years on the assumption that the benefits obtained by the business from using the asset decline over time.

It may be argued that this method links the depreciation charge to the costs of maintaining and running the computer system. In the early years these costs are low and the depreciation charge is high, while in later years this is reversed.

Answer 2

(a)

	Cost	*Depreciation*	*Carrying amount*
	$	$	$
Component 1			
Cost	900,000		
Dismantling	101,472		
($280,000 × 0.3624)	1,001,472	66,765	934,707
Component 2	650,000	130,000	520,000
Component 3	250,000	25,000	225,000
			1,679,707

(b)

Proceeds	140,000
CV at disposal	(934,707)
Loss on disposal	(794,707)

(c)

	Cost	*Depreciation*	*Carrying amount*
	$	$	$
Component 1			
Cost	910,000		
Dismantling	96,950		
($250,000 × 0.3878)	1,006,950	71,925	935,025
Component 2	650,000	260,000	390,000
Component 3	250,000	50,000	200,000
			1,525,025

Answer 3

20X7

			$	$
31 Mar	DEBIT	Loss on disposal	250	
		Accumulated depreciation*	6,750	
		Account receivable (sale price)	8,000	
	CREDIT	Non-current asset (cost)		15,000
	Being recording sales proceeds for disposal			
31 Dec	DEBIT	Loss on disposal	3,750	
		Accumulated depreciation**	8,750	
		Cash (sale proceeds)	2,500	
	CREDIT	Non-current asset (cost)		15,000
	Being recording sales proceeds for disposal			

* Depreciation at date of disposal = $6,000 + $750

** Depreciation at date of disposal = $6,000 + $2,750

You should be able to calculate that there was a loss on the first disposal of $250, and on the second disposal of $3,750, giving a total loss of $4,000.

WORKINGS

1 At 1 January 20X7, accumulated depreciation on the machines will be:

$$2 \text{ machines} \times 2 \text{ years} \times \frac{\$15{,}000}{5} \text{ per machine pa} = \$12{,}000, \text{ or } \$6{,}000 \text{ per machine}$$

2 Monthly depreciation is $\frac{\$3{,}000}{12}$ = $250 per machine per month

3 The machines are disposed of in 20X7.

(a) On 31 March – after 3 months of the year.

Depreciation for the year on the machine = 3 months × $250 = $750

(b) On 1 December – after 11 months of the year.

Depreciation for the year on the machine = 11 months × $250 = $2,750

Exam practice

Phoenix Real Estate

16 minutes

Phoenix Real Estate Limited ("Phoenix") is a property developer in China. In 20X3, Phoenix acquired the land use rights of two pieces of land in Beijing for hotel development:

Property One – Since the date of the acquisition of the land, the board of Phoenix has decided to run the hotel on its own and commenced the pre-operating activities of the hotel on 1 January 20X5 when the development is completed and the hotel is available for its intended use. The hotel's grand opening took place on 1 July 20X5.

Property Two – Since the date of the acquisition of the land, the board of Phoenix decided to lease the whole property to earn rental income. A lease agreement was entered into to lease the whole property to its holding company (the "Tenant") for a period of eighteen years for the operation of a hotel.

The monthly revenue amount of the hotel operation is provided by the Tenant at the close of business of each month-end date.

Other information on these two properties:

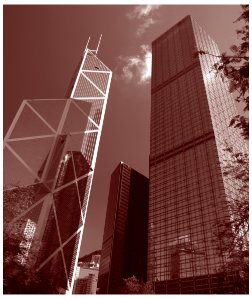
	Property One	Property Two
	RMB'000	RMB'000
Cost of land use right	45,000	48,000
Cost of construction (excluding the right amortisation of land use right)	303,000	267,000
Fair value of land use right at 31 December 20X5	60,000	100,000
Fair value of the building at existing status as at 31 December 20X5	560,000	340,000
Date of purchase of land use right	1 July 20X3	1 October 20X3
Term of land use right of the property	75 years	60 years
Estimated useful life of the property	50 years	40 years
Completion of construction of the building	December 20X4	June 20X5

Phoenix has adopted the cost model under HKAS 16 for property, plant and equipment and the fair value model under HKAS 40 for investment property (buildings only). Depreciation is provided to write off the cost of property, plant and equipment using the straight line method. The land use right is considered as a lease and accounted for in accordance with the requirements under HKAS 17. Amortisation of the cost of the land during the construction period is capitalised as part of the development cost of the property.

Required

Calculate the amount of (1) land use right and (2) carrying amount of the building for each property to be reflected in Phoenix's statement of financial position as at 31 December 20X5. **(9 marks)**

HKICPA September 2006 (amended)


chapter 6

Investment property

Topic list

Learning focus

Some entities own land or buildings and treat them as an investment, i.e. in order to generate income and cash flows independently of the other assets held by the entity. It is important that you understand the difference between investment properties and other classes of assets, and how to account for them.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
Account for transactions in accordance with Hong Kong Financial Reporting Standards		
3.10	**Investment property**	3
3.10.1	Identify an investment property within the scope of HKAS 40 and situation when a property can be transferred in and out of the investment property category	
3.10.2	Distinguish investment property from other categories of property holdings and describe the difference in accounting treatment	
3.10.3	Apply the recognition and measurement rules relating to investment property	
3.10.4	Account for investment property	
3.10.5	Disclose relevant information, including an accounting policy note, for investment property	

1 HKAS 40 *Investment Property*

Topic highlights

Land and building may be acquired for **investment purpose** rather than for use in the business. The cash flows generated by this investment are largely independent of other assets held by the entity. The accounting treatment of investment property is covered by **HKAS 40**.

HKAS 40 *Investment Property* was published in March 2000 with the objective of regulating the accounting treatment for investment property and related disclosure requirements.

HKAS 40 does not deal with issues covered in HKAS 17. It includes investment property held under a finance lease or leased out under an operating lease.

HKAS 40.5

1.1 Definitions

Key terms

Investment property is property (land or a building – or part of a building – or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both, rather than for:

(a) use in the production or supply of goods or services or for administrative purposes
(b) sale in the ordinary course of business.

Owner-occupied property is property held by the owner (or by the lessee under a finance lease) for use in the production or supply of goods or services or for administrative purposes.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Cost is the amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction.

Carrying amount is the amount at which an asset is recognised in the statement of financial position.

A property interest that is held by a lessee under an **operating lease** may be classified and accounted for as an **investment property**, if and only if the property would otherwise meet the definition of an investment property and the lessee uses the HKAS 40 **fair value model**. This classification is available on a property-by-property basis. *(HKAS 40.5)*

HKAS 40.8-12, 15

The standard provides the following examples of investment properties:

(a) **Land held for long-term capital appreciation** rather than for short-term sale in the ordinary course of business.

(b) Land held for a currently undetermined future use.

(c) A **building** owned by the reporting entity (or held by the entity under a finance lease) and **leased out under an operating lease**.

(d) A building that is vacant but held to be leased out under one or more operating leases.

(e) Property that is being constructed or developed for future use as investment property.

(f) A building held by an entity and leased to a parent or another **subsidiary**. Note, however, that while this is regarded as an investment property in the individual entity's financial statements, in the **consolidated** financial statements this property will be regarded as owner-occupied (because it is occupied by the group) and will therefore be treated in accordance with **HKAS 16**.

The standard also clarifies that the following are **not** investment properties, but are instead within the scope of the named standards:

(a) Property intended for sale in the ordinary course of business (HKAS 2)

(b) Property being constructed or developed for sale in the ordinary course of business (HKAS 2)

(c) Property being constructed or developed on behalf of third parties (HKAS 11)

(d) Owner occupied property (HKAS 16), which includes:

(i) property held for future owner-occupation
(ii) property held for future development before owner-occupation
(iii) property occupied by employees regardless of whether they pay market rent
(iv) owner-occupied property awaiting disposal

(e) Property leased to another entity under a finance lease.

Where a property is partly owner-occupied and partly held to earn rentals or for capital appreciation, its treatment depends on whether or not the portions of the property could be sold separately. If they could not be sold separately, the property is only treated as investment property if an insignificant portion is held for owner-occupier use.

Where an entity provides ancillary services to the occupants of a property it holds:

- The property is treated as investment property where those ancillary services are insignificant to the arrangement as a whole
- The property is treated as owner-occupied where the ancillary services are significant, for example the services provided to a hotel guest by the owner of the hotel indicate that a hotel is owner-occupied.

Self-test question 1

Propex had the following properties but is unsure how to account for them:

1 Tennant House which cost $150,000 five years ago. The property is freehold and is let out to private individuals for six-monthly periods. The current market value of the property is $175,000.

2 Stowe Place which cost $75,000. This is used by Propex as its headquarters. The building was acquired 10 years ago.

3 Crocket Square is a recently started development which is two-thirds complete. Propex intends to let this out to a company called Speedex in which it has a controlling interest.

4 Smith Tower is an office complex let out to a number of commercial tenants. Propex provides these tenants with security and maintenance services in the building.

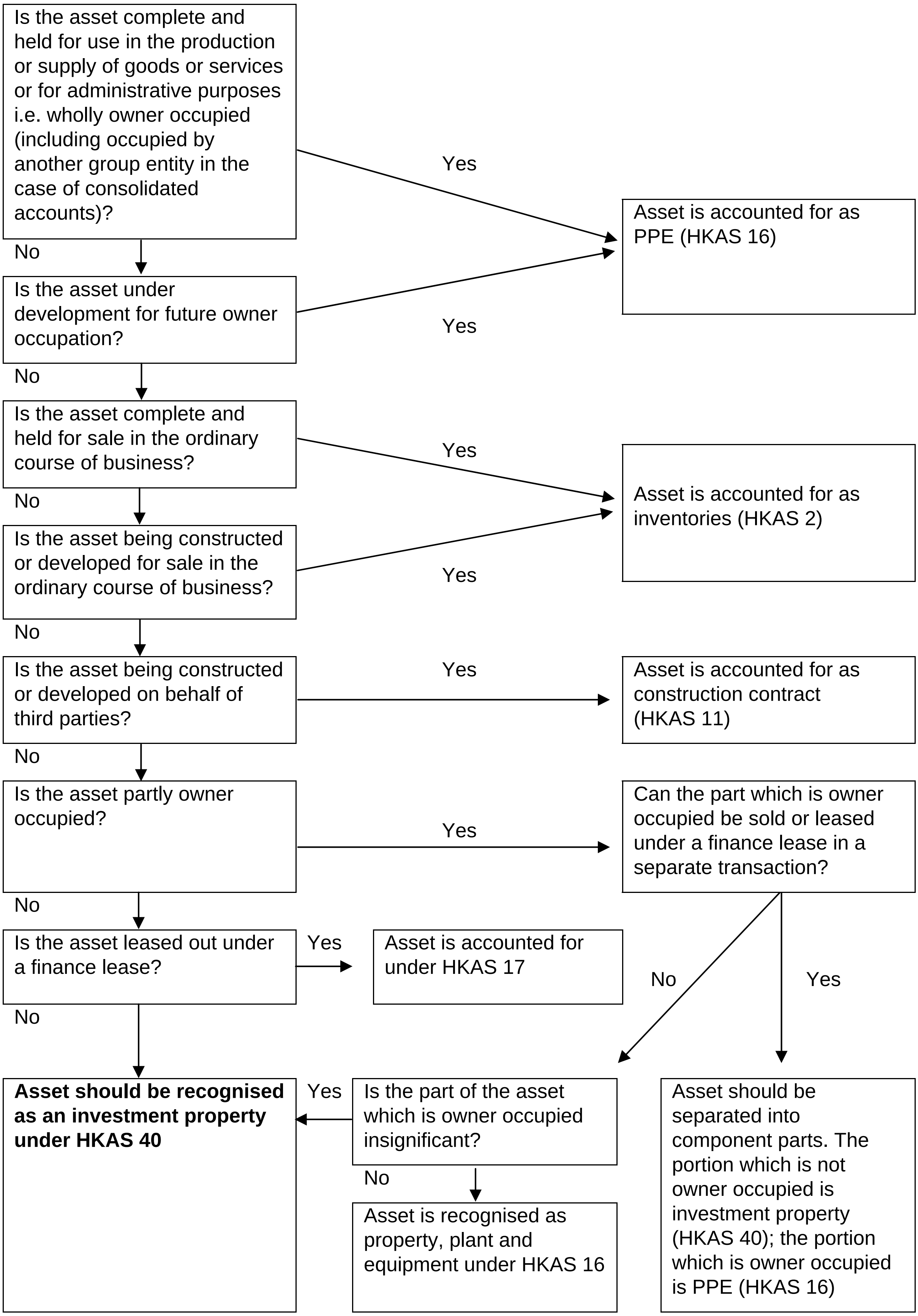
Propex depreciates its buildings at 2% per annum on cost.

Required

Describe the most appropriate accounting treatment for each of these properties.

(The answer is at the end of the chapter)

Below is the decision tree showing which HKFRS should be applied to various kinds of property:



HKAS 40.16

1.2 Recognition

Investment property should be recognised as an asset when **two conditions** are met:

(a) It is **probable** that the **future economic benefits** that are associated with the investment property will **flow to the entity**, and

(b) The **cost** of the investment property can be **measured reliably**.

HKAS 40.20,25

1.3 Initial measurement

An investment property should be measured initially at its **cost,** including transaction costs.

A property interest held under a lease and classified as an investment property shall be accounted for as if it were a finance lease. The asset is recognised at the lower of the fair value of the property and the present value of the minimum lease payments. An equivalent amount is recognised as a liability.

HKAS 40.30,34

1.4 Measurement subsequent to initial recognition

Topic highlights

Entities can choose between:

- **Fair value model**, with changes in fair value being measured
- **Cost model** – the treatment most commonly used under HKAS 16

HKAS 40 requires an entity to **choose between two models**:

- The fair value model
- The cost model

Whatever policy it chooses should be applied to **all of its investment property**.

Where an entity chooses to classify a property held under an **operating lease** as an investment property, there is **no choice**. The **fair value model must be used** for **all the entity's investment property**, regardless of whether it is owned or leased.

HKAS 40.33,35, 53, HKFRS 13.9-33,76, 81, 86

1.4.1 Fair value model

Where the fair value model is chosen, the following rules apply:

1. An entity that chooses the **fair value model** should measure all of its investment property at fair value, except in the extremely rare cases where this cannot be measured reliably. In such cases it should apply the HKAS 16 cost model.

2. A gain or loss arising from a change in the fair value of an investment property should be recognised in net profit or loss for the period in which it arises.

HKAS 40 was the first time that the HKICPA has allowed a fair value model for non-financial assets. This is not the same as a revaluation of assets where increases in carrying amount above a cost-based measure are recognised as revaluation surplus (i.e., as a reserve, in equity). Under the fair value model all changes in fair value are recognised in profit or loss.

HKFRS 13 *Fair Value Measurement*, issued in May 2011, deleted much of the guidance provided in HKAS 40 in respect of the determination of fair value. Instead the requirements of HKFRS 13 apply in measuring the fair value of investment properties.

This standard requires that the following are considered in determining fair value:

1 The asset being measured

2 The principal market (i.e. that where the most activity takes place) or where there is no principal market, the most advantageous market (i.e. that in which the best price could be achieved) in which an orderly transaction would take place for the asset

3 The highest and best use of the asset and whether it is used on a standalone basis or in conjunction with other assets

4 Assumptions that market participants would use when pricing the asset.

Having considered these factors, HKFRS 13 provides a hierarchy of inputs for arriving at fair value. It requires that level 1 inputs are used where possible:

Level 1 Quoted prices in active markets for identical assets that the entity can access at the measurement date.

Level 2 Inputs other than quoted prices that are directly or indirectly observable for the asset.

Level 3 Unobservable inputs for the asset.

The guidance which remains in HKAS 40 is as follows:

(a) Double counting should be prevented in deciding on the fair value of the assets. For example, elevators or air conditioning, which form an integral part of a building should be incorporated in the investment property rather than recognised separately.

(b) According to the definition in **HKAS 36** *Impairment of Assets,* fair value is not the same as "value in use"**.** The latter reflects factors and knowledge as relating solely to the entity, while the former reflects factors and knowledge applicable to the market.

(c) In those uncommon cases in which the **fair value of an investment property cannot be determined reliably** by an entity, the cost model in **HKAS 16** must be employed until the investment property is disposed of. **The residual value must be assumed to be zero**.

1.4.2 Operating lease and investment property

In respect of leased property that qualifies as an operating lease, the lessee has the option to classify the leased property as investment property provided that the lessee uses the fair value model of **HKAS 40** and the relevant criteria are met and all of the investment property must only be accounted for under the fair value model. This means that the components of land and buildings of the lease need not be split in order to calculate whether it is a finance lease or operating lease.

HKAS 40.56

1.4.3 Cost model

The model here is the same as the cost model in **HKAS 16**. Investment property should be measured at **depreciated cost, less any accumulated impairment losses**. If an entity chooses the cost model, it should disclose the fair value of its investment property.

HKAS 40.31

1.4.4 Changing models

An entity should apply its chosen fair value model or cost model to all its investment property. It should not change its model **unless the change will result in a more appropriate presentation**. **HKAS 40** states that it is very unlikely that a change from the fair value model to the cost model will end up in a more appropriate presentation.

HKAS 40.57-65

1.5 Transfers

Transfers to or from investment property are justified only **when there is a change in the use of the property**.

1.5.1 Transfers from investment property

HKAS 40 cites two instances when property is transferred from investment property to another category:

(a) Commencement of owner occupation
(b) Commencement of development with a view to sale.

In the first instance on transfer the property falls within the scope of HKAS 16, and the accounting guidance of that standard must be applied. In the second instance on transfer the property falls within the scope of HKAS 2. In both cases where the investment property was previously carried at fair value, the property's cost for subsequent accounting under **HKAS 16** or **HKAS 2** should be its fair value at the date of change of use.

1.5.2 Transfers to investment property

HKAS 40 also provides two instances when property is transferred to investment property from another category:

(a) End of owner occupation
(b) Commencement of an operating lease to another party.

In the first instance, the transfer removes the property from the scope of HKAS 16 and in the second from the scope of HKAS 2.

HKAS 16 is to be applied up to the date of change of use when an owner-occupied property becomes an investment property and the property has to be carried at fair value. The difference at the date of change between the carrying amount of the property under **HKAS 16** and its fair value should be **treated as a revaluation** under **HKAS 16**.

The following table summarises the requirements of HKAS 40 on recognition and measurement issues that arise when an entity uses the fair value model for investment property.

Transfer from	To	Measurement rules
Investment property carried at fair value	Owner-occupied property	The property's deemed cost for subsequent accounting in accordance with HKAS 16 shall be its fair value at the date of change in use.
	Inventories	The property's deemed cost for subsequent accounting in accordance with HKAS 2 shall be its fair value at the date of change in use.
Inventories	Investment property that will be carried at fair value	Any difference between the fair value of the property at the date of change in use and its previous carrying amount shall be recognised in profit or loss.
Owner-occupied property		An entity shall apply HKAS 16 to the owner-occupied property up to the date of change in use. The entity shall treat any difference at that date between the carrying amount of the property in accordance with HKAS 16 and its fair value in the same way as a revaluation in accordance with HKAS 16. (See Note below)

Note. Any resulting decrease in the carrying amount of the property is recognised in profit or loss. However, to the extent that an amount is included in revaluation surplus for that property, the decrease is recognised in other comprehensive income and reduces the revaluation surplus within equity.

Any resulting increase in the carrying amount is treated as follows:

(a) To the extent that the increase reverses a previous impairment loss for that property, the increase is recognised in profit or loss. The amount recognised in profit or loss cannot exceed the amount needed to restore the carrying amount to the carrying amount that would have been determined (net of depreciation) had no impairment loss been recognised; and

(b) Any remaining part of the increase is recognised in other comprehensive income and increases the revaluation reserve within equity. On subsequent disposal of the investment property, the revaluation surplus included in equity may be transferred to retained earnings. The transfer from revaluation reserve to retained earnings is not made through the statement of profit or loss and other comprehensive income.

HKAS 40.66,69,72

1.6 Disposals

An investment property should be **derecognised** (eliminated from the statement of financial position) on disposal or when it is permanently withdrawn from use and no future economic benefits are expected from its disposal.

A gain or loss on disposal arises when there is a difference between the net disposal proceeds and the carrying amount of the asset. It should generally be recognised in profit or loss as income or expense.

Compensation from third parties for investment property that was impaired, lost or given up should be recognised in profit and loss when the compensation becomes receivable.

1.7 Summary of accounting treatment of property

Depending on which standard's scope a property falls within, it may be subject to significantly different accounting treatment:

	HKAS 16 cost model	HKAS 16 revaluation model	HKAS 2	HKAS 40 cost model	HKAS 40 fair value model
Measurement in statement of financial position	Cost less depreciation less impairment losses	Revalued amount less depreciation less impairment losses	Lower of cost and net realisable value	Cost less depreciation less impairment losses (same as cost model in HKAS 16)	Fair value
Gains and losses	Depreciation and impairment recognised in profit or loss	Revaluations recognised in other comprehensive income	No depreciation	Depreciation and impairment recognised in profit or loss	Changes in fair value recognised in profit or loss. No depreciation

HKAS 40.75

1.8 Disclosure requirements

Disclosures in respect of investment properties are particularly important due to the choice of accounting treatment provided by the standard. Users must be aware of whether the carrying amount represented in the statement of financial position relates to cost or fair value.

Where the fair value model is used, users have an indication of the achievable proceeds on a sale of an investment property; where the cost model is used, the requirement to disclose fair value achieves the same end.

In addition, detail of amounts recognised in profit or loss, such as rental income and changes in fair value, help users to determine the quality of an investment property in generating returns.

The following must be disclosed:

- Whether an entity applies the cost model or fair value model
- Whether property interests held as operating leases are included in investment property
- Criteria for classification as investment property
- Use of independent professional valuer (encouraged but not required)
- Amounts recognised in profit or loss for:
  - rental income
  - direct operating expenses from property that did generate rental income
  - direct operating expenses from property that did not generate rental income
  - cumulative change in fair value recognised in profit or loss on sale of an investment property from a pool of assets in which the cost model is used to a pool in which the fair value model is used
- Any restrictions or obligations associated with the investment property

HKAS 40.76 - 78

1.8.1 Fair value model – additional disclosures

An entity that adopts the fair value model must also disclose the following:

(a) A **reconciliation** of the carrying amount of the investment property at the beginning and end of the period, including separate details for those properties for which reliable fair value cannot be determined.

(b) Disclosure of adjustments to valuations obtained (for example to avoid double counting).

(c) Where fair value cannot be established reliably:

(i) A description of the property
(ii) Explanation of why fair value cannot be established reliably
(iii) A range of estimates within which fair value is likely to lie (where possible)
(iv) The carrying amount of any property disposed of and gain or loss recognised.

HKAS 40.79

1.8.2 Cost model – additional disclosures

An entity that adopts the cost model must also disclose:

- depreciation methods used
- useful lives or depreciation rates used
- the gross carrying amount and accumulated depreciation at the start and end of the period
- a reconciliation of the carrying amount of the investment property at the beginning and end of the period
- the fair value of investment property

Topic recap

HKAS 40 Investment Property

Definition

Land, building or part of building held by the owner (or lessee under finance lease) to earn rentals/for capital appreciation rather than for use/sale in the ordinary course of business. Includes:

- Land held for undetermined future use
- Property being constructed for use as an investment property

A building held by one group company and leased to another group company is investment property in the individual company accounts and owner-occupied in the consolidated accounts.

Transfers to/from investment property allowed when there is a change in use:

- Commencement of owner occupation
- Commencement of development with view to sale
- End of owner occupation
- Commencement of operating lease to another party

Measurement

Initial measurement: cost including transaction costs

Subsequently choose and apply to **all** investment property:

Cost model

- Measured at depreciated cost less impairment losses (as HKAS 16)

Fair value model

- Measured to fair value at reporting date
- Changes in fair value recognised in profit or loss

Disclosure

- Which measurement model is applied
- Criteria for classification as investment property
- Use of independent valuer
- Amounts recognised in profit or loss
- Restrictions or obligations associated with the property.

Fair value model

- Reconciliation of carrying amount b/f and c/f
- Adjustments to valuations
- Further details where FV can't be established reliably

Cost model

- Depreciation methods
- Reconciliation of carrying amount b/f and c/f
- FV of property

Answer to self-test question

Answer 1

1 *Tennant House*

- Held for its investment potential and not for use by Propex
- Treat as investment property in accordance with HKAS 40
- Rental income to profit or loss
- If following fair value model – revalue to market value of $175,000. The difference of $25,000 credited to profit or loss
- If following cost model – depreciate based on cost and do not revalue. Depreciation for current period is $3,000 and net book value is $135,000 (150,000 – (5 × 3,000))
- Need to be consistent and use either fair value or cost model for all investment properties.

2 *Stowe Place*

- Held for use by Propex
- Considered as owner-occupied property and accounted for in accordance with HKAS 16
- Depreciate over useful life 75,000 × 2% = 1,500 per annum to profit or loss
- Carrying value of $75,000 – ($1,500 × 10) = 60,000 to be shown in statement of financial position.

3 *Crocket Square*

- Not yet complete so accounting treatment relates to the cost incurred to date
- Propex is constructing the property to let out to another company, Speedex. During construction, and after completion, the property is therefore within the scope of HKAS 40 and should be accounted for as an investment property in Propex's individual accounts
- As Speedex is a subsidiary of Propex, the property will be owner-occupied from a group perspective and therefore HKAS 16 is applied at a consolidation level.

4 *Smith Tower*

- The service and maintenance services provided by Propex to its tenants would be deemed insignificant to the arrangement as a whole. Therefore, Propex should treat Smith Tower as an investment property and apply the provisions of HKAS 40.

Exam practice

Cliff Land Limited

27 minutes

Cliff Land Limited (CLL) owns the following three buildings in Hong Kong:

	Building A	Building B	Building C
Usage	Warehouse	Director's quarter	Earning rental income
Date of acquisition	1 January 20X0	1 January 20W8	1 January 20X5
Cost of the building	$20 million	$36 million	$18 million
Fair value of the building at 31 December 20X7	$28 million	$22 million	$22 million

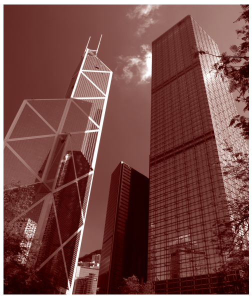
In the board meeting held on 30 September 20X7, the management of CLL determined to sell Buildings B and C. A property agency was appointed in the following month to identify potential buyers. In addition, CLL moved the storage of its inventories in Building A to a new production plant in Shenzhen. At 31 December 20X7, all three buildings were vacant.

CLL has accounted for (i) the building under property, plant and equipment at cost basis and depreciated the cost with the estimated useful life of 30 years, (ii) the investment property at fair value model, and (iii) the land cost as operating lease under HKAS 17. Cost and fair value of the land are assumed to be zero. Cost to sell the buildings is estimated at 0.5% of the disposal value of the asset.

Required

Determine the statement of financial position classification of these three buildings and calculate the respective amounts to be recognised on the statement of financial position as at 31 December 20X7. **(15 marks)**

HKICPA February 2008 (amended)


chapter 7

Government grants

Topic list

1 HKAS 20 *Government Grants*

1.1 Scope
1.2 Definitions
1.3 Government grants
1.4 Excluded government assistance
1.5 Disclosure
1.6 HK(SIC) Int-10 *Government Assistance – no specific relation to operating activities*

Learning focus

Entities in many different countries receive government grants for all sorts of reasons, very often to encourage growth and industry in certain areas, or to help them overcome external difficulties, such as economic difficulties. This chapter covers how to account for government grants.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
Account for transactions in accordance with Hong Kong Financial Reporting Standards		
3.03	**Government grants and assistance**	3
3.03.01	Accounting and presentation of government grants	
3.03.02	Disclosure of government grants and assistance in accordance with HKAS 20	

1 HKAS 20 *Government Grants*

Topic highlights

In many countries entities may receive government grants for various purposes (grants may be called subsidies, premiums, or given other titles). They may also receive other types of assistance which may be in many forms. The treatment of government grants is covered by **HKAS 20** *Accounting for Government Grants and Disclosure of Government Assistance.*

HKAS 20.2

1.1 Scope

HKAS 20 does *not* cover the following situations:

(a) Accounting for government grants in financial statements reflecting the effects of **changing prices**

(b) Government assistance given in the form of "**tax breaks**"

(c) The government acting as **part-owner** of the entity

(d) Government grants covered by HKAS 41 *Agriculture*

HKAS 20.3-5

1.2 Definitions

These definitions are provided in the standard.

Key terms

Government. Government, government agencies and similar bodies whether local, national or international.

Government assistance. Action by government designed to provide an economic benefit specific to an entity or range of entities qualifying under certain criteria.

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

Grants related to assets. Government grants whose primary condition is that an entity qualifying for them should purchase, construct or otherwise acquire non-current assets. Subsidiary conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.

Grants related to income. Government grants other than those related to assets.

Forgivable loans. Loans which the lender undertakes to waive repayment of under certain prescribed conditions.

Fair value. This is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

(*HKAS 20.3*)

Government assistance can be of **various forms** since both the type of assistance and the conditions related to it may differ. It may have the impact of encouraging an entity to undertake something it otherwise would not have done.

How will the financial statements be affected by the receipt of government assistance?

(a) Any resources transferred to an entity must be accounted for using an appropriate method.

(b) Disclosure in the notes to the accounts is required to show the magnitude to which an entity has benefited from such assistance.

HKAS 20.7-11

1.3 Government grants

Government grants (including non-monetary grants at fair value) should only be recorded when the entity has **reasonable assurance** that:

- the entity will comply with any **conditions** attached to the grant
- the entity will **actually receive** the grant

The receipt of the grant does not mean that the conditions attached to it have been or will be fulfilled.

The **manner of receipt** of the grant, whether it is in cash or as a reduction in a liability to the government, is irrelevant in the treatment of the grant.

Once a grant has been recognised, any **contingency** associated with it should be accounted for under HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

When a **forgivable loan** (as given in the key terms above) is received from the government and it is reasonably assured that the entity will meet the appropriate terms for forgiveness, it should be treated in the same way as a government grant. In addition, a loan at a **below-market rate of interest** is to be dealt with as a government grant.

A benefit of a government loan at a **below-market rate of interest** is treated as a government grant. The loan shall be recognised and measured in accordance with HKFRS 9 *Financial Instruments.* The benefit of the below-market rate of interest shall be measured as the difference between the initial carrying value of the loan determined in accordance with HKFRS 9 and the proceeds received. The benefit is accounted for in accordance with this standard. The entity shall consider the conditions and obligations that have been, or must be, met when identifying the costs for which the benefit of the loan is intended to compensate.

HKAS 20.12-22

1.3.1 Accounting treatment of government grants

There are two methods which *could* be used to account for government grants, and the arguments for each are given in **HKAS 20**.

(a) **Capital approach**: the grant is recognised outside profit or loss.

(b) **Income approach**: the grant is recognised in profit or loss over one or more periods.

Self-test question 1

What are the different arguments used in support of each method?

(The answer is at the end of the chapter)

HKAS 20 requires that **the income approach** should be adopted in the recognition of grants. In other words, grants received should be recognised in profit or loss on a systematic basis over the relevant accounting periods in which the entity recognises as expenses the related costs.

A systematic basis of matching should be used to avoid a violation of the accrual assumption to treat grants in profit or loss on a receipts basis. This latter basis would only be acceptable when no other basis was available.

The related cost to a government grant can easily be identified and thereby the period(s) in which the grant should be recognised in profit or loss, i.e. when the costs are incurred by the entity. Grants received relating to a depreciating asset will be recognised, in the same proportion, over the periods in which the asset is depreciated.

Self-test question 2

On 1 January 20X8, Xenon Co. purchased a non-current asset for cash of $100,000 and received a grant of $20,000 towards the cost of the asset. Xenon Co.'s accounting policy is to treat the grant as deferred income. The asset has a useful life of five years.

Required

Show the accounting entries to record the asset and the grant in the year ended 31 December 20X8.

(The answer is at the end of the chapter)

Certain obligations may have to be fulfilled for **grants relating to non-depreciable assets**. In such a case, the grant should be recognised in profit or loss over the periods in which the cost of meeting the obligation is incurred. For example, if a piece of land is granted on the condition that a building is erected on it, then the grant should be recognised in profit or loss over the building's life.

If a **series of conditions**, in the form of a package of financial aid, are attached to the grant, then the entity must be careful in identifying precisely those conditions which give rise to costs which in turn determine the periods in which the grant will be earned. The grant may also be split into parts and allocated on different bases.

Grants received as compensation for expenses or losses which an entity has **already incurred** and grants given merely to provide immediate financial support where there are no foreseeable related costs, should be recognised in profit or loss of the period in which they become receivable.

HKAS 20.23

1.3.2 Non-monetary government grants

When a non-monetary asset, such as a piece of land or other resources, is given by the government to an entity as a grant, the **fair value** of the asset is assessed and used to account for both the asset and the grant. On the other hand, both may be recorded at a nominal value.

HKAS 20.24-28

1.3.3 Presentation of grants related to assets

Two choices are available for disclosing government grants related to assets (including non-monetary grants at fair value) in the statement of financial position:

(a) **Deduct the grant** in arriving at the **carrying amount** of the asset.
(b) Set up the grant as **deferred income**.

The two alternatives are considered as equally acceptable and an example for both is shown below.

Example: Accounting for grants related to assets

In the year ended 31 December 20X8, Tiger-Lily Co. receives a grant of $100,000 towards the cost of a new freehold property in a development zone. The cost of the property is $700,000, and the purchase was completed on 30 June 20X8. The property is to be depreciated at an annual rate of 2% on cost.

Illustrate how the grant will affect the financial statements of Tiger-Lily for the years ended 31 December 20X8, 20X9 and 20Y0 assuming profits before depreciation in those years of $250,000, $280,000 and $315,000.

Solution

The results of the company would be as follows:

(a) **Reducing the cost of the asset**

	20X8	*20X9*	*20Y0*
	$	$	$
Profits			
Profit before depreciation	250,000	280,000	315,000
Depreciation*	12,000	12,000	12,000
Profit	238,000	268,000	303,000

*The depreciation charge on a straight line basis, for each year, is 2% × ($700,000 – $100,000) = $12,000.

STATEMENT OF FINANCIAL POSITION AT YEAR END (EXTRACT)

	$	$	$
Non-current asset at cost	600,000	600,000	600,000
Depreciation	12,000	24,000	36,000
Carrying amount	588,000	576,000	564,000

(b) **Treating the government grant as deferred income**

	20X8	*20X9*	*20Y0*
	$	$	$
Profits			
Profit before grant and depreciation	250,000	280,000	315,000
Depreciation	(14,000)	(14,000)	(14,000)
Government grant	2,000	2,000	2,000
Profit	238,000	268,000	303,000

STATEMENT OF FINANCIAL POSITION AT YEAR END (EXTRACT)

	$	$	$
Non-current asset at cost	700,000	700,000	700,000
Depreciation	(14,000)	(28,000)	(42,000)
Carrying amount	686,000	672,000	658,000
Deferred income			
Government grant deferred income	98,000	96,000	94,000

Whichever of these methods is used, the **cash flows** in relation to the purchase of the asset and the receipt of the grant are often disclosed separately because of the significance of the movements in cash flow.

HKAS 20.29-31

1.3.4 Presentation of grants related to income

Grants related to income are a credit in the statement of profit or loss and other comprehensive income. There are two alternative methods of disclosure.

(a) Present as a **separate credit** or under a general heading, e.g. "other income".
(b) **Deduct from the related expense**.

The disclosure has been a subject of controversy. Some would argue that it is not good practice to offset income and expenses in the statement of profit or loss and other comprehensive income, others would say that offsetting is acceptable since the expenses would not have been incurred had the grant not been available. **A proper understanding** of the financial statements is required for the disclosure of the grant, particularly the effect on any item of income or expense which is to be separately disclosed.

HKAS 20.32-33

1.3.5 Repayment of government grants

If a grant must be repaid it should be accounted for as a **change in an accounting estimate.** In other words, the revision is accounted for prospectively. HKAS 8 requires that the nature and amount of such a change in an accounting estimate is disclosed.

(a) **Repayment of a grant related to income**: apply first against any unamortised deferred income set up in respect of the grant; any excess should be recognised immediately as an expense.

(b) **Repayment of a grant related to an asset**: increase the carrying amount of the asset or reduce the deferred income balance by the amount repayable. The cumulative additional depreciation that would have been recognised to date in the absence of the grant should be immediately recognised as an expense.

The circumstances relating to repayment may entail a reassessment of the **asset value** and an impairment of the new carrying amount of the asset.

HKAS 20.34-36

1.4 Excluded government assistance

The definition of government grants does not include some forms of government assistance.

(a) Some forms of government assistance **cannot reasonably have a value placed on them**, e.g. free technical or marketing advice, provision of guarantees.

(b) There are transactions with government which **cannot be distinguished from the entity's normal trading transactions**, e.g. government procurement policy resulting in a portion of the entity's sales. Any segregation would be arbitrary.

The government assistance may have to be disclosed because of its significance; nature, extent and duration.

HKAS 20.39

1.5 Disclosure

Disclosure is required of the following:

(a) **Accounting policy** adopted, including method of presentation.

(b) **Nature and extent** of government grants recognised and other forms of assistance received.

(c) **Unfulfilled conditions and other contingencies** attached to recognised government assistance.

1.6 HK(SIC) Int-10 *Government Assistance – no specific relation to operating activities*

The aim of government assistance to entities in some countries is to encourage entities or to provide long-term support of business activities either in certain regions or industry sectors. Conditions to receive assistance may have no particular relationship with the operating activities of the entity. Examples of this kind of assistance are transfers of resources by governments to entities which:

- operate in a specific industry.
- continue to operate in newly privatised industries.
- commence or continue to operate in underdeveloped areas.

If the government assistance is considered as a "government grant" within the scope of **HKAS 20,** then it should be accounted for in accordance with this standard.

Even if there are no circumstances particularly relating to the operating activities of the entity other than the requirement to operate in certain regions or industry sectors, government assistance to entities still meets the definition of government grants in **HKAS 20** and should not be credited directly to equity.

Topic recap

HKAS 20 Government Grants

Government Grants

Transfer of resources from government to an entity in return for compliance with certain conditions.

Includes:
- forgivable loans
- below market interest loans
- non-monetary assets (grant = fair value of asset)

Excludes government assistance without value.

Recognise when there is reasonable assurance that:
1. the entity will comply with conditions attached to the grant
2. the entity will receive the grant.

Presentation

Grants related to assets
1. Deduct from carrying amount of asset, or
2. Set up deferred income account.

Grants related to income
1. Deduct from related expense, or
2. Present as separate credit.

Repayment is accounted for as a change in accounting estimate

Grants related to assets
1. Increase carrying amount of asset or reduce deferred income balance
2. Recognise cumulative additional depreciation as expense.

Grants related to income
1. Reduce any unamortised deferred income balance
2. Recognise excess as expense.

Disclosure
- Accounting policy
- Nature and extent of grants recognised and other assistance received
- Unfulfilled conditions and other contingencies.

Government Assistance

Outside definition of grants:
1. Government assistance without value e.g.
   - Free technical advice
   - Provision of guarantees
2. Transactions with government that cannot be distinguished from normal trading transactions.

Disclose if significant

Answers to self-test questions

Answer 1

The standard gives the following arguments in support of each method.

Capital approach

(a) The grants are a **financing device**, so should go through the statement of financial position. In the statement of profit or loss and other comprehensive income they would simply offset the expenses which they are financing. No repayment is expected by the government, so the grants should be recognised outside profit or loss.

(b) Grants are **not earned**, they are incentives without related costs, so it would be wrong to take them to profit or loss.

Income approach

(a) The grants are **not received from shareholders** so should not be recognised directly in equity, but should be recognised in profit or loss in appropriate periods.

(b) Grants are **not given or received for nothing**. They are earned by compliance with conditions and by meeting obligations. They should therefore be recognised in profit or loss over the periods in which the entity recognises as expenses the related costs for which the grant is intended to compensate.

(c) Grants are an extension of **fiscal policies** and so as income taxes and other taxes are expenses, so grants should be recognised in profit or loss.

Answer 2

Acquisition of the asset and receipt of the grant on 1 January 20X8:

		$	$
DEBIT	Non current assets	100,000	
CREDIT	Cash		100,000

To record the asset at its cost

DEBIT	Cash	20,000	
CREDIT	Deferred income		20,000

To record the receipt of the grant

In the year ended 31 December 20X8 the asset is depreciated and a portion of the grant is released to the statement of profit or loss:

DEBIT	Depreciation expense ($100,000 / 5 years)	20,000	
CREDIT	Accumulated depreciation		20,000
DEBIT	Deferred income ($20,000 / 5 years)	4,000	
CREDIT	Operating expenses		4,000

The release of the deferred income is matched to the depreciation expense, so the net effect is an expense of $16,000 relating to the asset.

Exam practice

PMT and WY

9 minutes

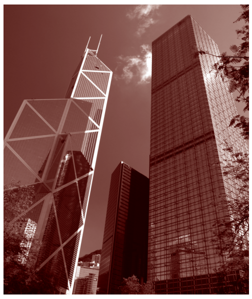
Peak Medical Technology Corporation ("PMT") conducts research and product development for an anaesthetic injection under contract with WY Corporation ("WY"), a pharmaceutical company. The research and development contract requires that WY pays PMT an up-front amount of $1.5 million when the contract is signed, $2 million upon the successful completion of clinical trials, and $1.5 million upon the delivery of the first pilot unit of the injection. All payments are non-refundable. The total cost of completion of the project is estimated to be $3 million.

PMT has invested $25 million in equipment for its research and development centre, which has an anticipated useful life of eight years. Depreciation is charged on a straight-line basis. In the period of acquisition, PMT received a government grant of $10 million towards purchase of the equipment, which is conditional on certain employment targets being achieved within the next four years.

Required

Determine how PMT should recognise and measure the government grant by reference to the relevant accounting standards. **(5 marks)**

HKICPA May 2007 (amended)


chapter 8

Intangible assets and impairment of assets

Topic list

Learning focus

Impairment of assets is particularly relevant in the current economic climate and several companies are now having to apply the requirements with regard to accounting for impairment for the first time.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
Account for transactions in accordance with Hong Kong Financial Reporting Standards		
3.09	**Intangible assets**	3
3.09.01	Define an intangible asset and scope of HKAS 38	
3.09.02	Apply the definition of an intangible asset to both internally-generated and purchased intangibles	
3.09.03	Account for the recognition and measurement of intangible assets in accordance with HKAS 38	
3.09.04	Describe the subsequent accounting treatment of intangible assets including amortisation	
3.09.05	Distinguish between research and development and describe the accounting treatment of each	
3.09.06	Explain how goodwill arises	
3.09.07	Account for goodwill	
3.09.08	Disclose relevant information in respect of intangible assets under HKAS 38	
3.13	**Impairment of assets**	3
3.13.01	Identify assets that are within the scope of HKAS 36	
3.13.02	Identify an asset that may be impaired by reference to common external and internal indicators	
3.13.03	Identify the cash generating unit an asset belongs to	
3.13.04	Calculate the recoverable amount with reference to value-in-use and fair value less cost to sell	
3.13.05	Calculate the impairment loss, including the loss relating to cash-generating units	
3.13.06	Allocate impairment loss and account for subsequent reversal	
3.13.07	Disclose relevant information with regard to impairment loss, including critical judgment and estimate	

1 HKAS 38 *Intangible Assets*

Topic highlights

Intangible assets are defined by **HKAS 38** as non-monetary assets without physical substance. They must be:

- **identifiable**.
- **controlled** as a result of a past event.
- able to provide **future economic benefits**.

HKAS 38 *Intangible Assets* was issued in August 2004 and revised in May 2009 to reflect changes introduced by **HKFRS 3 (revised)** *Business Combinations*.

1.1 The objectives of the standard

(a) To establish the criteria for when an intangible asset may or should be **recognised**.
(b) To specify how intangible assets should be **measured**.
(c) To specify the **disclosure requirements** for intangible assets.

HKAS 38.2,3

1.2 The scope of the standard

HKAS 38 applies to all intangible assets with the following **exceptions**:

- Financial assets (HKAS 32)
- The recognition and measurement of exploration and evaluation assets (HKFRS 6)
- The development and extraction of minerals, oils, gas and other non-regenerative resources (HKFRS 6)
- Intangible assets held for sale in the ordinary course of business (HKAS 2 and HKAS 11)
- Deferred tax assets (HKAS 12)
- Leases within the scope of HKAS 17
- Assets arising from employee benefits (HKAS 19)
- Goodwill acquired in a business combination (HKFRS 3 (revised))
- The recognition and measurement of insurance contracts (HKFRS 4)
- Intangible assets within the scope of HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*

HKAS 38.8-10

1.3 Definition of an intangible asset

Key terms

An **intangible asset** is an identifiable non-monetary asset without physical substance.

An **asset** is a resource which is:

(a) controlled by the entity as a result of events in the past
(b) something from which the entity expects future economic benefits to flow

Examples of items that might be considered as intangible assets therefore include computer software, patents, copyrights, motion picture films, customer lists, franchises, brands and fishing rights.

An item should not be recognised as an intangible asset, however, unless it meets this definition in full. In other words it is:

(a) identifiable
(b) controlled by the entity as a result of past events, and
(c) expected to result in future economic benefits.

Each of these elements of the definition is considered in turn below.

HKAS 38.11,12

1.3.1 Identifiable

An asset is identifiable if it:

(a) is separable, i.e. if it could be rented or sold either individually or together with a related contract or asset, or

(b) arises from contractual or other legal rights regardless of whether those rights are separable.

Goodwill, whether purchased or internally generated, is not identifiable and is therefore not considered to be an intangible asset within the scope of HKAS 38.

Other **internally generated intangible items**, such as brands and customer lists do, however, meet these criteria, however, they may not meet the remaining two criteria within the definition of an intangible asset, or the recognition criteria (section 1.4).

Purchased intangible assets, such as a purchased patent or brand are normally identifiable.

HKAS 38.13-16

1.3.2 Control by the entity

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.

Whereas the application of the control criteria to purchased assets is relatively simple, it is less straightforward in the case of internally generated assets. Therefore, additional guidance is provided as follows:

Market and technical knowledge

The following provide evidence that an entity can control access to the future economic benefits arising from expenditure to develop market and technical knowledge:

- The existence of copyrights
- A legal duty of employees to maintain confidentiality with regard to the knowledge

If such a legal right exists, and provided that the knowledge is identifiable and is expected to result in future economic benefits, it qualifies as an intangible asset.

Skilled staff

Expenditure on training results in more skilled staff, and often increased revenues and better efficiency. The costs of such training, however, are very unlikely to qualify as an intangible asset because an entity does not control the future actions of its staff. These staff may leave the organisation at any time.

Market share/customer base

Expenditure on advertising and building customer relationships results in the growth of market share and a loyal customer base. However, unless relationships with customers are protected by legal rights, the entity can not control the actions of its customers, and they may change to a different supplier. Therefore, such expenditure on creating market share does not qualify as an intangible asset.

HKAS 38.17

1.3.3 Expected future economic benefits

An item can only be recognised as an intangible asset if economic benefits are expected to flow in the future from ownership of the asset.

Future economic benefits may include:

- revenue from the sale of products or services
- cost savings
- other benefits resulting from the use of an asset by an entity

Again, this element of the definition is easily applied to purchase intangible assets, such as patents or copyrights allowing production of items to sell. It may be more difficult to apply to expenditure on internally generated items such as research and development projects, as the success of such a project may be hard to gauge. For this reason, HKAS 38 considers research and development in more detail and this is covered in section 2 of this chapter.

HKAS 38.21-23

1.4 Recognition of an intangible asset

An intangible asset meeting the definition above should be recognised if, and only if, **both** the following apply:

(a) It is probable that the future economic benefits that are attributable to the asset will flow to the entity.

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

Management has to exercise its judgment in assessing the degree of certainty attached to the flow of economic benefits to the entity. External evidence is best.

HKAS 38.25

1.4.1 Separately acquired intangible assets

Normally, the fact that an entity purchases an **intangible asset** indicates an expectation that the expected future economic benefits embodied in the asset will flow to the entity. In addition, the cost can clearly be measured reliably.

Therefore, purchased intangible assets are normally recognised in the financial statements.

HKAS 38.33-34

1.4.2 Intangible assets acquired as part of a business combination

In accordance with HKFRS 3 (revised), any intangible asset for which a fair value can be reliably determined should be recognised separately. This is the case even where the purchased entity does not recognise the asset in its own statement of financial position.

Sufficient information exists to measure the fair value of an asset reliably where it is separable or arises from contractual or other legal rights.

HKAS 38.48,51,52, 63

1.4.3 Internally generated assets

Internally generated goodwill does not meet the definition of an intangible asset and therefore is never recognised in the financial statements.

Other internally generated assets may meet the recognition criteria, however due to the difficulty of assessing future economic benefits and determining a reliable cost of an internally generated asset, HKAS 38 requires that all internal expenditure that may result in an intangible asset is classified as research or development, and provides more detailed recognition guidance which is applicable. This is considered in greater detail in section 2 of the chapter.

In any case, **internally-generated brands, mastheads, publishing titles, customer lists and items similar in substance shall not be recognised as intangible assets.**

HKAS 38.24

1.5 Initial measurement of an intangible asset

An intangible asset is initially measured at cost.

HKAS 38.27-29

1.5.1 Separately acquired intangible assets

The cost of a separately acquired intangible asset includes its purchase price and any directly attributable costs of preparing the asset for its intended use.

Directly attributable costs may include professional fees and testing costs, but not advertising and promotional expenditure or administration and general overhead costs.

HKAS 38.33

1.5.2 Intangible assets acquired as part of a business combination

When an intangible asset is acquired as **part of a business combination** (where one company has acquired the shares of another company), the cost of the intangible asset is its fair value at the date of the acquisition.

For example, if company A has acquired company B, and company B owns a drilling licence with a fair value of $2m at the date of acquisition, then the cost of the licence in the consolidated accounts will be $2m.

HKAS 38.44

1.5.3 Intangible assets acquired by way of government grant

According to HKAS 38, intangible assets acquired by way of government grant and the grant itself may be recorded initially either at cost (which may be zero) or fair value.

HKAS 38.45

1.5.4 Exchanges of assets

Fair value is used to measure the cost of the intangible asset acquired if one intangible asset is exchanged for another unless:

(a) the exchange lacks commercial substance, or

(b) the fair values of both the asset received and the asset given up cannot be measured reliably.

In such cases, the cost of the intangible asset acquired is measured at the carrying amount of the asset given up.

1.5.5 Internally generated assets

Internally generated intangible assets are recognised at cost. The elements of this are discussed in more detail in section 2.

HKAS 38.72,74,75

1.6 Subsequent measurement of an intangible asset

After recognition, an entity may choose to apply either the cost model or revaluation model. Intangible assets are therefore carried at either:

- cost less accumulated amortisation less accumulated impairment losses, or
- fair value at date of revaluation less subsequent accumulated amortisation and subsequent accumulated impairment losses.

The detailed rules with regard to revaluation and amortisation are considered in more detail later in this chapter after the recognition rules and initial measurement rules for research and development costs are discussed.

2 Research and development costs

HKAS 38.8,52

Topic highlights

Research costs are always recognised as an expense. Development costs must be recognised as an asset if they meet certain criteria.

HKAS 38 requires that internally generated assets are classified into research and development phases.

2.1 Definitions

Key terms

Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.

HKAS 38 provides examples of both research and development as follows.

HKAS 38.56

2.1.1 Examples of research costs

(a) Activities aimed at obtaining new knowledge

(b) The search for, evaluation and final selection of, applications of research findings or other knowledge

(c) The search for alternatives for materials, devices, products, processes, systems or services

(d) The formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, systems or services

HKAS 38.59

2.1.2 Examples of development activities

(a) The design, construction and testing of pre-production or pre-use prototypes

(b) The design of tools, jigs, moulds and dies involving new technology

(c) The design, construction and operation of a pilot plant on a scale which is not feasible for commercial production

(d) The design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services

HKAS 38.53

2.2 Recognition

Although it defines the terms research and development, HKAS 38 provides the accounting treatment for the "research phase" and "development phase" of a project. If an entity cannot distinguish between these phases, the standard requires that costs are treated as if incurred in the research phase only.

HKAS 38.55

2.2.1 Research phase

Research activities, which are carried out at the research stage of a project, do not meet the recognition criteria under HKAS 38. It is uncertain that future economic benefits will flow to the entity from the project at the research stage of a project and there is too much doubt about the likely success or otherwise of the project.

Research costs should therefore be written off as an expense as they are incurred.

HKAS 38.57

2.2.2 Development phase

Development costs **must** be recognised as intangible assets when the following **strict criteria** can be demonstrated:

(a) The **technical feasibility** of completing the intangible asset so that it will be available for use or sale.

(b) Its **intention to complete** the intangible asset and use or sell it.

(c) Its **ability to use or sell** the intangible asset.

(d) How the intangible asset will generate **probable future economic benefits**. Among other things, the entity should demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.

(e) Its ability to **measure** the expenditure attributable to the intangible asset during its development **reliably**.

When these criteria are not met, development costs should be written off as an expense as incurred.

HKAS 38.65-66, 71

2.3 Initial measurement

Topic highlights

Internally generated intangible assets are initially measured at cost

The costs allocated to an internally generated intangible asset should only be those costs that can be **directly attributed** or allocated on a reasonable and consistent basis to creating, producing or preparing the asset for its intended use. The principle here is similar to that applied to the cost of non-current assets and inventory.

The cost of an internally operated intangible asset is the sum of the **expenditure incurred from the date when** the intangible asset first **meets the recognition criteria**. If, as often happens, considerable costs have already been recognised as expenses before management could demonstrate that the criteria have been met, this earlier expenditure should not be retrospectively recognised at a later date as part of the cost of an intangible asset.

Self-test question 1

Mountain Co. is developing a new production process. During 20X1, expenditure incurred was $500,000, of which $310,000 was incurred before 1 December 20X1 and $190,000 between 1 December 20X1 and 31 December 20X1. Mountain can demonstrate that, at 1 December 20X1, the production process met the criteria for recognition as an intangible asset. How should the expenditure be treated?

(The answer is at the end of the chapter)

At this stage it may be useful to summarise the rules seen for the recognition and initial measurement of separately purchased intangibles, intangibles acquired as part of a business acquisition and internally generated development expenditure.

Summary of the recognition and initial measurement requirements of HKAS 38

	Separately purchased intangible	Intangible acquired as part of business combination	Internally generated intangible – development
Recognise as an asset if:	• Meets definition of intangible asset • Probable economic benefits • Cost reliably measured	• Meets definition of intangible asset • Probable economic benefits • Fair value reliably measured	• Technically feasible • Intention to complete • Commercially viable • Probable economic benefits • Resources available to complete • Expenditure reliably measured

	Separately purchased intangible	Intangible acquired as part of business combination	Internally generated intangible – development
Initially measured at:	Cost + directly attributable costs in preparing asset for use	Fair value at date of acquisition	Directly attributable costs from date when criteria first met

HKAS 38.68–70

2.4 Recognition of an expense

Expenditure on an intangible should be **expensed as incurred** when it does not meet the criteria for recognition either as an identifiable intangible asset or as goodwill arising on an acquisition.

Examples of such expenditure are stated in the HKAS:

- Start up costs, i.e. costs of establishing a new business
- Training costs
- Advertising and promotional costs
- Business relocation or reorganisation costs

Prepaid costs for services, for example advertising or marketing costs for campaigns that have been prepared but not yet launched, can still be recognised as a **prepayment**.

HKAS 38 BC46A-46H

2.4.1 Advertising and promotional activities

There is often confusion as to whether the costs of advertising and promotional activities qualify as an intangible asset. HKAS 38 has been amended to clarify that for advertising and promotional activities:

(a) In the case of goods, an expense is recognised when the entity has the right to access those goods.

(b) In the case of services, an expense is recognised when the entity receives those services.

(c) A right to access goods is received by the entity when the supplier has made them available to the entity.

(d) The contract terms for the supply of goods or services determine when an expense should be recognised.

(e) A prepayment can be recognised as an asset when payment has been made in advance of the entity obtaining the right to access the goods or receiving the services.

The amendment clarifies that catalogues are considered to be a form of advertising and promotional activity. Expenses incurred in printing mail order catalogues are recognised once the catalogues are printed and not when they are distributed to customers.

HKAS 38.72,74,75,81

2.5 Measurement of intangible assets subsequent to initial recognition

HKAS 38 allows two methods of measuring for intangible assets after they have been first recognised:

1 **Cost model**: an intangible asset is **carried at its cost**, less any accumulated amortisation and less any accumulated impairment losses.

2 **Revaluation model:** an intangible asset is carried at a revalued amount, which is its **fair value** at the date of revaluation, less any subsequent accumulated amortisation and any subsequent accumulated impairment losses.

The rules with regard to the application of the revaluation model are as follows:

(a) The fair value must be measured reliably with reference to an **active market** in that type of asset.

(b) The **entire class** of intangible assets of that type must be revalued at the same time (to prevent a business from choosing to revalue only those particular assets that have enjoyed favourable price movements, and retaining the others at cost).

(c) If an intangible asset in a class of revalued intangible assets cannot be revalued because there is **no active market** for this asset, the asset should be carried at its **cost less any accumulated amortisation and impairment losses**.

(d) Revaluations should be made with such **regularity** that the carrying amount does not differ from that which would be determined using fair value at the end of the reporting period.

HKAS 38.8,78

2.5.1 Active market

Key term

An **active market** is a market in which all the following conditions exist:

(a) The items traded in the market are homogenous
(b) Willing buyers and sellers can normally be found at any time; and
(c) Prices are available to the public.

Since an active market for an intangible asset will not usually exist, the revaluation model will usually not be available. For example, intangible assets such as copyrights, publishing rights and film rights are each sold at unique sale value, so a continuous active market is not accessible. A revaluation to fair value would therefore be inappropriate. However, a fair value might be obtainable for assets such as fishing rights, quotas or taxi cab licences.

HKAS 38.85-87

2.5.2 Accounting for a revaluation

Where the carrying amount of an intangible asset is revalued upwards to its fair value, the amount of the revaluation should be credited to other comprehensive income and accumulated in a revaluation surplus in equity.

However, a revaluation surplus resulting from a **reversal of a previous revaluation** decrease that has been charged to profit or loss can be recognised as income.

On the other hand, the amount of a **downward revaluation** on an intangible asset should be charged as an expense against income, unless an upward revaluation has previously been recorded on the same intangible asset. In such case, the revaluation loss should be first debited to other comprehensive income against any previous revaluation surplus recorded for the asset.

Self-test question 2

A non-current asset with a carrying value of $160m was impaired and written down to its recoverable value of $120m two years ago.

After an upturn in business, the asset has a market value of $135m. Had the impairment not taken place, the carrying value of the asset would have been $130m.

Required

Consider how this impairment is reversed.

(The answer is at the end of the chapter)

When the revaluation model is adopted, the cumulative revaluation surplus of an intangible asset may be **transferred to retained earnings** when the asset is disposed of and the surplus is eventually realised. However, the surplus may also be realised over the period in which the intangible asset is being used by the entity. The amount of the surplus realised each year is calculated as the difference in amortisation charges based on the revalued amount of the asset and the historical cost of the asset. The realised surplus should not be included in profit or loss, instead it should be transferred from revaluation surplus directly to retained earnings and disclosed in the statement of changes in equity.

2.6 Amortisation of intangible assets

Topic highlights

Capitalised intangible assets are amortised over their expected useful life. Where this is indefinite, an annual impairment test replaces amortisation.

HKAS 38.88,90,94

2.6.1 Useful life

An intangible asset may have a **finite or indefinite** useful life. An indefinite useful life, in this sense, means that there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity.

The useful life of an intangible asset is affected by many factors, including: technical, technological, commercial or other types of obsolescence; expected usage; life cycles of typical product; the level of maintenance expenditure required; the stability of the industry; expected actions by competitors; and legal or similar restrictions on the use of the asset, such as the expiry dates of related leases. Intangible assets which are susceptible to technological obsolescence, such as computer software, normally have short lives. However, uncertainty does not justify the choice of a life that is unrealistically short.

The useful life of an intangible asset may originate from **contractual or other legal rights**. It should not exceed the period of the rights, though it may be shorter depending on the duration in which the asset is to be used by the entity.

HKAS 38.100

2.6.2 Residual value

The residual value of an intangible asset with a finite useful life is assumed to be zero. This is not the case when a third party has a commitment to buying the intangible asset at the end of its useful life or when an active market exists for that type of asset (so that its expected residual value can be measured) and it is likely that there will be a market for the asset at the end of its useful life.

HKAS 38.97, 104

2.6.3 Amortisation period

An intangible asset with a finite useful life is amortised over its **expected useful life**, starting when the asset is **available for use**.

Amortisation should cease at the earlier of the date that the asset is classified **as held for sale** in accordance with HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* and the date that the asset is **derecognised**.

Annual review of the amortisation period of an intangible asset with finite useful life should be carried out at the end of each financial year.

HKAS 38.98,104

2.6.4 Amortisation method

The amortisation method used should reflect the **pattern in which the asset's future economic benefits are consumed**. If such a pattern cannot be predicted reliably, the straight line method should be used.

HKAS 38 has been amended to remove wording perceived as prohibiting the use of the unit of production method if it results in a lower amount of accumulated amortisation than under the straight line method. Entities may use the unit of production method when the resulting amortisation charge reflects the expected pattern of consumption of the expected future economic benefits embodied in an intangible asset.

The amortisation method used for an intangible asset with a finite useful life should be **reviewed at each financial year end**.

HKAS 38.99

2.6.5 Accounting for amortisation

The amortisation charge for a period is recognised in profit or loss in the same way as depreciation on tangible non-current assets.

HKAS 38.107-109

2.6.6 Intangible assets with indefinite useful lives

An intangible asset with an indefinite useful life **should not be amortised**, instead **HKAS 36** requires that such an asset is tested for impairment at least annually.

The useful life of an intangible asset that is not being amortised should be **reviewed each year** to determine whether it is still appropriate to assess its useful life as indefinite. Reassessing the useful life of an intangible asset as finite rather than indefinite is an indicator that the asset may be impaired and in these circumstances it should be tested for impairment as well as being amortised over its remaining life.

Self-test question 3

It can be difficult to establish the useful life of an intangible asset in practice. Write brief notes on factors to consider when determining the useful life of a *purchased* brand name and how to provide evidence that its useful life might, in fact, exceed 20 years.

(The answer is at the end of the chapter)

Example: Computer software and hardware

The treatments can be illustrated by reference to computer software and hardware. The treatment depends on the nature of the asset and its origin.

Asset	Origin	Treatment
Computer software	Purchased	Capitalise
Operating system for hardware	Purchased	Include in hardware cost
Computer software **Operating system for hardware** **(For use or sale)**	Internally developed	Charge to expense until "Development criteria" are met. Amortise over useful life, based on pattern of benefits (straight line is default)

HKAS 38.112-113

2.7 Disposals/retirements of intangible assets

An intangible asset should be derecognised from the statement of financial position when it is disposed of or when there is no further expected economic benefit from its future use. On disposal the gain or loss arising from the **difference between the net disposal proceeds and the carrying amount** of the asset should be taken to profit or loss as a gain or loss on disposal (i.e. treated as income or expense).

For example, if a fishing licence with a carrying amount of $2m is sold for $3m, then the licence is derecognised from the statement of financial position and $1m profit on disposal is taken to profit.

HKAS 38.118,122, 124,126

2.8 Disclosure requirements

Extensive disclosure is required for intangible assets as listed in the standard. The accounting policies for intangible assets that have been adopted are to be disclosed in the financial statements.

For **each class of intangible assets**, disclosure is required of the following:

(a) The method of amortisation used (e.g., straight line method).

(b) The useful life of the assets or the amortisation rate used.

(c) The gross carrying amount, the accumulated amortisation and the accumulated impairment losses as at the beginning and the end of the period.

(d) A reconciliation of the carrying amount as at the beginning and at the end of the period (additions, retirements/disposals, revaluations, impairment losses, impairment losses reversed, amortisation charge for the period, net exchange differences, other movements).

(e) The carrying amount of internally-generated intangible assets.

The financial statements should also disclose the following:

(a) In the case of intangible assets that are assessed as having an indefinite useful life, the carrying amounts and the reasons supporting that assessment.

(b) For intangible assets acquired by way of a **government grant** and initially recognised at fair value, the **fair value initially recognised**, the **carrying amount**, and whether they are carried under the **cost model** or the **revaluation model** for subsequent remeasurements.

(c) The carrying amount, nature and remaining amortisation period of any intangible asset that is **material to the financial statements of the entity as a whole**.

(d) The existence (if any) and amounts of intangible assets whose **title is restricted** and of intangible assets that have been **pledged as security** for liabilities.

(e) The amount of any **commitments for the future acquisition of intangible assets**.

Where intangible assets are accounted for at revalued amounts, disclosure is required of the following:

(a) The **effective date of the revaluation** (by class of intangible assets).

(b) The **carrying amount** of revalued intangible assets.

(c) The carrying amount that would have been shown (by class of assets) **if the cost model had been used**, and the amount of amortisation that would have been charged.

(d) The amount of any **revaluation surplus** on intangible assets, as at the beginning and end of the period, and movements in the surplus during the year (and any restrictions on the distribution of the balance to shareholders).

The financial statements should also disclose the amount of research and development expenditure that has been charged as an expense of the period.

2.9 HK(SIC) Int-32 *Intangible Assets – Website Costs*

Websites are being used for business purposes to a large extent, including taking orders for products or services; promotion and advertising of products and services; and trading access to information contained on the website.

Many companies incur significant costs in developing such websites, and these may include the following:

(a) **Planning costs** – including, for example, the costs of undertaking feasibility studies, determining the objectives and functionalities of the website, exploring ways of achieving the desired functionalities, identifying appropriate hardware and web applications and selecting suppliers and consultants.

(b) **Application and infrastructure development costs** – including the costs of obtaining and registering a domain name and of buying or developing hardware and operating software that relate to the functionality of the site (for example, updateable content management systems and e-commerce systems, including encryption software, and interfaces with other IT systems used by the entity).

(c) **Content costs** – expenditure incurred on preparing, accumulating and posting the website content.

(d) **Operating costs**.

The issue arises as to how these costs should be treated within the financial statements.

2.9.1 HK(SIC) Int-32 treatment

HK(SIC) Int-32 resolves that a website developed by an entity and funded by internal expenditure is viewed as an internally generated intangible asset that is subject to the requirements of HKAS 38 *Intangible Assets.* This is the case whether the website is for internal or external access.

Specifically, the treatment is as follows:

(a) **Website planning costs** are an expense charged to profit or loss.

(b) **Application and infrastructure development costs**. Expenditure which can be directly attributed, or allocated on a reasonable and consistent basis, to preparing the website for its intended use is to be included in the cost of the website and recognised as an intangible asset. Examples include expenditure on purchasing or creating content (other than content for marketing an entity's own products and services) solely for a website, and expenditure to enable use of the content (such as acquisition fee of a licence to reproduce) on the website. These expenditures should be included in the cost of development when the condition is met. However, HKAS 38 does not allow the recognition of an expenditure as part of the cost of an intangible asset at a later date if the expenditure was initially recognised as an expense in previous financial statements (for instance, when the content of a fully amortised copyright is subsequently provided on a website).

(c) **Content development**. According to HKAS 38, expenditure incurred in the content development stage to advertise and promote an entity's own products and services (such as digital photographs of products) should be recognised as an expense when incurred. For example, expenditure on professional services for taking digital photographs of an entity's products and for enhancing their display should be recorded as an expense when the professional services are received, not when the digital photographs are displayed on the website.

(d) **Operating**. The operating stage commences when the development of a website is complete. Unless expenditure meets the criteria in HKAS 38, it should be recognised as an expense when it is incurred.

A website which is recognised as an intangible asset under HK(SIC) Int-32 should be measured after initial recognition by applying the requirements as stated in HKAS 38. The useful life of a website is best estimated to be short.

2.10 Current developments

The IASB proposed amendments to IAS 38 in December 2012. As HKAS 38 is converged with IAS 38, these will also affect HKAS 38. The amendments would clarify that amortisation methods must reflect a pattern of **consumption** of economic benefits from an asset rather than a pattern of **generation** of economic benefits by an asset. Therefore a revenue-based method of amortisation is not allowed.

A revenue-based method of amortisation is a method whereby the amortisation charge in a given year is calculated based on the revenue earned in that year as a proportion of total revenues expected to be generated by the asset over its useful life.

Comments on the Exposure Draft are due by 2 April 2013. Finalised amendments are expected in the fourth quarter of 2013.

2.11 Section summary

- An intangible asset should be recognised only on the condition that it is probable that future economic benefits will flow to the entity and the cost of the asset can be measured reliably.
- An asset is initially recorded at cost but carried either at cost or revalued amount in subsequent periods.
- Expense the costs as incurred if the recognition criteria are not met.
- Amortisation of an intangible asset with finite useful life should be spread over the useful life of the asset. No amortisation should be recorded for an intangible asset with an indefinite useful life.

Self-test question 4

Stauffer is a public listed company reporting under HKFRS. It has asked for your opinion on the accounting treatment of the following items:

(a) The Stauffer brand has become well known and has developed a lot of customer loyalty since the company was set up eight years ago. Recently, valuation consultants valued the brand for sale purposes at $14.6m. Stauffer's directors are delighted and plan to recognise the brand as an intangible asset in the financial statements. They plan to report the gain in the revaluation surplus as they feel that crediting it to profit or loss would be imprudent.

(b) On 1 October 20X5 the company was awarded one of six licences issued by the government to operate a production facility for five years. A "nominal" sum of $1m was paid for the licence, but its fair value is actually $3m.

(c) The company undertook an expensive, but successful advertising campaign during the year to promote a new product. The campaign cost $1m, but the directors believe that the extra sales generated by the campaign will be well in excess of that over its four year expected useful life.

(d) Stauffer owns a 30-year patent which it acquired two years ago for $8m which is being amortised over its remaining useful life of 16 years from acquisition. The product sold is performing much better than expected. Stauffer's valuation consultants have valued its current market price at $14m.

(e) On 1 August 20X6, Stauffer acquired a smaller company in the same line of business. Included in the company's statement of financial position was an in-process research and development project, which showed promising results (and was the main reason why Stauffer purchased the other company), but was awaiting government approval. The project was included in the company's own books at $3m at the acquisition date, while the company's net assets were valued at a fair value of $12m (excluding the project). Stauffer paid $18m for 100% of the company and the research and development project was valued at $5m by Stauffer's valuation consultants at that date. Government approval has now been received, making the project worth $8m at Stauffer's year end.

Required

Explain how the directors should treat the above items in the financial statements for the year ended 30 September 20X6.

(The answer is at the end of the chapter)

3 Goodwill (HKFRS 3 (revised))

Topic highlights

Purchased goodwill arising on consolidation is retained in the statement of financial position as an intangible asset under *HKFRS 3 (revised)*. It must then be reviewed annually for impairment under *HKAS 36*.

Goodwill is a type of intangible asset, however as we have seen in the earlier sections of this chapter, it does not fall within the scope of HKAS 38. Instead, HKFRS 3 applies, providing guidance on the calculation and accounting treatment of goodwill.

The detailed calculation of goodwill, and accounting treatment is considered in more detail in the chapters of the Learning Pack which cover group accounting. Here we introduce the concept of goodwill and its treatment in the accounts.

3.1 What is goodwill?

Goodwill is **created by good relationships** between a business and its customers:

- through reputation for high quality products or standard or service
- through good customer service
- through the personality of staff members

The value of goodwill to a business might be considerable, however as we have already seen, **internally generated goodwill is not recognised in the statement of financial position**.

This may seem odd, given its value to a business in generating future revenues, which may be far more than many tangible assets, particularly in a service organisation, however there is good reason for not recognising internally generated goodwill:

(a) Goodwill is **inherent** in the business but has not been paid for and it does not possess an "objective" value. How much such goodwill is worth can be guessed, but the guesswork is a matter of subjective opinion and is not based on concrete facts.

(b) Goodwill keeps **changing** from day to day. It might be damaged by one bad act of customer relations and improved by a good one. Staff with a good personality might retire or leave the entity and new staff need time to familiarise themselves with the job, and so on. Since the value of goodwill is continually changing, it cannot practically be recorded in the accounts of the business.

3.2 Purchased goodwill

Topic highlights

Purchased goodwill is shown in the statement of financial position because it has been paid for. It has no tangible substance, and so it is an **intangible non-current asset**.

Whereas a business which builds up internally generated goodwill over time cannot objectively value this goodwill, at such time as that business is sold, its goodwill becomes measurable. This is because the price paid to purchase an existing business will generally exceed the sum of the values of the individual assets within the business. The excess represents payment for the goodwill of the business.

3.2.1 Measurement of purchased goodwill

When a business is sold, the selling price is likely to include a premium for goodwill.

The calculation of this premium is not really a problem for accountants, who must simply record the goodwill in the accounts of the new business. The value of the goodwill is a **matter for the purchaser and seller to agree upon in fixing the purchase/sale price**. Two approaches may be taken to this issue:

1. The selling price of the business is agreed by the seller and the buyer **without specifically considering the value of goodwill**. The purchased goodwill will then be the excess of the purchase consideration over the value of the identifiable net assets of the new business.
2. Negotiation is a major element in the computation of goodwill. There are various ways of valuing goodwill and a majority of them are related to the profit record of the acquired business.

It does not matter how goodwill is calculated, the amount recorded by the buyer will be the difference between the purchase consideration and his own valuation of the net assets acquired. If A values his net assets at $40,000, goodwill is agreed at $21,000 and B agrees to pay $61,000 for the business when the net assets are valued at only $38,000, then the goodwill recorded by B will be $23,000 ($61,000 – $38,000).

3.3 HKFRS 3 (revised) *Business Combinations*

Topic highlights

Purchased goodwill is retained in the statement of financial position as an intangible asset under the requirements of **HKFRS 3 (revised)**. It must then be reviewed for impairment annually.

HKFRS 3 (revised) deals with the accounting treatment of goodwill obtained through a business combination, in other words goodwill arising when one company (the parent) acquires a controlling interest in another company (the subsidiary).

Various definitions for goodwill are possible. HKFRS 3 (revised) defines goodwill differently from the traditional definition and places much emphasis on benefits, rather than the method of computation.

Key term

Goodwill. Future economic benefits arising from assets that are not capable of being individually identified and separately recognised. *(HKFRS 3 (revised))*

HKFRS 3.32

3.3.1 Accounting for goodwill arising in a business combination

Acquired goodwill is initially measured at **cost** and recognised as **an asset** in the accounts. Cost is the excess of the purchase consideration over the fair value of the acquiree's identifiable assets, liabilities and contingent liabilities.

After initial recognition, acquired goodwill is **not amortised**, but is then measured **at cost less any accumulated impairment losses**. According to HKAS 36 *Impairment of Assets*, goodwill is to be tested for impairment at least once a year.

3.3.2 Goodwill and non-controlling interests

Where the parent company acquires less than 100% of the equity shares in the subsidiary company, another party will own some of the subsidiary. This party is referred to as the non-controlling interest.

The revised HKFRS 3 considers the group as an **economic entity**. All providers of equity including non-controlling interests are treated as shareholders in the group, even if they are not shareholders in the parent.

Therefore, it may be necessary to recognise goodwill attributed to the non-controlling interest.

We will have a discussion on this in a later chapter.

HKFRS 3.34-36

3.3.3 Bargain purchase

A **bargain purchase** is sometimes referred to as negative goodwill. It arises when the value of the combination is less than the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed. This may occur where there is a forced sale, or the purchased company is loss-making. Alternatively, it may be the result of the application of recognition and measurement rules within HKFRS 3 (revised).

Prior to the recognition of a gain on a bargain purchase, the acquirer must carry out a reassessment to see whether it has correctly identified all of the assets acquired and all of the liabilities assumed. The acquirer must recognise any additional assets or liabilities that are identified in that review and must review the procedures used to measure the amounts this HKFRS requires to be recognised at the date of acquisition for all of the following:

(a) The identifiable assets acquired and liabilities assumed.

(b) The non-controlling (formerly minority) interest in the accquiree, if any.

(c) For a business combination achieved in stages, the acquirer's previously held interest in the acquiree.

(d) The consideration transferred.

The purpose of this review is to ensure that the measurements appropriately reflect all the available information as at the acquisition date.

Self-test question 5

What are the characteristics of goodwill which separate it from other types of intangible assets?
Should these differing characteristics affect the accounting treatment of goodwill?
State your reasons.

(The answer is at the end of the chapter)

4 HKAS 36 *Impairment of Assets*

Topic highlights

HKAS 36 *Impairment of Assets* covers the write down of assets where their carrying value exceeds the recoverable amount.

4.1 Introduction

The fundamental principle of HKAS 36 is relatively simple. If an asset's carrying value is higher than its "recoverable amount", then the asset is said to have suffered an impairment loss. Its value should therefore be reduced by the amount of the **impairment loss**.

HKAS 36 provides guidance on:

(a) when an asset should be tested for a possible impairment
(b) how the impairment test is carried out
(c) how any resulting impairment loss is accounted for and disclosed

Before we consider each of these in turn, the next two sections explain the scope of HKAS 36 and provide a list of important definitions within it.

HKAS 36.2

4.2 Scope

HKAS 36 applies to all tangible, intangible and financial assets including those which have been revalued, except for the following:

- Inventories
- Assets arising from construction contracts
- Deferred tax assets
- Assets arising under **HKAS 19** *Employee Benefits*
- Financial assets within the scope of **HKFRS 9** *Financial Instruments*
- Investment property measured at fair value
- Biological assets related to agricultural activity that are measured at fair value less costs to sell
- Deferred acquisition costs and intangible assets arising from an insurer's contractual rights under insurance contracts within the scope of HKFRS 4 *Insurance Contracts*
- Non-current assets held for sale, which are dealt with under HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*

Instead, the relevant standard's requirements for recognition and measurement of assets should be applied.

HKAS 36.6

4.3 Definitions

HKAS 36 provides a number of definitions, including the following:

Key terms

Impairment loss. The amount by which the carrying amount of an asset exceeds its recoverable amount.

Carrying amount. The amount at which an asset is recognised after deducting any accumulated depreciation (amortisation) and accumulated impairment losses thereon.

Recoverable amount of an asset is the higher of its fair value less costs to sell and its value in use.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Value in use is the present value of the future cash flows expected to be derived from an asset.

(HKAS 36)

HKAS 36.10

4.4 Identification of a possible impairment

An impairment test is required for all assets when there is an indication of impairment at the reporting date. In addition, certain assets should be tested for impairment annually. They are:

- goodwill acquired in a business combination
- intangible assets with an indefinite useful life
- intangible assets which are not yet available for use.

Note that the concept of **materiality** applies, and only material impairment needs to be identified.

HKAS 36.12

4.4.1 Indications of impairment

The various ways in which the indications of a possible impairment of assets might be recognised are suggested in HKAS 36. These suggestions are mostly based on common sense.

(a) **External sources of information**

(i) A fall in the asset's market value that is more significant than would normally be expected from passage of time over normal use.

(ii) A significant change in the technological, market, legal or economic environment of the business in which the assets are employed.

(iii) An increase in market interest rates or market rates of return on investments likely to affect the discount rate used in calculating value in use.

(iv) The carrying amount of the entity's net assets being more than its market capitalisation.

(b) **Internal sources of information**

(i) Evidence is available of obsolescence or physical damage to an asset.

(ii) Significant changes with an adverse effect on the entity have taken place in the period or are expected to in the near future with the result that the asset's expected use or useful life will change.

(iii) Evidence is available that an asset is performing or will perform worse than expected.

(iv) Cash outflows to operate and maintain an asset are significantly higher than those budgeted.

(v) Cash inflows from an asset are significantly lower than budgeted.

4.5 Impairment test

Topic highlights

Impairment is determined by comparing the carrying amount of the asset with its **recoverable amount**.

The recoverable amount of an asset is the higher of the asset's **fair value less costs to sell** and **its value in use**.

Where there are indications of impairment, or for those assets which require testing annually, an impairment test must be performed. This involves comparing the carrying amount of the asset with its recoverable amount.

We have already defined recoverable amount as the higher of fair value less costs to sell and value in use.

HKAS 36.28

4.5.1 Fair value less costs to sell

Fair value is established in accordance with the requirements of HKFRS 13 *Fair Value Measurement*. As we have already seen, it is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

While HKAS 36 provides no guidance on establishing fair value, it does clarify that costs of disposal may include legal costs, stamp duty and similar transaction taxes, costs of removing the asset, and direct incremental costs to bring an asset into condition for its sale. They do not, however, include termination benefits (as defined in HKAS 19) and costs associated with reducing or reorganising a business following the disposal of an asset are not direct incremental costs to dispose of the asset.

HKAS 36.30,33,39, 44,54-56

4.5.2 Value in use

Value in use is the present value of the future cash flows expected to be derived from an asset.

The **pre-tax cash flows** and a **pre-tax discount rate** should be employed to calculate the present value.

The calculation of **value in use** must reflect the following:

(a) An estimate of the **future cash flows** the entity expects to derive from the asset
(b) Expectations about **possible variations** in the amount and timing of future cash flows
(c) The **time value of money**
(d) The price for bearing the **uncertainty** inherent in the asset
(e) **Other factors** that would be reflected in pricing future cash flows from the asset

The standard provides further guidance in the assessment of cash flows and choice of discount rate.

Cash flows

The HKAS states the following:

(a) Cash flow projections should be based on **"reasonable and supportable" assumptions**.

(b) Projections of cash flows, normally up to a maximum period of five years, should be based on the most **recent budgets or financial forecasts**.

(c) A **steady or declining growth rate** for each subsequent year (unless a rising growth rate can be justified) can be used in extrapolating short-term projections of cash flows beyond this period. Unless a higher growth rate can be justified, the long-term growth rate employed should not be higher than the average long-term growth rate for the product, market, industry or country.

HKAS 36 further states that future cash flows may include:

(a) Projections of **cash inflows** from **continuing use** of the asset.

(b) Projections of **cash outflows** necessarily incurred to **generate the cash inflows** from continuing use of the asset.

(c) **Net cash flows** received/paid on **disposal** of the asset at the end of its useful life assuming an arm's length transaction.

An asset's current condition is the basis for estimating future cash flows. It should be noted that future cash flows associated with restructurings to which the entity is not yet committed, or to future costs to add to, replace part of, or service the asset are excluded.

Estimates of future cash flows should **exclude** the following:

(a) Cash inflows/outflows from financing activities.
(b) Income tax receipts/payments.

Foreign currency future cash flows should initially be prepared in the currency in which they will arise and will be discounted using an appropriate rate. Translation of the resulting figure into the reporting currency should then be based on the spot rate at the year end.

Discount rate

The **discount rate** should be a current pre-tax rate (or rates) that reflects:

- the current assessment of the time value of money, and
- the risks specific to the asset.

A rate that reflects current market assessments of the time value of money and the risks specific to the asset is the **return that investors would require if they were to choose an investment that would generate cash flows of amounts, timing and risk profile equivalent to those that the entity expects to derive from the asset**.

This rate is estimated from:

- the rate implicit in current market transactions for similar assets, or

- the weighted average cost of capital of a listed entity that has a single asset which is similar to that under review in terms of service potential and risks

The discount should not include a risk weighting if the underlying cash flows have already been adjusted for risk.

Example: Recoverable amount

An entity has a single manufacturing plant which has a carrying value of $749,000. A new government elected in the country passes legislation significantly restricting exports of the product produced by the plant. As a result, and for the foreseeable future, the entity's production will be cut by 40%. Cash flow forecasts have been prepared derived from the most recent financial budgets/forecasts for the next five years approved by management (excluding the effects of general price inflation):

Year	*1*	*2*	*3*	*4*	*5*
	$'000	$'000	$'000	$'000	$'000
Future cash flows	230	211	157	104	233 (including disposal proceeds)

If the plant was sold now it would realise $550,000, net of selling costs.

The entity estimates that the pre-tax discount rate specific to the plant is 15%, excluding the effects of general price inflation.

Required

Calculate the recoverable amount of the plant.

Note. PV factors at 15% are as follows.

Year	*PV factor at 15%*
1	0.86957
2	0.75614
3	0.65752
4	0.57175
5	0.49718

Solution

- The fair value less costs to sell is given as $550,000
- The value in use is calculated as $638,000:

Year	*Future cash flows* $'000	*PV factor at 15%*	*Discounted future cash flows* $'000
1	230	0.86957	200
2	211	0.75614	160
3	157	0.65752	103
4	104	0.57175	59
5	233	0.49718	116
			638

The recoverable amount is the higher of $550,000 and $638,000, thus $638,000.

4.6 Recognition and measurement of an impairment loss

Topic highlights

Where the carrying amount exceeds the recoverable amount of an asset the difference should be recognised as an impairment loss.

An impairment loss is recognised in profit or loss unless it reverses a previous upwards revaluation.

4.6.1 Measurement of an impairment loss

An impairment loss is measured as the excess of carrying amount over recoverable amount. When impairment is identified, the impaired asset must be written down to its recoverable amount.

HKAS 36.59-61

4.6.2 Recognition of an impairment loss

If the recoverable amount of an asset is less than its carrying amount in the statement of financial position, an impairment loss has occurred. This loss should be **recognised immediately**.

(a) The asset's **carrying amount** should be reduced to its recoverable amount in the statement of financial position.

(b) The **impairment loss** should be recognised immediately.

The recognition of an impairment loss depends on whether the asset in question is held at historic cost or a revalued amount.

Where an **asset is held at historic cost** any impairment loss is recognised in profit or loss.

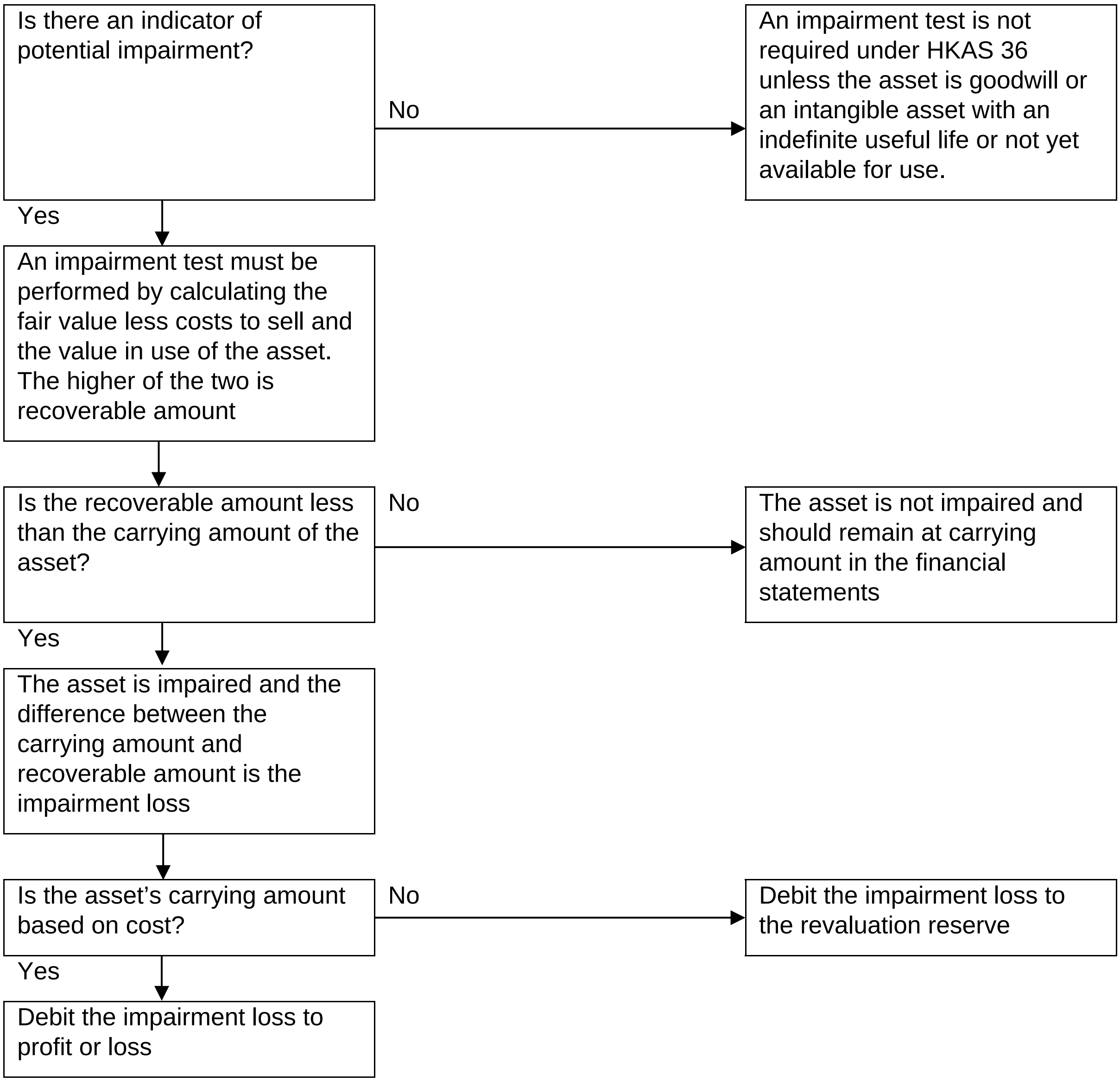
Where an **asset is held at a revalued amount** any impairment loss is recognised as follows:

(a) To the extent that there is a revaluation surplus held in respect of the asset, the impairment loss should be charged to revaluation surplus.

(b) Any excess should be charged to profit or loss.

4.6.3 Summary decision tree

The following decision tree will help to summarise the accounting steps seen so far:



Example: Impairment loss

The accountant of Louella Co. has identified a machine which she believes to be impaired. The machine cost $68,000 on 1 January 20X7 and was revalued to $75,000 on 31 December of that year, resulting in a revaluation surplus of $10,400. The machine continued to be depreciated over the remaining nine years of its ten-year life.

By 31 December 20X8, the development of new technology meant that the machine had fallen in value such that its fair value less costs to sell was just $42,000. The accountant calculated a value in use of $45,000.

What impairment loss should the accountant recognise and where should it be recorded?

Solution

- The recoverable amount is \$45,000, being the higher of fair value less costs to sell and value in use.
- The carrying amount of the machine is \$66,667 (\$75,000 × 8/9).
- Therefore an impairment loss of \$21,667 must be recognised.
- The revaluation surplus at the year end in relation to the machine is \$8,867 (\$10,400 – (\$75,000/9 – \$68,000/10) being the depreciation reserves transfer).
- Therefore \$8,867 is charged to other comprehensive income against the revaluation surplus and the remaining \$12,800 is charged to profit or loss.

HKAS 36.63,110,114, 117,119

4.7 Subsequent accounting for an impaired asset

After reducing an asset to its recoverable amount, the **depreciation charge** on the asset should then be based on its new carrying amount, its estimated residual value (if any) and its estimated remaining useful life.

The annual review of assets to determine whether there may have been some impairment should be **applied to all assets**, including assets that have already been impaired in the past.

4.7.1 Reversal of impairment losses

In some cases, the recoverable amount of an asset that has previously been impaired might turn out to be **higher** than the asset's current carrying value. An impairment loss recognised previously for an asset should be reversed if, and only if, there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognised.

(a) The reversal of the impairment loss should be **recognised immediately** as income in profit or loss for the year.

(b) The carrying amount of the asset should be increased to its **new recoverable amount**.

The asset cannot be revalued to a carrying amount that is higher than its value would have been if the asset had not been impaired originally, i.e. its **depreciated carrying value** had the impairment not taken place. Depreciation of the asset should now be based on its new revalued amount, its estimated residual value (if any) and its estimated remaining useful life.

HKAS 36.6,66

4.8 Cash generating units

Topic highlights

When it is not possible to calculate the recoverable amount of a single asset, then that of its **cash generating unit (CGU)** should be measured instead.

HKAS 36 explains the important concept of cash generating units. As a basic rule, the recoverable amount of an asset should be calculated for the **asset individually**. However, there will be occasions when it is not possible to estimate such a value for an individual asset, particularly in the calculation of value in use. This is because cash inflows and outflows cannot be attributed to the individual asset.

If it is not possible to calculate the recoverable amount for an individual asset, the recoverable amount of the asset's **cash generating unit** should be measured instead.

Key term

A **cash generating unit** is the smallest identifiable group of assets for which independent cash flows can be identified and measured.

HKAS 36.69,72

4.8.1 Identifying the cash generating unit to which an asset belongs

If the **recoverable amount** cannot be determined for an individual asset, an entity should identify the smallest aggregation of assets that generate largely independent cash inflows.

As part of the identification process, an entity may take into account:

- How management monitors the entity's operations (for example, by product line, business or location)
- How management makes decisions about continuing or disposing of the entity's operations and assets.

An asset or a group of assets is identified as a cash generating unit when an active market exists for the output produced by the asset or the group. This is so even if some or all of the output is used internally.

Unless a change is justified, it is necessary to identify consistently from period to period, the cash generating units for the same type of asset.

The group of net assets (less liabilities) considered for impairment and those considered in the computation of the recoverable amount should be alike. (For the treatment of goodwill and corporate assets see below.)

Self-test question 6

Shrub is a retail store belonging to Forest, a chain of such stores. Shrub makes all its retail purchases through Forest's purchasing centre. Pricing, marketing, advertising and human resources policies (except for hiring Shrub's cashiers and salesmen) are decided by Forest. Forest also owns five other stores in the same city as Shrub (although in different neighbourhoods) and 20 other stores in other cities. All stores are managed in the same way as Shrub. Shrub and four other stores were purchased five years ago and goodwill was recognised.

What is the cash generating unit for Shrub?

(The answer is at the end of the chapter)

Self-test question 7

Motorbike Publishing Co. owns 100 magazine titles of which 40 were purchased and 60 were self-created. The price paid for a purchased magazine title is recognised as an intangible asset. The costs of creating magazine titles and maintaining the existing titles are recognised as an expense when incurred. Cash inflows from direct sales and advertising are identifiable for each magazine title. Titles are managed by customer segments. The level of advertising income for a magazine title depends on the range of titles in the customer segment to which the magazine title relates. Management has a policy to abandon old titles before the end of their economic lives and replace them immediately with new titles for the same customer segment.

What is the cash generating unit for the company?

(The answer is at the end of the chapter)

4.9 Goodwill and impairment

HKAS 36.80,84

4.9.1 Allocating goodwill to cash generating units

Acquired goodwill does not generate independent cash flows and has to be **allocated** to the **cash generating units** (or groups of cash generating units) of the buyer. These units are expected to benefit from the synergies of the combination and should:

(a) represent the **lowest level** within the entity at which the goodwill is monitored for internal management purposes.

(b) not be **larger than an operating segment** as defined by **HKFRS 8** *Operating Segments* before aggregation.

Pragmatically, the allocation of goodwill may not be completed before the first reporting date after a business combination, especially if the buyer uses provisional values to account for the combination for the first time. The initial allocation of goodwill must be done before the end of the first reporting period after the date of acquisition.

HKAS 36.88, 90

4.9.2 Testing cash generating units with goodwill for impairment

We have to consider the following two situations:

(a) where goodwill has been allocated to a cash generating unit.

(b) where goodwill has been allocated to a group of units because allocation to a specific cash generating unit is impossible.

In the first instance, the annual impairment test is to be carried out on the cash generating unit to which goodwill has been allocated. The **carrying amount** of the unit, including goodwill, is **compared with the recoverable amount**. An impairment loss must be recognised when the carrying amount of the unit is bigger than the recoverable amount.

In the second instance, where goodwill is not allocated to a CGU, the impairment test of that CGU is carried out by **comparing its carrying amount** (excluding goodwill) **with its recoverable amount**. An impairment loss must be recognised if the carrying amount is bigger than the recoverable amount.

The annual impairment test must be performed at the **same time every year** although it may be performed at any time during an accounting period.

4.9.3 Impairment of goodwill where there is a non-controlling interest

If there is a **non-controlling (minority) interest** in a cash generating unit to which goodwill has been allocated, and the non-controlling interest is measured as a proportion of the net assets of the subsidiary, adjustment is required before comparing carrying amount and recoverable amount.

You may find it easier to come back to this section after studying the groups chapters where alternative measurements of the non-controlling interest are discussed.

The issue here is that without adjustment, we are not comparing like with like:

- The carrying amount of goodwill represents only that goodwill attributable to the parent company, however,
- The recoverable amount of the cash-generating unit includes the value of **full goodwill** including that attributable to the non-controlling interest which is not recognised in the financial statements.

Therefore, the carrying amount of the goodwill should be **grossed up** to include the goodwill attributable to the non-controlling interest before the impairment test is conducted.

Example: Non-controlling interest

On 1 January 20X9 a parent acquires a 75% interest in a subsidiary for $2,400,000, when the identifiable net assets of the subsidiary are $1,800,000. The non-controlling interest is measured as a proportion of the net assets of the subsidiary. The subsidiary is a cash generating unit.

At 31 December 20X9, the recoverable amount of the subsidiary is $1,400,000. The carrying amount of the subsidiary's identifiable assets is $1,600,000.

Calculate the impairment loss at 31 December 20X9.

Solution

At 31 December 20X9 the cash generating unit consists of the subsidiary's identifiable net assets (carrying amount $1,600,000) and goodwill of $1,050,000 (2,400,000 + (25% × 1,800,000) – 1,800,000). Goodwill is grossed up to reflect the 25% non-controlling interest.

At 31 December 20X9:	*Goodwill*	*Net assets*	*Total*
	$'000	$'000	$'000
Carrying amount	1,050	1,600	2,650
Unrecognised non-controlling interest	350	–	350
	1,400	1,600	3,000
Recoverable amount			(1,400)
Impairment loss			1,600
Allocation of impairment loss			
– unrecognised (goodwill)	(350)	–	
– recognised (goodwill / net assets)	(1,050)	(200)	
Carrying value	–	1,400	

4.10 Corporate assets

HKAS 36.100,102

Corporate assets include group and divisional assets that do not generate cash inflows independently from other assets and hence their carrying amount cannot be fully attributed to a cash generating unit under review. Head office building, equipment or a research centre are examples of corporate assets.

An entity should identify all the corporate assets that relate to a cash generating unit in an impairment test of that unit.

(a) An entity compares the carrying amount of the unit (including the portion of the asset) with its recoverable amount when a portion of the carrying amount of a corporate asset **can be allocated** to the unit on a reasonable and consistent basis.

(b) If a portion of the carrying amount of a corporate asset **cannot be reasonably and consistently allocated** to the unit, the entity:

 (i) recognises the impairment loss by comparing the carrying amount of the unit (excluding the asset) with its recoverable amount.

 (ii) allocates a portion of the carrying amount of the asset on a reasonable and consistent basis by identifying the smallest group of cash generating units that includes the cash generating unit to which the asset belongs.

 (iii) recognises the impairment loss by comparing the carrying amount of that group of cash generating units (including the portion of the asset allocated to the group of units) with the recoverable amount of the group of units.

Example: Corporate assets

Rainbow has identified three CGUs within its business, and allocated assets to each as follows:

	Carrying value of allocated assets
CGU 1	$640,000
CGU 2	$2,150,000
CGU 3	$1,300,000

Rainbow operates from a corporate campus with a carrying value of $2 million. This has not yet been allocated to the CGUs, however it is considered that it can be allocated in full based on carrying value.

The recoverable values of CGUs 1 to 3 are $980,000, $3,145,000 and $1,800,000 respectively.

What impairment losses (if any) have the CGUs suffered?

Solution

	CV of assets	*HO allocation*	*Total*	*Recoverable amount*	*Impairment loss*
	$	$	$	$	$
CGU 1	640,000	312,958	952,958	980,000	-
CGU 2	2,150,000	1,051,345	3,201,345	3,145,000	56,345
CGU 3	1,300,000	635,697	1,935,697	1,800,000	135,697
	4,090,000	2,000,000	6,090,000		192,042

Head office allocation:

CGU 1	640/4,090 × $2 million	=	$312,958
CGU 2	2,150/4,090 × $2 million	=	$1,051,345
CGU 3	1,300/4,090 × $2 million	=	$635,697

HKAS 36.104,105

4.11 Allocating an impairment loss to the assets of a cash generating unit

An impairment loss should be recognised for a **cash generating unit** if the recoverable amount for the cash generating unit is less than the carrying amount in the statement of financial position for all the assets in the unit.

When an impairment loss is recognised for a cash generating unit, the loss should be allocated between the assets in the unit in the following order:

(a) First, to the **goodwill** allocated to the cash generating unit (if any).

(b) Then, to all other assets in the cash generating unit within the scope of HKAS 36 (see section 4.2), on a **pro rata basis**.

In allocating an impairment loss, the carrying amount of an asset should not be reduced below the highest of:

(a) its fair value less costs to sell,
(b) its value in use (if determinable), or
(c) zero.

Any remaining amount of an impairment loss should be recognised as a liability if required by other HKAS.

Example: Impairment loss (1)

On 31 December 20X1 Invest purchased all the shares of MH for $2 million. The net fair value of the identifiable assets acquired and liabilities assumed of MH at that date was $1.8 million.

MH made a loss in year ended 31 December 20X2 and at 31 December 20X2 the net assets of MH – based on fair values at 1 January 20X2 – were as follows:

	$'000
Property, plant and equipment	1,300
Capitalised development expenditure	200
Net current assets	250
	1,750

An impairment review on 31 December 20X2 indicated that the recoverable amount of MH at that date was $1.5 million. The capitalised development expenditure has no ascertainable external market value and the current fair value less costs to sell of the property, plant and equipment is $1,120,000. Value in use could not be determined separately for these two items.

Required

Calculate the impairment loss that would arise in the consolidated financial statements of Invest as a result of the impairment review of MH at 31 December 20X2 and show how the impairment loss would be allocated.

Solution

	Asset values at 31 Dec 20X2 before impairment	*Allocation of impairment loss (W1)/(W2)*	*Carrying value after impairment loss*
	$'000	$'000	$'000
Goodwill (2,000 – 1,800)	200	(200)	
Property, plant and equipment	1,300	(180)	1,120
Development expenditure	200	(70)	130
Net current assets	250	–	250
	1,950	(450)	1,500

WORKINGS

1 *Impairment loss*

Carrying value	1,950
Recoverable amount	1,500
Impairment loss	450
Amount to allocate against goodwill	200
Amount to allocate pro-rata against other assets	250

2 *Allocation of the impairment losses on pro-rata basis*

	Initial value	*Impairment pro-rated*	*NBV if fully allocated*	*Reallocation*	*Actual loss allocated*	*Impaired value*
	$'000	$'000	$'000	$'000	$'000	$'000
PPE (250 × 1,300/1,500)	1,300	217	1,083	(37)	180	1,120
Dev exp (250 × 200/1,500)	200	33	167	37	70	130

The amount not allocated to the PPE because they cannot be taken below their recoverable amount is allocated to other remaining assets pro-rata, in this case all against the development expenditure.

Hence the development expenditure is reduced by a further 37 (217 – 180), making the total impairment 70 (33 + 37).

The net current assets are not included when pro-rating the impairment loss as they are outside the scope of HKAS 36.

Example: Impairment loss (2)

The Burgos Group is made up of two cash generating units (as a result of a combination of various past 100% acquisitions), plus a head office, which was not allocated to any given cash generating unit as it supports both divisions.

Due to falling sales as a result of an economic crisis, an impairment test was conducted at the year end. The consolidated statement of financial position showed the following net assets at that date.

	Division A	*Division B*	*Head office*	*Unallocated goodwill*	*Total*
	$m	$m	$m	$m	$m
Property, plant & equipment (PPE)	780	620	90	-	1,490
Goodwill	60	30	-	10	100
Net current assets	180	110	20	-	310
	1,020	760	110	10	1,900

The recoverable amounts (including net current assets) at the year end were as follows:

	$m	
Division A	1,000	
Division B	720	
Group as a whole	1,825	(including Head office PPE at fair value less costs to sell of $80m)

The recoverable amounts of the two divisions were based on value in use. The fair value less costs to sell of any individual item was substantially below this.

No impairment losses had previously been necessary.

Required

Discuss, with suitable computations showing the allocation of any impairment losses, the accounting treatment of the impairment test.

Solution

Where there are multiple cash generating units, HKAS 36 *Impairment of Assets* requires two levels of tests to be performed to ensure that all impairment losses are identified and fairly allocated. First Divisions A and B are tested individually for impairment. In this instance, both are impaired and the impairment losses are allocated first to any goodwill allocated to that unit and second to other non-current assets (within the scope of HKAS 36) on a pro-rata basis. This results in an impairment of the goodwill of both divisions and an impairment of the property, plant and equipment in Division B only.

A second test is then performed over the whole business including unallocated goodwill and unallocated corporate assets (the Head office) to identify if those items which are not a cash generating unit in their own right (and therefore cannot be tested individually) have been impaired.

The additional impairment loss of (W2) $15m is allocated first against the unallocated goodwill of $10m, eliminating it and then to the unallocated head office assets reducing them to $85m. Divisions A and B have already been tested for impairment so no further impairment loss is allocated to them or their goodwill as that would result in reporting them at below their recoverable amount.

Carrying values after impairment test:

	Division A	*Division B*	*Head office*	*Unallocated goodwill*	*Total*
	$m	$m	$m	$m	$m
PPE 780/(620 – 10)/(90 – 5)	780	610	85	-	1,475
Goodwill (60 – 20)/(30 – 30)/(10 – 10)	40	-	-	-	40
Net current assets	180	110	20	-	310
	1,000	720	105	-	1,825

WORKINGS

1 *Test of individual CGUs:*

	Division A	*Division B*
	$m	$m
Carrying value	1,020	760
Recoverable amount	(1,000)	(720)
Impairment loss	20	40
Allocated to:		
Goodwill	20	30
Other assets in the scope of HKAS 36	-	10
	20	40

2 *Test of group of CGUs:*

	$m
Revised carrying value (1,000 + 720 + 110 + 10)	1,840
Recoverable amount	(1,825)
Impairment loss	15
Allocated to:	
Unallocated goodwill	10
Other unallocated assets	5
	15

HKAS 36.122,123, 124

4.12 Reversal of an impairment loss

Topic highlights

Impairment of goodwill may never be reversed.

Where a cash generating unit has been impaired in the past, this impairment can be reversed. The reversal of the loss is allocated to the assets of the unit, **except for goodwill** pro rata with the carrying amounts of those assets. The increases in carrying amounts are treated in the same way as reversals of individual asset impairment, in other words, the carrying amount of an asset cannot increase above the lower of:

(a) its recoverable amount

(b) the carrying amount of the asset net of depreciation had no impairment been recognised previously.

Self-test question 8

Cannon Co. operates in a number of countries, with its operations in each being classified as separate cash generating units. In one of the countries of operation, Adascus, legislation was passed two years ago restricting exports, and as a result management of Cannon expected production to decrease by 30% in their Adascan operation. Accordingly the Adascan CGU was tested for impairment and an impairment of $1.473 million recognised in profit:

	Goodwill	*Assets*
	$'000	$'000
Cost at 1 January 20X1	1,000	2,000
Depreciation	–	(167)
	1,000	1,833
Impairment	(1,000)	(473)
CV at 31 December 20X1	–	1,360

The average remaining useful life of assets remained unchanged after the impairment, at 11 years.

Two years later at 31 December 20X3, it is thought that the effect of the legislation is less drastic than expected, and production is expected to increase by 25%. The recoverable amount of the Adascan CGU is now $1.91 million.

Required

Calculate the reversal of the impairment loss.

(The answer is at the end of the chapter)

HKAS 36.126,130, 131

4.13 Disclosure

HKAS 36 calls for substantial disclosure about impairment of assets. The information to be disclosed includes the following:

For each class of asset:

(a) The amount of impairment losses recognised in profit or loss in the period and the line item in the statement of profit or loss and other comprehensive income where they are included.

(b) The amount of reversals of impairment losses recognised in the period and the line item in the statement of profit or loss and other comprehensive income where they are included.

(c) The amount of impairment losses on revalued assets recognised in other comprehensive income in the period.

(d) The amount of reversals of impairment losses on revalued assets recognised in other comprehensive income in the period.

For each material **impairment loss** recognised or reversed during the period for an individual asset, including goodwill, or a **cash generating unit**:

(a) The events and circumstances that led to the recognition or reversal of the impairment loss.

(b) The amount of the impairment loss recognised or reversed.

(c) For an individual asset:

- the nature of the asset
- if the entity reports segment information in accordance with HKFRS 8, the reportable segment to which the asset belongs

(d) For a cash generating unit:

– a description of the cash generating unit

– the amount of the impairment loss recognised or reversed by class of assets and reportable segment (if HKFRS 8 applies)

– if the aggregation of assets for identifying the cash generating unit has changed, a description of the old and new ways of aggregating assets and reasons for the change

(e) Whether the recoverable amount of the asset or cash generating unit is fair value less costs to sell or value in use.

(f) If recoverable amount is fair value less costs to sell, the basis used to determine this amount.

(g) If recoverable amount is value in use, the discount rates used in the current and previous estimates.

For the aggregate **impairment losses** and the aggregate reversals of impairment losses recognised during the period which are not material:

(a) The main classes of assets affected by impairment losses and reversals.

(b) The main events and circumstances that led to the recognition of these impairment losses and reversals.

4.14 Current developments

The IASB issued an exposure draft in January 2013 which proposes to amend IAS 36 (and so HKAS 36) to reduce disclosure requirements in relation to the recoverable amount of impaired assets. The standard currently requires that the recoverable amount of CGUs which include goodwill or intangibles with indefinite useful lives is disclosed when the carrying amount of the goodwill or intangible assets with indefinite lives is significant in relation to the entity's total goodwill or intangibles with indefinite lives. The amendments will remove this requirement and instead require that recoverable amount of an asset or CGU is disclosed only where there has been an impairment loss or reversal in the period.

4.15 Section summary

The main aspects of HKAS 36 to consider are:

- **indications** of impairment of assets
- **measuring recoverable amount**, as net selling price or value in use
- **measuring value in use**
- **cash generating units**
- **accounting treatment** of an impairment loss, for individual assets and cash generating units
- **reversal** of an impairment loss

Topic recap

HKAS 38 *Intangible Assets*

- Identifiable non-monetary asset without physical substance
- controlled by the entity as a result of a past event
- from which the entity expected future benefits to flow

Separately acquired

Recognise if:
1 probable future economic benefits will flow
2 cost can be measured reliably

Measure at cost + directly attributable costs.

Acquired in business combination

Recognise if:
1 probable future economic benefits will flow
2 fair value can be measured reliably

Measure at fair value at date of acquisition.

Internally generated

Research

Investigation undertaken to gain new knowledge

Expense to profit or loss

Development

Application of research findings for the production of new or improved materials, processes etc

Recognise if:
1 technically feasible
2 intend to complete
3 commercially viable
4 probable economic benefits
5 resources available to complete
6 expenditure reliably measured

Measure at directly attributable costs since date when recognition criteria met.

Subsequent measurement

Cost model

Cost less accumulated amortisation less accumulated impairment losses

or

Revaluation model

Revalued amount less subsequent amortisation less subsequent impairment losses

Only allowed where there is an active market i.e.
- items are homogenous
- willing buyers and sellers exist
- prices are public

Amortisation

- Amortise over useful life
- Residual value assumed to be nil
- Where useful life is indefinite an annual impairment test replaces amortisation

Goodwill

- Internally generated goodwill is not recognised (HKAS 38)
- Purchased positive goodwill is recognised in the statement of financial position at cost less impairment losses (HKFRS 3)
- A bargain purchase (negative goodwill) is reviewed and then recognised as a gain in profit or loss (HKFRS 3)

HKAS 36 Impairment

Indicators of impairment

External sources:
- Fall in market value
- Change in area of business asset employed in
- Increase in interest rates
- Entity's net assets exceed market capitalisation.

Internal sources
- Obsolescence/damage
- Changes within entity
- Evidence of under-performance of asset
- Costs of maintaining asset higher than expected
- Cash generated by an asset lower than expected.

Testing

Impairment test is required where there are indicators of impairment or annually for:
- goodwill
- intangibles with an indefinite life
- intangibles not yet available for use

Accounting

Asset held at historic cost: Impairment loss recognised in profit or loss.

Asset held at revalued amount: Impairment loss charged against revaluation reserve in respect of the asset and then to profit or loss.

CGU:
Impairment loss allocated to:
1 goodwill in the CGU
2 all other assets in the CGU within the scope of HKAS 36 on pro rata basis.

NB loss allocated to goodwill may never be reversed.

Test cash generating unit where it is not possible to calculate the recoverable amount of a single asset:
- allocate goodwill to CGUs benefiting from synergies of combination
- allocate corporate assets to CGUs if possible
- adjustment may be required to carrying amount of goodwill where there is a non-controlling interest.

Impairment loss arises where

Carrying amount > Recoverable amount

Recoverable amount: Higher of
- Fair value less costs to sell
- Value in use

Value in use: Future cash flows expected to be derived from asset discounted to present value using pre-tax rate.

Disclosure requirements:
- Impairment losses/reversals recognised in period on assets held at cost & assets at revalued amount
- Additional disclosures for material impairment losses/reversals

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Answers to self-test questions

Answer 1

At the end of 20X1, the production process is recognised as an intangible asset at a cost of $190,000. This is the expenditure incurred since the date when the recognition criteria were met, that is 1 December 20X1. The $310,000 expenditure incurred before 1 December 20X1 is expensed, because the recognition criteria were not met. It will never form part of the cost of the production process recognised in the statement of financial position.

Answer 2

The reversal of the impairment loss is recognised to the extent it increases the carrying amount of the non-current asset to what it would have been had the impairment not taken place.

This means that the reversal of the impairment loss can only be recognised at $10m. The asset is recognised at $130m and a reversal of the impairment loss of $10m is recognised in the statement of profit or loss.

Answer 3

Factors to consider would include the following:

(a) Legal protection of the brand name and the control of the entity over the (illegal) use by others of the brand name (i.e. control over piracy).

(b) Age of the brand name.

(c) Status or position of the brand in its particular market.

(d) Ability of the management of the entity to manage the brand name and to measure activities that support the brand name (e.g. advertising and PR activities).

(e) Stability and geographical spread of the market in which the branded products are sold.

(f) Pattern of benefits that the brand name is expected to generate over time.

(g) Intention of the entity to use and promote the brand name over time (as evidenced perhaps by a business plan in which there will be substantial expenditure to promote the brand name).

Answer 4

Stauffer brand

The Stauffer brand is an "internally generated" intangible asset rather than a purchased one. HKAS 38 specifically prohibits the recognition of internally generated brands, on the grounds that they cannot be reliably measured in the absence of a commercial transaction. Stauffer will not therefore be able to recognise the brand in its statement of financial position.

Licence

The licence is an intangible asset acquired by a government grant. It can be accounted for in one of two ways:

- The asset is recorded at the nominal price (cash paid) of $1m and depreciated at $200,000 per annum of its five year life, or
- The asset is recorded at its fair value of $3m and a government grant is shown as deferred income at $2m. The asset is depreciated over the five years at an annual rate of $600,000 per annum. The grant is amortised as income through profit or loss over the same period at a rate of $400,000 per annum. This results in the same net cost of $200,000 in profit or loss per annum as the first method.

Advertising campaign

The advertising campaign is treated as an expense. Advertising expenditure cannot be capitalised under HKAS 38, as the economic benefits it generates cannot be clearly identified so no intangible asset is created.

Patent

The patent is amortised to a nil residual value at $500,000 per annum based on its acquisition cost of $8m and remaining useful life of 16 years.

The patent cannot be revalued under the HKAS 38 rules as there is no active market as a patent is unique. HKAS 38 does not permit revaluation without an active market as the value cannot be reliably measured in the absence of a commercial transaction.

Acquisition

The difference between the price that Stauffer paid and the fair value of the net assets of the acquired company will represent goodwill. The research and development project must also be valued at fair value in a business combination to ensure the goodwill is stated accurately, while in the acquiree's own financial statements it would not be revalued as there is no active market because it is unique. Consequently, in a business combination HKAS 38/HKFRS 3 (revised) permit intangible assets that do not have an active market to be valued on an "arm's length" basis.

The values attributed in the group financial statements on the acquisition date are therefore:

	$m
Net assets (excluding R&D project)	12
R&D project	5
Goodwill (remainder)	1
Purchase price	18

The fair value of the research and development project is measured at the acquisition date, not at the year end and so it is not recorded at $8m. The project will be amortised over the expected useful life of the product developed once the product is available for production.

Answer 5

Goodwill may be distinguished from other intangible non-current assets by reference to the following characteristics.

(a) It is incapable of realisation separately from the business as a whole.

(b) Its value has no reliable or predictable relationship to any costs which may have been incurred.

(c) Its value arises from various intangible factors such as skilled employees, effective advertising or a strategic location. These indirect factors cannot be valued.

(d) The value of goodwill may fluctuate widely according to internal and external circumstances over relatively short periods of time.

(e) The assessment of the value of goodwill is highly subjective.

It could be argued that, because goodwill is so different from other intangible non-current assets it does not make sense to account for it in the same way. Thus the capitalisation and amortisation treatment would not be acceptable. Furthermore, because goodwill is so difficult to value, any valuation may be misleading, and it is best eliminated from the statement of financial position altogether. However, there are strong arguments for treating it like any other intangible non-current asset. This issue remains controversial.

Answer 6

In identifying Shrub's cash generating unit, an entity considers whether, for example:

(a) Internal management reporting is organised to measure performance on a store-by-store basis.

(b) The business is run on a store-by-store profit basis or on a region/city basis.

All Forest's stores are in different neighbourhoods and probably have different customer bases. So, although Shrub is managed at a corporate level, Shrub generates cash inflows that are largely independent from those of Forest's other stores. Therefore, it is likely that Shrub is a cash generating unit.

Answer 7

It is likely that the recoverable amount of an individual magazine title can be assessed. Even though the level of advertising income for a title is influenced, to a certain extent, by the other titles in the customer segment, cash inflows from direct sales and advertising are identifiable for each title. In addition, although titles are managed by customer segments, decisions to abandon titles are made on an individual title basis.

Therefore, it is likely that individual magazine titles generate cash inflows that are largely independent one from another and that each magazine title is a separate cash generating unit.

Answer 8

- At 31 December 20X3, the carrying amount of the assets are:

	$'000
CV at 31 December 20X1	1,360
Depreciation X2 (1,360/11)	(124)
Depreciation X3	(124)
	1,112

- Recoverable amount is $1.91 million and the excess over carrying amount is therefore $798,000.
- The impairment of goodwill cannot be reversed.
- The impairment of assets can be reversed provided that the new carrying amount is not in excess of the carrying amount had no impairment arisen ie $1.5 million ($1.833m × 9/11 years).
- Therefore, a reversal of $388,000 ($1.5m – $1.112m) is recognised in profit or loss.

Exam practice

York Marble Limited

32 minutes

York Marble Limited ("YM") has operated a tile manufacturing plant in the city centre for more than 15 years. Due to a recent change in government policy on environmental protection and city development, YM was ordered to close the production plant by the end of September 20Y1 and return the leasehold land to the government early at a consideration based on the market price of land with a similar remaining lease term and location.

As at 31 May 20Y1, YM had the following assets related to the production plant:

	$m
Buildings and infrastructure	23.8
Production equipment	48.0
Electricity generator	5.2
Land under operating lease up to 20Z4	13.0
Inventories – Raw materials	8.4
Inventories – Finished products	6.4

According to the original lease, YM is required to dismantle the buildings and infrastructure before returning the bare land to the government. Previously, the company has recognised a provision for the dismantling to be carried out by the end of the lease term of the land in the cost of these assets. The carrying amount of the provision at 31 May 20Y1 is $1.5 million. Based on a quotation from a contractor, it costs $3 million for this exercise to be carried out by September 20Y1.

All production equipment will be relocated to another manufacturing plant of YM 60 km away for continuing usage. The relocation and installation costs are estimated to be $4 million. YM agreed to sell the electricity generator to another company at $4 million. The relocation cost will be borne by the buyer.

Although the final consideration of the leasehold land to be paid by the government has yet to be determined, the government has indicated to YM that the amount would be not less than $35 million.

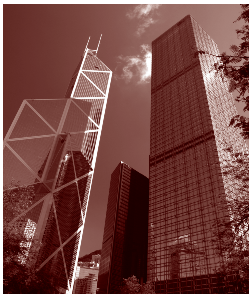
YM will continue manufacturing until the end of August and it is expected that all the raw materials will be consumed for the production of tiles and sold at a profit. Half of the finished products were made to order with a gross profit of 20% and delivered to customers in early June 20Y1. The remaining half is obsolete and old model items which could only be sold at 40% of the cost.

Required

Discuss the accounting treatment under Hong Kong Financial Reporting Standards that should be adopted by YM for each individual asset as at 31 May 20Y1.

(18 marks)

HKICPA December 2011


chapter 9

Leases

Topic list

Learning focus

Leasing transactions are extremely common in business and you will often come across them in both your business and personal capacity. It is important for the accountant to be able to advise from the perspective of both the lessor and the lessee. Off-balance sheet finance and substance over form are both vital issues of which the accountant should be aware.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
Account for transactions in accordance with Hong Kong Financial Reporting Standards		
3.14	**Leases**	3
3.14.01	Identify the types of lease within the scope of HKAS 17 and define the terminology used in relation to leases	
3.14.02	Classify leases as operating or finance leases by looking at the substance of the transaction	
3.14.03	Account for operating leases from the perspective of both the lessee and the lessor	
3.14.04	Disclose the relevant information relating to operating leases in the accounts of both the lessee and the lessor	
3.14.05	Account for finance leases from the perspective of both the lessee and the lessor	
3.14.06	Disclose the relevant information relating to finance leases in the accounts of both the lessee and the lessor	
3.14.07	Account for manufacturer/dealer leases	
3.14.08	Account for sale and leaseback transactions	
3.14.09	Explain the term off-balance sheet finance and the importance of substance over form	
3.14.10	Explain how to determine whether an arrangement contains a lease	

1 HKAS 17 *Leases*

Topic highlights

HKAS 17 covers the accounting for lease transactions by both lessees and lessors. A lease is a contract for the hire of a specific asset.

A **lease** is a contract between a lessee and lessor for the hire of a specific asset. The lessor retains ownership of the asset but conveys the right of the use of the asset to the lessee for an agreed period of time in return for the payment of specified rentals.

HKAS 17.2

1.1 Scope of HKAS 17

HKAS 17 is applied in accounting for all leases other than:

- leases to explore for or use minerals, oil, natural gas and similar resources
- licensing agreements for items such as films, video recordings, plays, manuscripts, patents and copyrights.

The standard is not applied as the basis of measurement for:

- property held by lessee that is accounted for as an investment property
- investment property provided by lessors under operating leases
- biological assets held by lessees under finance leases
- biological assets provided by lessors under operating leases.

1.2 Types of lease

Topic highlights

There are two forms of lease: finance lease and operating lease.

In some cases, leasing can be considered to be a medium-term or long-term source of finance. From the point of view of the lessee, therefore, leasing such an asset is very **similar to purchasing** it using a loan. The lessee has all of the benefits and responsibilities of ownership except for the capital allowances. These types of longer-term lease are known as **finance leases**.

Other leases are of a very different nature. For example, a businessman may decide to hire (lease) a car for a week while his own is being repaired. A lease of this nature is for a short period of time compared with the asset's useful life and the lessor will expect to lease it to many different lessees during that life. Furthermore, the lessor rather than the lessee will be responsible for maintenance. These types of lease are known as **operating leases**.

HKAS 17.4

1.2.1 Definitions

HKAS 17 *Leases* classifies leases as either finance leases or operating leases and requires that different accounting treatment is applied for each.

In distinguishing between them, the standard gives the following definitions.

Key terms

Lease. An agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.

Finance lease. A lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred.

Operating lease. A lease other than a finance lease. *(HKAS 17)*

The classification of a lease as either finance or operating is therefore largely dependent upon the transfer of risks and rewards. The next section explains what is meant by this term.

HKAS 17.7-11

1.2.2 Risks and rewards

Risks are the risks of ownership, not other types of risk. These include:

- possibility of losses from idle capacity
- possibility of losses from technological obsolescence
- variations in return due to changing economic conditions.

Rewards are represented by:

- the expectation of profitable operation over the asset's economic life
- unrestricted access to the asset
- any gain from appreciation in value or realisation of a residual value.

HKAS 17 applies the same definitions and accounting principles to both lessees and lessors, but the **different circumstances** of each may lead each to classify the same lease differently.

An assessment of risks and rewards may be inconclusive in deciding what type of lease a particular arrangement is. In this instance, the standard provides examples of situations which indicate an arrangement is a finance lease.

HKAS 17 provides the following examples of finance lease:

(a) The lease transfers ownership of the asset to the lessee by the end of the lease term.

(b) The lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised.

(c) The lease term is for the major part of the economic life of the asset even if title is not transferred.

(d) At the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset.

(e) The leased assets are of a specialised nature such that only the lessee can use them without major modifications being made.

There are also some indicators of situations which individually or in combination could also lead to a lease being classified as a finance lease.

(a) If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee.

(b) Gains or losses from the fluctuation in the fair value of the residual fall to the lessee (e.g. in the form of a rent rebate equalling most of the sales proceeds at the end of the lease).

(c) The lessee has the ability to continue the lease for a secondary period at a rent which is substantially lower than market rent.

HKAS 17.13,15A

1.2.3 Classification of a lease

Classification is made at the **inception of the lease**. Any revised agreement should be treated as a new agreement over its term. In contrast, changes in estimates (e.g. of economic life or residual value of the property) or changes in circumstances (e.g. default by the lessee) do not lead to a new classification of a lease for accounting purposes.

Land and buildings

When a lease includes both land and building elements, an entity must consider each of these elements in turn and classify them as finance or operating lease separately. With regard to the land, the standard states that an important consideration is that land normally has an indefinite economic life. This is likely to result in the land element being classified as an operating lease in view of the low level of risks and rewards associated with the land which would have been transferred to the lessee during the lease period.

HKAS 17.4

1.3 Other definitions

HKAS 17 gives a substantial number of definitions.

Key terms

Minimum lease payments. The payments over the lease term that the lessee is or can be required to make, excluding contingent rent, costs for services and taxes to be paid by and be reimbursable to the lessor, together with:

(a) For a lessee, any amounts guaranteed by the lessee or by a party related to the lessee.

(b) For a lessor, any residual value guaranteed to the lessor by one of the following:

- (i) The lessee
- (ii) A party related to the lessee
- (iii) An independent third party financially capable of meeting this guarantee.

However, if the lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised, the minimum lease payments comprise the minimum payments payable over the lease term to the expected date of exercise of this purchase option and the payment required to exercise it.

Interest rate implicit in the lease. The discount rate that, at the inception of the lease, causes the aggregate present value of the:

(a) minimum lease payments, and
(b) unguaranteed residual value

to be equal to the sum of:

(a) the fair value of the leased asset
(b) any initial direct costs

Initial direct costs are **incremental costs** that are directly attributable to negotiating and arranging a lease, except for such costs incurred by manufacturer or dealer lessors. Examples of initial direct costs include amounts such as commissions, legal fees and relevant internal costs.

Lease term. The non-cancellable period for which the lessee has contracted to lease the asset together with any further terms for which the lessee has the option to continue to lease the asset, with or without further payment, when at the inception of the lease it is reasonably certain that the lessee will exercise the option.

Key terms (cont'd)

A **non-cancellable lease** is a lease that is cancellable only in one of the following situations:

(a) Upon the occurrence of some remote contingency.

(b) With the permission of the lessor.

(c) If the lessee enters into a new lease for the same or an equivalent asset with the same lessor.

(d) Upon payment by the lessee of an additional amount such that, at inception, continuation of the lease is reasonably certain.

The **inception of the lease** is the earlier of the date of the lease agreement and the date of commitment by the parties to the principal provisions of the lease. As at this date:

(a) A lease is classified as either an operating lease or a finance lease

(b) In the case of a finance lease, the amounts to be recognised at the lease term are determined.

Economic life is either the:

(a) period over which an asset is expected to be economically usable by one or more users

(b) number of production or similar units expected to be obtained from the asset by one or more users

Useful life is the estimated remaining period, from the beginning of the lease term, without limitation by the lease term, over which the economic benefits embodied in the asset are expected to be consumed by the entity.

Guaranteed residual value is:

(a) for a lessee, that part of the residual value which is guaranteed by the lessee or by a party related to the lessee (the amount of the guarantee being the maximum amount that could, in any event, become payable).

(b) for a lessor, that part of the residual value which is guaranteed by the lessee or by a third party unrelated to the lessor who is financially capable of discharging the obligations under the guarantee.

Unguaranteed residual value is that portion of the residual value of the leased asset, the realisation of which by the lessor is not assured or is guaranteed solely by a party related to the lessor.

Gross investment in the lease is the aggregate of:

(a) the minimum lease payments receivable by the lessor under a finance lease
(b) any unguaranteed residual value accruing to the lessor

Net investment in the lease is the gross investment in the lease discounted at the interest rate implicit in the lease.

Unearned finance income is the difference between the:

(a) gross investment in the lease
(b) net investment in the lease

The **lessee's incremental borrowing rate of interest** is the rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset.

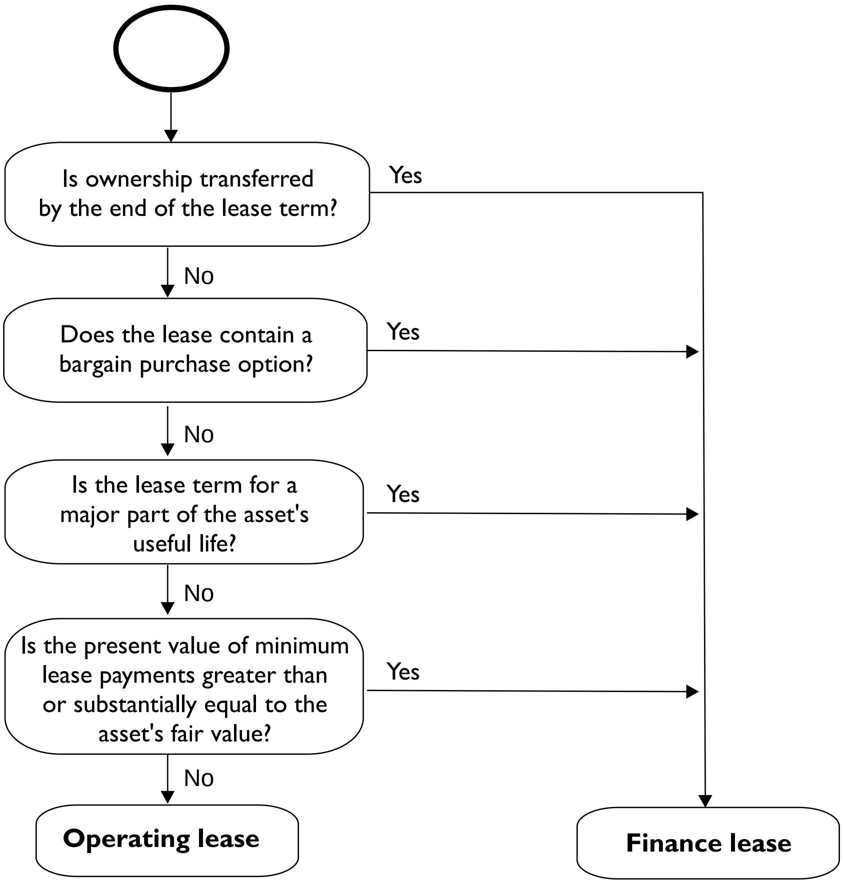
Contingent rent is that portion of the lease payments that is not fixed in amount but is based on a factor other than just the passage of time (e.g. percentage of sales, amount of usage, price indices, market rates of interest).

(HKAS 17)

Some of these definitions are only of relevance when we look at lessor accounting in section 3.

1.4 Section summary

The following diagram should help you remember how to determine whether a lease is a **finance lease** or an **operating lease**.



2 Lessee accounting

Topic highlights

Lessee accounting:

- **Operating leases**: recognise rental expense on a straight line basis.
- **Finance leases**: record an asset in the statement of financial position and a liability to pay for it (at the lower of fair value of the asset or present value of minimum lease payments); apportion the finance charge to give a constant periodic rate of return.

HKAS 17.33

2.1 Operating leases

As stated in HKAS 17, **rentals** under an operating lease should be charged as an expense over the period of the lease on a **straight line basis**. This is so even if unequal lease payments are made, unless another systematic and rational basis is justified by the circumstances.

Example: Operating lease

Flora Co. entered an operating lease agreement in order to obtain use of a photocopier for a period of three years starting on 1 October 20X9. The terms of the lease stated that payment of $2,500 should be made annually in arrears for each of the three years of the lease in addition to an initial non-refundable deposit of $1,500.

What expense is recognised in Flora Co.'s financial statements for the year ended 31 December 20X9?

Solution

Total amount payable	$1,500 + (3 × $2,500)	=	$9,000
Annual expense	$9,000/3 years	=	$3,000
Expense for y/e 31 Dec 20X9	$3,000 × 3/12	=	$750

2.1.1 HK(SIC) Int-15 *Operating Leases – Incentives*

In negotiating a new or renewed operating lease, the lessor may provide incentives for the lessee to enter into the agreement. Examples include an up-front cash payment to the lessee. The question arises as to how incentives in an operating lease should be recognised in the financial statements of both the lessee and the lessor.

HK(SIC) Int-15 provides that all incentives for the agreement of a new or renewed operating lease should be recognised as an integral part of the net consideration agreed for the use of the leased asset, irrespective of the incentive's nature or the form or the timing of payments.

The lessee should recognise the aggregate benefit of incentives as a reduction of rental expense over the lease term, generally on a straight line basis.

Costs incurred by the lessee, including costs in connection with a pre-existing lease should be accounted for in accordance with the relevant HKAS.

Example: Operating lease incentives

Fauna Co. enters into an operating lease agreement on 1 August 20X8 in order to obtain use of a machine. The lease term is four years and $5,000 is payable annually in advance. As an incentive, the lessor has agreed a reduction of 40% off the first year's rental payment.

What expense is recorded by Fauna Co. in the year ended 31 December 20X8 in respect of this agreement?

Solution

Total amount payable	($5,000 × 4) – $2,000	=	$18,000
Annual expense	$18,000/4 years	=	$4,500
Expense for y/e 31 Dec 20X8	$4,500 × 5/12	=	$1,875

HKAS 17.35

2.1.2 Lessees' disclosures for operating leases

Disclosures of the following, which are in addition to the requirements under HKFRS 7 (see Chapter 18), are required:

- The total of **future minimum lease payments** under non-cancellable operating leases for each of the following periods:
  - Not later than one year
  - Later than one year and not later than five years
  - Later than five years.
- The total of **future minimum sublease payments** expected to be received under non-cancellable subleases at the end of the reporting period.
- Lease and sublease payments **recognised** as an expense for the period, with separate amounts for minimum lease payments, contingent rents, and sublease payments.

- A **general description** of the lessee's significant leasing arrangements including, but not limited to, the following:
  - Basis on which contingent rent payments are determined
  - Existence and terms of renewal or purchase options and escalation clauses

Restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

2.2 Finance leases

From the lessee's point of view there are two main **accounting problems**:

(a) Whether the asset should be **capitalised** as if it had been purchased.
(b) How the **lease charges** should be allocated between different accounting periods.

HKAS 17.20,25,27, 28

2.2.1 Accounting treatment

HKAS 17 requires that a finance lease is accounted for as follows:

1 **An asset and corresponding liability are recorded**

At the inception of the lease an asset and corresponding liability are recorded at the **lower of** the **fair value** of the leased asset and the **present value of the minimum lease payments**.

Note that HKAS 17 uses the term "fair value" in a way that differs from the definition of fair value in HKFRS 13 *Fair Value Measurement*. Therefore, in respect of leases fair value should be measured in accordance with HKAS 17 rather than HKFRS 13.

The interest rate implicit in the lease is used to determine the present value of the minimum lease payments. If it is not practical to determine this rate then the lessee's incremental borrowing rate may be used.

Any initial direct costs of the lessee are added to the amount recognised as an asset. These may be incurred in connection with securing or negotiating the lease, but should only include costs which are directly attributable to activities performed by the lessee to obtain the finance lease.

2 **The asset is depreciated**

The asset held under the finance lease is depreciated over the shorter of the lease term and the useful life of the asset.

If there is a reasonable certainty that the lessee will obtain ownership at the end of the lease, the asset should be depreciated over the asset's useful life. The policy of depreciation adopted should be **consistent** with similar non-leased assets and calculations should follow the bases set out in HKAS 16 (see Chapter 5).

HKAS 17 (revised) introduced guidance on **impairment** of leased assets by referring to HKAS 36.

3 **Lease payments are recorded**

Minimum lease payments should be split into the finance charge under the finance lease and a reduction of the outstanding obligation for future amounts payable.

The finance charge allocated to the accounting periods should produce a **constant periodic rate of interest** on the outstanding balance of the lease obligation for each accounting period, or a reasonable approximation thereto.

The normal method applied in order to achieve this is the **actuarial method,** discussed in the next section. An alternative method is the sum of digits method, however this is not examinable.

Contingent rents should be charged in the periods in which they are incurred.

2.2.2 Actuarial method

The **actuarial method**, which is the best and most scientific method for interest allocation, is derived from the assumption that interest charged by the lessor will be the same as the lessor's desired rate of return, multiplied by its capital investment.

(a) The capital investment is identical to the fair value of the asset (less any initial deposit paid by the lessee) at the commencement of the lease.

(b) The amount of capital invested reduces as each instalment is paid. The interest on the lease decreases gradually as capital is repaid. It follows that the interest accruing is greatest in the early part of the lease term. We will go through a simple example of the actuarial method in this section.

Example: Finance lease with payments in arrears

On 1 January 20X0, Gordon Co. leased an asset with a fair value of $38 million and a useful life of five years. The lease term was five years and the interest rate implicit in the lease was 9.9%. The company is required to make five annual instalments of $10 million on 31 December, with the first payment on 31 December 20X0.

Show the lease obligation working for each year of the lease and identify amounts to be recognised in profit or loss in 20X0.

Solution

Interest is calculated as 9.9% of the outstanding *capital* balance at the beginning of each year. The outstanding capital balance reduces each year by the capital element comprised in each instalment. The outstanding capital balance at 1 January 20X0 is the $38 million fair value at which both the asset and liability are initially recorded. Depreciation on the plant is to be provided for at the rate of 20% per annum on a straight line basis assuming a residual value of nil.

Year	*Balance of lease at 1 Jan*	*Interest 9.9%*	*Annual lease payment at 31 Dec*	*Balance of lease at 31 Dec*
	$'000	$'000	$'000	$'000
20X0	38,000	3,762	(10,000)	31,762
20X1	31,762	3,144	(10,000)	24,906
20X2	24,906	2,466	(10,000)	17,372
20X3	17,372	1,720	(10,000)	9,092
20X4	9,092	908	(10,000)	-

Amounts to be included in profit or loss in 20X0 are:	$m
Depreciation (38m/5 years)	7.600
Finance cost	3.762

Note that the $10m lease payment in 20X0 includes payment of the $3.762m interest for the year plus a capital amount of $6.238m.

Example: Finance lease with deposit and payments in arrears

On 1 January 20X5 Jennifer Co. acquired a machine from Alice Co. under a finance lease. The cash price of the machine was $7,710 while the minimum payments in the lease agreement totalled $10,000. The agreement required the immediate payment of a $2,000 deposit with the balance being settled in four equal annual instalments commencing on 31 December 20X5. The finance charge of $2,290 represents interest of 15% per annum, calculated on the remaining balance of the liability during each accounting period.

Required

Show the breakdown of each instalment between interest and capital, using the actuarial method.

Solution

Interest is calculated as 15% of the outstanding *capital* balance at the beginning of each year. The outstanding capital balance reduces each year by the capital element comprised in each instalment. The outstanding capital balance at 1 January 20X5 is $5,710 ($7,710 fair value less $2,000 deposit).

Year	*Capital at 1 Jan*	*Interest 15%*	*Instalment*	*Capital at 31 Dec*
	$	$	$	$
20X5	5,710	856	2,000	4,566
20X6	4,566	685	2,000	3,251
20X7	3,251	488	2,000	1,739
20X8	1,739	261	2,000	–
		2,290	8,000	

In the above examples, repayments are made at the end of each reporting period i.e. in arrears. It may be that repayments are made at the start of a reporting period, i.e. in advance, and in this case the lease obligation table takes a slightly different format. The following example illustrates this.

Example: Finance lease with payments in advance

Jesmond acquired an asset by way of a five-year term finance lease on 1 July 20X0. The asset had a fair value of $102,500 and a useful life of five years and the lease contract required five equal payments in advance of $25,000 each. The interest rate implicit in the lease is 11%. Jesmond's year end is 30 June.

Draw up the lease liability table for Jesmond for the whole five-year period, identifying amounts for inclusion in the statement of profit or loss for the year ended 30 June 20X1.

Solution

	B/f	*Repayment*	*C/f*	*Interest at 11%*	*C/f*
	$	$	$	$	$
30.6.X1	102,500	(25,000)	77,500	8,525	86,025
30.6.X2	86,025	(25,000)	61,025	6,713	67,738
30.6.X3	67,738	(25,000)	42,738	4,701	47,439
30.6.X4	47,439	(25,000)	22,439	2,468	24,907
30.6.X5	24,907	(25,000)*			

* There is a rounding difference of $93.

STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 30 JUNE 20X1	$
Depreciation ($102,500/5 years)	20,500
Finance cost	8,525

Note that in this example, interest is calculated *after* the repayment ie it is based on the amount owed throughout a period. Therefore, the table includes items in a different order to that seen previously.

2.2.3 Finance leases with different payment schedules

In the examples above, all finance leases agreements have involved one annual payment. In some cases, payments are required monthly or quarterly. Where this is the case, the working should be drawn up as we have seen, with one row representing each payment period. Therefore, where there are quarterly repayments, the table will include four rows for each accounting year:

	B/f	*Interest 7%*	*Repayment*	*C/f*
31.3.X1	119,400	8,358	(20,000)	107,758
30.6.X1	107,758	7,543	(20,000)	95,301
30.9.X1	95,301	6,671	(20,000)	81,972
31.12.X1	81,972	5,738	(20,000)	**67,710**
		28,310		
		Finance charge		Year end liability

HKAS 17.31

2.2.4 Lessees' disclosure for finance leases

HKAS 17 states that it is not appropriate to show liabilities for leased assets as deductions from the leased assets and therefore these amounts should not be netted off.

In addition, a distinction should be made between **current and non-current** lease liabilities, if the entity makes this distinction for other liabilities.

HKAS 17 also requires substantial disclosures to be provided in the notes to the accounts (in addition to those required by HKFRS 7: see Chapter 18), including the following:

(a) The **net carrying amount** at the end of the reporting period for each class of asset.

(b) A **reconciliation** between the total of minimum lease payments at the end of the reporting period, and their present value. In addition, an entity should disclose the total of minimum lease payments at the end of the reporting period, and their present value, for each of the following periods:

  (i) Not later than one year
  (ii) Later than one year and not later than five years
  (iii) Later than five years.

(c) **Contingent rents** recognised as an expense for the period.

(d) Total of **future minimum sublease payments** expected to be received under non-cancellable subleases at the end of the reporting period.

(e) A **general description** of the lessee's significant leasing arrangements including, but not limited to, the following:

  (i) The basis on which contingent rent payments are determined

  (ii) The existence and terms of renewal or purchase options and escalation clauses

  (iii) Restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

Example: Lessee disclosures

These disclosure requirements will be illustrated for Gordon Co. (the first example in section 2.2.2). We will assume that Gordon Co. makes up its accounts to 31 December and uses the actuarial method, as shown in the example above, to apportion finance charges.

Solution

The company's accounts for the first year of the lease, the year ended 31 December 20X0, would include the information given below.

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X0 (EXTRACTS)

	$'000	$'000
Non-current assets		
Assets held under finance leases		
Plant and machinery at cost	38,000	
Less accumulated depreciation ($38,000/5 years)	7,600	
		30,400
Non-current liabilities		
Obligations under finance leases		
(Balance at 31 December 20X1)		24,906
Current liabilities		
Obligations under finance leases (31,762 – 24,906)		6,856

(Note that only the outstanding **capital** element is disclosed under liabilities, i.e. the total of the minimum lease payments with future finance charges separately deducted.)

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X0 (EXTRACT)

	$'000
Interest payable and similar charges	
Interest on finance leases	3,762

Self-test question 1

Potter leases an asset (as lessee) on 1 January 20X1, incurring $20,000 of costs in setting up the agreement. Potter agrees to pay a non-refundable deposit of $58,000 on inception together with six annual instalments of $160,000, payable in arrears.

Potter also guaranteed to the lessor that the lessor would receive at least $80,000 when the asset is sold in the general market at the end of the lease term.

The fair value of the asset (equivalent to the present value of minimum lease payments) on 1 January 20X1 is $800,000. Its useful life to the company is five years.

The interest rate implicit in the lease has been calculated as 10%.

Required

(a) Prepare the relevant extracts from the financial statements of Potter in respect of the above lease for the year ended 31 December 20X1.

(b) Explain what would happen at the end of the lease if the asset could be sold by the lessor:

(i) For $80,000
(ii) For only $60,000

(The answer is at the end of the chapter)

2.2.5 Arguments against capitalisation

The main argument in favour of capitalisation of assets acquired under a finance lease is substance over form. The substance of the arrangement is that the lessee owns the asset, since the risks and rewards of ownership have transferred to them and they in effect pay for the asset by way of a financing arrangement.

The main arguments **against** capitalisation are as follows:

(a) **Legal position**. The benefit of a lease to a lessee is an intangible asset, not the ownership of the equipment. It may be misleading to users of accounts to capitalise the equipment when a lease is legally quite different from a loan used to purchase the equipment.

Capitalising leases also raises the question of whether other executory contracts should be treated similarly, for example contracts of employment.

(b) **Complexity**. Many small businesses will find that they do not have the expertise necessary for carrying out the calculations required for capitalisation.

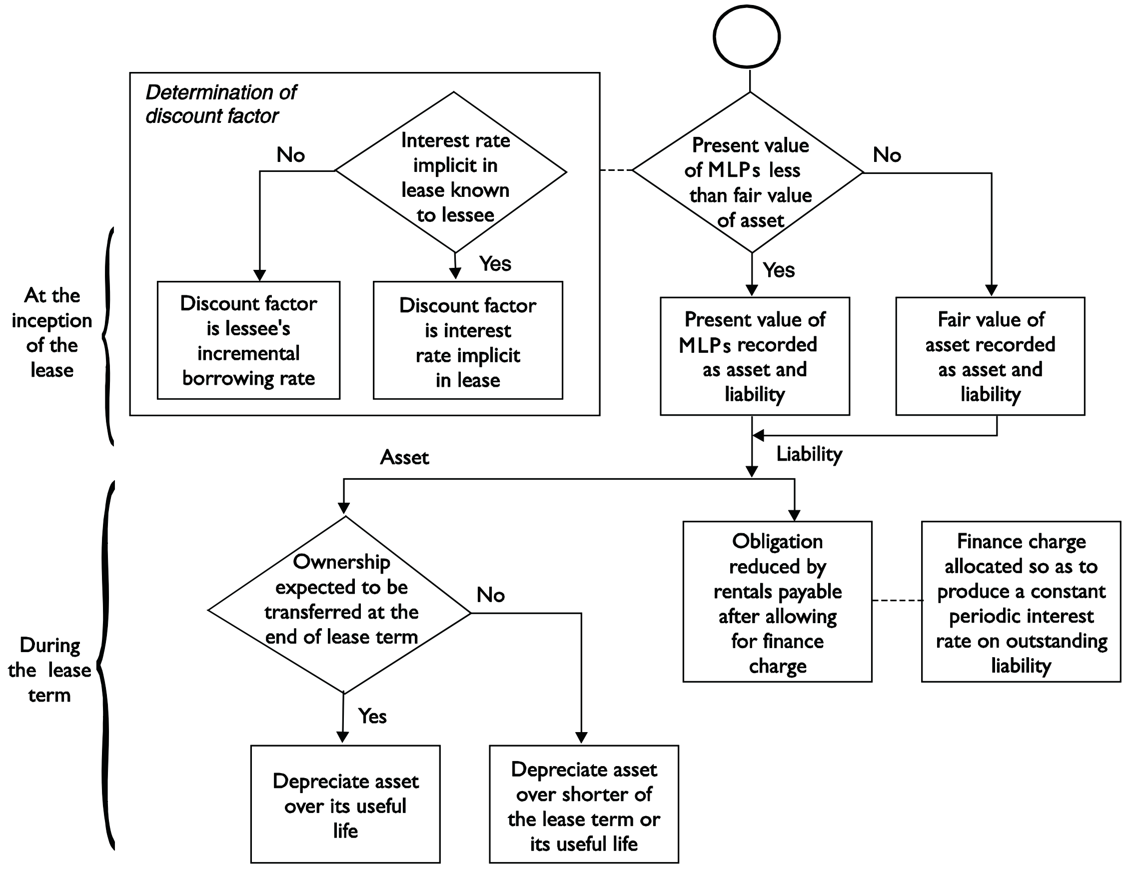
(c) **Subjectivity**. To some extent, capitalisation is a somewhat arbitrary process and this may lead to a lack of consistency between companies.

(d) **Presentation**. The impact of leasing can be more usefully described in the notes to financial statements. These can be made readily comprehensible to users who may not understand the underlying calculations.

2.3 Recap

The following diagram gives a useful summary of the **accounting treatment for a finance lease by a lessee**.

Accounting for a finance lease by a lessee



MLPs = Minimum lease payments

3 Lessor accounting

Topic highlights

Lessor accounting:

- **Operating leases**: record as long-term asset and depreciate over useful life, record income on a straight line basis over the lease term.
- **Finance leases**: record the amount due from the lessee in the statement of financial position at the net investment in the lease, recognise finance income to give a constant periodic rate of return.

To a certain extent at least, the accounting treatment of leases adopted by lessors will be a **mirror image** of that used by lessees.

HKAS 17.49-53

3.1 Operating leases

3.1.1 Accounting treatment

Statement of financial position

An **asset** held by a lessor under an operating lease is treated as a long-term asset and depreciation is recorded over its useful life. The depreciation basis should be the same as the lessor's policy on similar non-lease assets which shall follow the guidance in HKAS 16.

In determining whether there is an impairment of the leased asset, the lessor should refer to the issues discussed in HKAS 36.

Statement of profit or loss and other comprehensive income

Income under an operating lease, excluding charges for services such as insurance and maintenance, should be recognised over the period of the lease on **a straight line basis**. This is so even if the receipts are not on such a basis, unless another systematic and rational basis is identified as more representative of the time pattern in which the benefit from the leased asset is receivable.

In accordance with HK(SIC)Int-15 *Operating Leases – Incentives* (see section 2.1.1), the lessor should recognise the aggregate cost of incentives as a reduction of rental income over the lease term, generally on a straight line basis.

Initial direct costs incurred by lessors in negotiating and arranging an operating lease should be capitalised and amortised over the lease term. These costs are included in the **carrying amount** of the leased asset and recognised as an expense over the lease term on the same basis as lease income.

HKAS 17.56

3.1.2 Lessors' disclosures for operating leases

The following should be disclosed (on top of HKFRS 7 requirements).

- For each class of asset, the **gross carrying amount**, the accumulated depreciation and accumulated impairment losses at the end of the reporting period:
  - Depreciation recognised in income for the period
  - Impairment losses recognised in income for the period
  - Impairment losses reversed in income for the period.
- The **future minimum lease payments** under non-cancellable operating leases in the aggregate and for each of the following periods:
  - Not later than one year
  - Later than one year and not later than five years

  – Later than five years.

- Total **contingent rents** recognised in income.
- A **general description** of the lessor's leasing arrangements.

3.2 Finance leases

Some of the definitions listed in the Key terms in section 1 of this chapter are relevant to lessor accounting and you should review them again.

- Unguaranteed residual value
- Gross investment in the lease
- Unearned finance income
- Net investment in the lease

HKAS 17.36,38-41

3.2.1 Accounting treatment

According to HKAS 17, the **amount due from the lessee** under a finance lease is to be shown as a receivable, at an amount of the **net investment in the lease**, in the statement of financial position of the lessor.

The finance income under a finance lease should be recognised so as to generate a **constant periodic rate of return** on the lessor's outstanding net investment in each period. A reasonable approximation may be made to arrive at the constant periodic rate of return.

The lease payments (excluding costs for services) for the accounting period should be applied against the gross investment in the lease. This will result in **reducing both the principal and the unearned finance income**.

Regular review should be carried out on the **estimated unguaranteed residual values** used to calculate the lessor's gross investment in a lease. If there has been a reduction in the value, the income allocation over the lease term must be revised. Immediate recognition is required for any reduction in respect of amounts already accrued.

The initial amount of the finance lease receivable should include the **initial direct costs** incurred by lessors (e.g. commissions, legal fees and other costs that are directly attributable to negotiating and arranging a lease).

Example: Finance leases: lessor accounting

Hire Co. leased an asset to another company with effect from 1 January 20X8. The terms of the lease were as follows:

- Lease term of eight years
- Rentals of $11,000 are payable in advance
- The interest rate implicit in the lease is 12.8%

The fair value of the asset on 1 January 20X8 was $59,500 and legal fees associated with the lease amounting to $500 were payable by Hire Co. on this date.

What amounts are recognised in Hire Co.'s financial statements for the year ended 31 December 20X8 in respect of the lease?

Solution

The net investment in the lease is calculated as:

	$
Amount due from lessee (fair value of the asset)	59,500
Direct costs	500
	60,000

This net investment reduces over the period of the lease due to payments received; it will also increase due to interest receivable. In other words, the movement is the direct opposite of the movement seen in the finance lease obligation of a lessee:

	$
Balance 1 January 20X8	60,000
Instalment 1 January 20X8	(11,000)
Balance c/f	49,000
Interest at 12.8%	6,272
Balance at 31 December 20X8	55,272
Instalment 1 January 20X9	(11,000)
Balance c/f	44,272

Therefore, in the statement of financial position of Hire Co., a current and non-current asset is recognised.

Non-current asset: Net investment in finance lease	$44,272
Current asset: Net investment in finance lease (55,272 – 44,272)	$11,000

Interest receivable of $6,272 is recognised in the statement of profit or loss and other comprehensive income.

HKAS 17.42-46

3.3 Manufacturer or dealer lessors

In some instances, manufacturers lease out assets which they have made, rather than sell them. Similarly, dealers acquire assets for resale but in some circumstances may instead lease these out to third parties.

Unlike normal lessor companies which buy assets at their fair value and in leasing them out make a profit only on the financing arrangements, these companies acquire the asset in the first place for less than fair value:

- Manufacturers acquire the asset for cost
- Dealers generally acquire the asset at a discount

Therefore, the manufacturer or dealer makes two types of income:

1 A profit or loss (being the difference between the cost /reduced price and fair value), and
2 Interest from financing arrangements.

HKAS 17 therefore requires the following accounting treatment:

(a) The **selling profit/loss** is recognised in income for the period as if it was an outright sale. For this purpose:

– revenue is the lower of the fair value of the asset or the present value of the minimum lease payments calculated using a market rate of interest

– cost of sales is the cost (or carrying amount if different) of the asset less the present value of any unguaranteed residual value.

(b) If **interest rates are artificially low**, the selling profit is restricted to that which would apply had a commercial rate been applied.

(c) **Costs** incurred in connection with negotiating and arranging a lease are recognised as an **expense** when the **selling profit** is recognised (at the start of the lease term).

HKAS 17.55

3.3.1 Manufacturers or dealers and operating leases

A lessor who is a **manufacturer or dealer** should not recognise any selling profit on entering into an operating lease because it is not the equivalent of a sale. The manufacturer or dealer has retained the assets with a view to using them to generate rental income.

HKAS 17.47

3.4 Lessors' disclosures for finance leases

The following should be disclosed (in addition to the requirements of HKFRS 7):

(a) A **reconciliation** between the total gross investment in the lease at the end of the reporting period, and the present value of minimum lease payments receivable at the end of the reporting period. In addition, an entity should disclose the total gross investment in the lease and the present value of minimum lease payments receivable at the end of the reporting period, for each of the following periods:

 (i) Not later than one year
 (ii) Later than one year and not later than five years
 (iii) Later than five years.

(b) Unearned finance income.

(c) The unguaranteed residual values accruing to the benefit of the lessor.

(d) The accumulated allowance for uncollectible minimum lease payments receivable.

(e) Contingent rents recognised in income in the period.

(f) A general description of the lessor's material leasing arrangements.

4 Sale and leaseback transactions

HKAS 17.58-65

In a sale and leaseback transaction, an asset is sold and then **leased back** by the same seller. The lease payment and sale price are normally linked because they are part of the same package in the negotiation. The type of lease involved determines the accounting treatment for the lessee and the seller.

(a) In a sale and leaseback transaction which results in a **finance lease**, any apparent profit or loss (that is, the difference between the sale price and the previous carrying amount) should be deferred and amortised in the financial statements of the seller/lessee over the lease term. It should not be recognised as income immediately since, in substance, there has been no genuine sale.

(b) If the leaseback is an **operating lease**:

 (i) Any profit or loss should be recognised immediately, provided it is clear that the transaction is established at a **fair value**.

 (ii) Where the **sale price is below fair value**, any profit or loss should be recognised immediately except that if the apparent loss is compensated by future lease payments at below market price it should to that extent be deferred and amortised over the period for which the asset is expected to be used.

 (iii) If the **sale price is above fair value**, the excess over fair value should be deferred and amortised over the period over which the asset is expected to be used.

Immediate recognition of the loss (carrying value less fair value) is required where the fair value of the asset at the time of the sale is less than the carrying amount in an operating lease.

A sale and leaseback should be accounted in the **same way as other leases** by the buyer or lessor.

If the disclosure requirements of both the lessees and lessors are followed, it should result in satisfactory disclosure of sale and leaseback transactions.

Example: Sale and finance leaseback

Osborne Co. owned an asset with a carrying amount of $840,000 on 1 March 20X8. On this date Osborne Co. sold the asset to a bank for $1,320,000, being the present value of the minimum lease payments, and then undertook to lease it back under a 40-year finance lease.

The annual rental is $39,000 payable in advance.

End of reporting period for Osborne Co. is 28 February.

Required

How should the transaction be accounted for by Osborne Co.?

Solution

At the date of sale/inception of the lease

		$	$
On the sale of the asset:			
DEBIT	Cash	1,320,000	
CREDIT	Asset		840,000
	Deferred income		480,000
On the lease back of the asset:			
DEBIT	Asset	1,320,000	
CREDIT	Finance lease obligation		1,320,000
On the payment of the first instalment:			
DEBIT	Finance lease obligation	39,000	
CREDIT	Cash		39,000

Amounts charged to the statement of profit or loss and other comprehensive income for the year ended 28 February 20X9 will include:

- depreciation of the asset ($1,320,000/40 years) $33,000
- a release of the deferred income ($480,000/40 years) $12,000
- interest accrued on the lease at the implicit rate

Example: Sale and operating leaseback

On 1 January 20X2 Cable Co. owned an asset with a carrying amount of $80,000. The fair value of the asset on that date was $90,000.

In order to improve its liquidity position, Cable Co. has negotiated possible agreements to sell the asset and lease it back under an operating lease for seven years. The financial controller is currently assessing the four agreements.

The agreements are as follows:

Agreement 1	Sale for $90,000 with annual future lease payments at a market rate of $15,000
Agreement 2	Sale for $75,000 with annual future lease payments of $15,000
Agreement 3	Sale for $50,000 with annual future lease payments of $10,000
Agreement 4	Sale for $110,000 with annual future lease payments of $17,500

How would each of these agreements be accounted for in Cable Co.'s financial statements?

Solution

Agreement 1 Sale is for fair value and therefore a profit of $10,000 is recognised immediately in profit or loss.

Agreement 2 Sale is for less than fair value however the loss is not compensated for by low future rentals. Therefore, the loss of $5,000 is recognised immediately.

Agreement 3 Sale is for less than fair value and the loss is compensated for by low future rentals. Therefore, the loss of $30,000 is recognised in the statement of financial position and released to profit or loss over the lease term.

Agreement 4 Sale is for more than fair value. Therefore, a profit of $10,000 being the difference between the fair value and carrying amount is recognised in profit or loss immediately and the excess profit of $20,000 is recognised in the statement of financial position and released to profit over the lease term.

5 Off-balance sheet finance explained

Topic highlights

HKAS 17 (revised) has closed many loopholes, but some still argue that it is **open to manipulation**.

Key term

Off-balance sheet finance is the funding or refinancing of a company's operations in such a way that, under legal requirements and traditional accounting conventions, some or all of the finance may not be shown in its statement of financial position.

"Off-balance sheet transactions" are transactions which meet the above objective. These transactions may involve the **removal of assets** from the statement of financial position, as well as liabilities, and they are also likely to have a significant impact on profit or loss.

5.1 Reasons for off-balance sheet finance

Off-balance sheet transactions may be entered into for a number of reasons, including the following:

(a) In some countries, companies traditionally have a lower level of gearing than companies in other countries. Off-balance sheet finance is used to **keep gearing low**, probably because of the views of analysts and brokers.

(b) A company may need to keep its gearing down in order to stay within the terms of **loan covenants** imposed by lenders.

(c) A listed company with high borrowings is often expected (by analysts and others) to declare a **rights issue** in order to reduce gearing. This has an adverse effect on a company's share price and so off-balance sheet financing is used to reduce gearing *and* the expectation of a rights issue.

(d) Analysts' short-term views are a problem for companies **developing assets** which are not producing income during the development stage. Such companies will match the borrowings associated with such developing assets, along with the assets themselves, off-balance sheet. They are brought back into the statement of financial position once income is being generated by the assets. This process keeps return on capital employed higher than it would have been during the development stage.

(e) In the past, groups of companies have excluded **subsidiaries** from consolidation in an off-balance sheet transaction because they carry out completely different types of business and have different characteristics. The usual example is a leasing company (in say a retail group) which has a high level of gearing. This exclusion is now disallowed.

You can see from this brief list of reasons that the overriding motivation is to avoid **misinterpretation**.

In other words, the company does not trust the analysts or other users to understand the reasons for a transaction and so avoids any effect such transactions might have by taking them off-balance sheet. Unfortunately, the position of the company is then misstated and the user of the accounts is misled.

You must understand that not all forms of 'off-balance sheet finance' are undertaken for cosmetic or accounting reasons. Some transactions are carried out to **limit or isolate risk**, to reduce interest costs and so on. In other words, these transactions are in the best interests of the company, not merely a cosmetic repackaging of figures which would normally appear in the statement of financial position.

5.2 The problem with off-balance sheet finance

Due to increasingly sophisticated off-balance sheet finance transactions, the users of financial statements do not always have a proper or clear view of the **state of the company's affairs**. The disclosures required by national company law and accounting standards did not in the past provide sufficient rules for disclosure of off-balance sheet finance transactions and so very little of the true nature of the transaction was exposed.

Whatever the purpose of such transactions, **insufficient disclosure** creates a problem. This problem has been debated over the years by the accountancy profession and other interested parties and some progress has been made (see the later sections of this chapter). However, company collapses during recessions have often revealed much higher borrowings than originally thought, because part of the borrowing was off-balance sheet.

The main argument used for banning off-balance sheet finance is that the true **substance** of the transactions should be shown, not merely the **legal form**, particularly when it is exacerbated by poor disclosure.

6 Interpretations relating to lease accounting

6.1 HK(SIC) Int-27 *Evaluating the Substance of Transactions in the Legal Form of a Lease*

HK(SIC) Int-27 addresses issues that may arise when an arrangement between an entity and an investor involves the **legal form of a lease**. It contains the following provisions:

(a) Accounting for arrangements between an entity and an investor should **reflect the substance of the arrangement**. All aspects of the arrangement should be evaluated to determine its substance, with weight given to those aspects and implications that have an **economic effect**.

In this respect, HK(SIC) Int-27 includes a list of indicators that individually demonstrate that an arrangement may not, in substance, involve a lease under HKAS 17 *Leases*:

(i) An entity retains all of the risks and rewards of ownership of an underlying asset and enjoys substantially the same rights to its use as before the arrangement.

(ii) The primary reason for the arrangement is to achieve a particular tax result.

(iii) An option is included on terms that make its exercise almost certain.

These indicators are particularly relevant in the case of sale and leaseback transactions, where the substance of the transaction may be a secured loan.

(b) If an arrangement **does not meet the definition of a lease**, and is therefore outside the scope of HKAS 17, HK(SIC) Int-27 considers:

(i) whether a separate investment **account** and lease payment obligation that might exist represent assets and liabilities of the entity.

(ii) how the entity should account for other obligations resulting from the arrangement.

(iii) how the entity should account for a fee it might receive from an investor.

HK(SIC) Int-27 includes a list of **indicators** that collectively **demonstrate** that, in substance, a separate investment account and lease payment obligations **do not meet the definitions of an asset and a liability and should not be recognised** by the entity.

Other obligations of an arrangement, including any guarantees provided and obligations incurred upon early termination, should be accounted for under **HKAS 37** or **HKAS 39/HKFRS 9**, depending on the terms. Further, it agreed that the criteria in **HKAS 18.20** should be applied to the facts and circumstances of each arrangement in determining when to recognise a fee as income that an entity might receive.

(c) A series of transactions that involve the legal form of a lease is **linked**, and therefore should be accounted for as **one transaction**, when the overall economic effect cannot be understood without reference to the series of transactions as a whole.

6.2 HK(IFRIC) Int-4 *Determining whether an Arrangement contains a Lease*

6.2.1 The issue

In recent years arrangements have developed that do not take the legal form of a lease but which convey rights to use assets in return for a payment or series of payments. Examples of such arrangements include the following:

(a) Outsourcing arrangements.

(b) Telecommunication contracts that provide rights to capacity.

(c) Take-or-pay and similar contracts, in which purchasers must make specified payments regardless of whether they take delivery of the contracted products or services.

6.2.2 HK(IFRIC) Int-4 treatment

The Interpretation specifies that an arrangement that meets the following **criteria** is, or contains, a lease that should be **accounted for in accordance with HKAS 17 *Leases***:

(a) **Fulfilment of the arrangement depends upon a specific asset**. The asset need not be explicitly identified by the contractual provisions of the arrangement. Rather, it may be implicitly specified because it is not economically feasible or practical for the supplier to fulfil the arrangement by providing use of alternative assets.

(b) The arrangement conveys a **right to control the use of the underlying asset**. This is the case if any of the following conditions are met:

(i) The purchaser in the arrangement has the **ability or right to operate the asset** or direct others to operate the asset (while obtaining more than an insignificant amount of the output of the asset).

(ii) The purchaser has the **ability or right to control physical access to the asset** (while obtaining more than an insignificant amount of the output of the asset).

(iii) There is only a remote possibility that parties other than the purchaser will take more than an insignificant amount of the output of the asset and the price that the purchaser will pay is neither fixed per unit of output nor equal to the current market price at the time of delivery.

6.3 HK-Int 4 *Lease – Determination of the Length of Lease Term in respect of Hong Kong Land Leases*

6.3.1 The issue

This Interpretation addresses the issue of how the length of the lease term of a Hong Kong land lease should be determined for the purpose of applying the amortisation (depreciation) requirements under HKAS 16 and HKAS 17, as appropriate.

6.3.2 HK-Int 4 treatment

The lease term of a Hong Kong land lease for the purpose of applying the amortisation (depreciation) requirements under HKAS 16 and HKAS 17, as appropriate, shall be determined by reference to the legal form and status of the lease. Renewal of a lease is assumed only when the lessee has a renewal option and it is reasonably certain at the inception of the lease that the lessee will exercise the option. Options for extending the lease term that are not at the discretion of the lessee shall not be taken into account by the lessee in determining the lease term.

Consequently, lessees shall not assume that the lease term of a Hong Kong land lease will be extended for a further 50 years, or any other period, while the HKSAR Government retains the sole discretion as to whether to renew. Any general intention to renew certain types of property leases expressed by the HKSAR Government is not sufficient grounds for a lessee to include such extensions in the determination of the lease term for amortisation (depreciation).

Similarly, for the leases in the New Territories expiring shortly before 30 June 2047, the legal limit in these leases shall be assumed to be the maximum lease term.

For those leases which extend beyond 30 June 2047 (e.g. those with an original lease term of 999 years), lessees shall assume that any legal rights under the leases that extend the lease term to beyond 30 June 2047 will be protected for the full duration of the lease in the absence of any indication to the contrary.

7 Current developments

In August 2010, the IASB and American standards board, FASB, issued an Exposure Draft of a new standard which is intended to replace IAS 17. It is highly likely that such a new standard will in turn be adopted by the HKICPA and so replace HKAS 17.

The Exposure Draft proposes that there is no distinction between operating and finance leases, and instead all leases are accounted for in the same way. A "right of use" approach is suggested for both lessees and lessors; this would result in the recognition of a liability for payments and an asset, being the right to use the underlying asset.

The IASB intends to re-expose the topic of leases during the course of 2013 and as yet there is no target date for the issue of a new IFRS, and hence HKFRS.

Topic recap

HKAS 17 Leases

Lease – contract for the hire of a specific asset

Finance lease

A lease that transfers substantially all of the risks and rewards incidental to ownership of an asset. Legal title may or may not pass at the end of the lease term

Lessee accounting

Record asset and corresponding liability at lower of fair value and PV of minimum lease payments.

Depreciate asset over shorter of lease term and UL of asset.

Allocate finance charge to give constant periodic rate of return (actuarial method).

Lessor accounting

Record amount due from lessee at net investment in lease.

Recognise finance income to give constant periodic rate of return.

Manufacturers / dealers recognise the difference between cost of the asset and fair value as an outright sale.

Operating lease

A lease other than a finance lease

Lessee accounting

Recognise rental expenditure on a straight line basis.

Lessor accounting

Recognise non-current asset and depreciate.

Record income on a straight line basis over the lease term.

Sale and finance leaseback

- Profit or loss deferred and amortised over the lease term
- If substance is a secured loan record proceeds as a financial liability (HK(SIC)Int 27)

Sale and operating leaseback

Sale at FV	Recognise profit/loss immediately
Sale > FV	Defer excess profit
Sale < FV	Recognise profit/loss immediately but defer any loss where compensated for by low future lease payments

Answer to self-test question

Answer 1

(a) **Financial statement extracts**

STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 DECEMBER 20X1

	$
Depreciation [(800,000 + 20,000 – 80,000)/5)]	148,000
Finance costs (Working)	74,200

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X1 (EXTRACT)

	$
Non-current assets	
Leased asset [(800,000 + 20,000) – 148,000]	672,000
Non-current liabilities	
Finance lease liability – over one year (Working)	561,820
Current liabilities	
Finance lease liability – within one year (Working) (656,200 – 561,820)	94,380

WORKING

	Bal b/f	*Interest accrued at 10%*	*Payment 31 Dec*	*Bal c/f 31 Dec*
	$	$	$	$
	800,000			
	(58,000)			
20X1	742,000	74,200	(160,000)	656,200
20X2	656,200	65,620	(160,000)	561,820

(b) **Treatment of guaranteed residual value**

At the end of the lease, the lessee will have an asset at residual value of $80,000 in its statement of financial position and a finance lease liability of $80,000 representing the residual value guaranteed to the lessor.

(i) If the lessor is able to sell the asset for the value guaranteed by the lessee, the lessee has no further liability and derecognises the asset and lease liability:

		$	$
DEBIT	Finance lease liability	80,000	
CREDIT	Leased asset		80,000

(ii) If the lessor is unable to sell the asset for the value guaranteed by the lessee, the lessee has a liability to make up the difference of $80,000 – $60,000 = $20,000:

Recognise impairment loss on asset (as soon as known during the lease term):

		$	$
DEBIT	Profit or loss	20,000	
CREDIT	Leased asset		20,000

Make guaranteed payment to lessor and derecognise the asset and lease liability:

		$	$
DEBIT	Finance lease liability	80,000	
CREDIT	Cash		20,000
	Leased asset		60,000

Exam practice

Thompson Manufacturing Inc. — 27 minutes

On 1 January 20X7, Thompson Manufacturing Inc. (TMI), the lessor, entered into a non-cancellable lease agreement for equipment with Silver Rod Company (SRC), the lessee. The following information pertains to the lease:

Annual lease payment due at the beginning of each year, beginning on 1 January 20X7	$53,069
Option to purchase at the end of lease term	$10,000
Lease term	5 years
Economic useful life of leased equipment	8 years
Lessor's manufacturing cost	$200,000
Fair value of leased equipment at 1 January 20X7	$227,500
Estimated unguaranteed residual value of leased equipment at the end of lease term	$30,000
Lessor's implicit rate	12.93%
Lessee's incremental borrowing rate	10%

Required

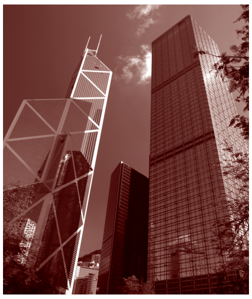
(a) Discuss how the purchase option at the end of the lease term offered by TMI to SRC will affect the classification of this lease by SRC. **(3 marks)**

(b) Prepare an amortisation schedule that would be suitable for TMI for the lease term. **(5 marks)**

(c) Prepare all the journal entries that TMI should make for each of the years ended 31 December 20X7 and 20X8. **(7 marks)**

(Total = 15 marks)

HKICPA September 2008 (amended)



chapter 10

Inventories

Topic list

Learning focus

Inventory and short-term work-in-progress valuation has a direct impact on a company's gross profit and it is usually a material item in any company's accounts. This is therefore an important subject area as far as the statement of profit or loss is concerned as there are different accounting treatments for inventories.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
Account for transactions in accordance with Hong Kong Financial Reporting Standards		
3.06	**Inventories**	3
3.06.01	Scope and definition of HKAS 2 *Inventories*	
3.06.02	Calculate the cost of inventories in accordance with HKAS 2	
3.06.03	Use accepted methods of assigning costs including the allocation of overheads to inventories	
3.06.04	Explain the potential impact of net realisable value falling below cost and make the required adjustments	
3.06.05	Calculate and analyse variances in a standard costing system and advise on the appropriate accounting treatment to be adopted in respect of inventories	
3.06.06	Prepare a relevant accounting policy note and other required disclosures in respect of inventories	

1 Accounting for inventories

Topic highlights

Inventory is measured at the lower of cost and net realisable value.

The inventory balance is significant to many companies both as an asset and due to its impact on profits. The measurement of inventory, however, remains a highly subjective area and a number of different methods may be used in practice.

HKAS 2 provides guidance on the measurement of inventory and its recognition as an expense.

HKAS 2.2,3

1.1 Scope

HKAS 2 applies to all inventories other than:

- work in progress under **construction contracts** (covered by HKAS 11 *Construction Contracts)*
- **financial instruments** (covered by HKFRS 9 *Financial Instruments)*
- **biological assets** (covered by HKAS 41)

The standard does not apply to the measurement of inventories held by:

- producers of **agricultural and forest products**
- **commodity-broker traders**

HKAS 2.6,8

1.2 Definitions

The standard provides the following definitions:

Key terms

Inventories are assets:

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

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

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (*HKAS 2*)

The definition of inventories in effect refers to:

- finished goods, being those held for sale
- work in progress (WIP), being those in the process of production, and
- raw materials, being those supplies to be consumed in the production process.

HKAS 2.9

1.3 Measurement of inventories

The standard states that "Inventories shall be measured at the lower of cost and net realisable value."

These terms are explained in more detail in sections 1.4 and 1.7 of the chapter.

HKAS 2.10

1.4 Cost of inventories

Topic highlights

Cost includes all costs of purchase, costs of conversion and other costs incurred in bringing inventories to their present condition and location.

The cost of inventories includes all:

- costs of p**urchase**
- costs of **conversion**
- **other costs** incurred

Each of these types of cost is covered in turn below.

HKAS 2.11

1.4.1 Costs of purchase

HKAS 2 states that the costs of purchase may include all of:

- **purchase price**
- **import duties** and other irrecoverable taxes
- transport, handling and any other cost **directly attributable** to the acquisition of finished goods, services and materials

Costs of purchase should be net of trade discounts, rebates and other similar amounts when measuring inventory.

HKAS 2.12-14

1.4.2 Costs of conversion

Costs of conversion of inventories includes:

(a) costs **directly related** to the units of production, e.g. direct materials, direct labour.

(b) a systematic allocation of fixed and variable **production overheads** that are incurred in converting materials into finished goods.

Key terms

Fixed production overheads are defined by the standard as those indirect costs of production that remain relatively constant regardless of the volume of production such as depreciation and maintenance of factory buildings and equipment and the cost of factory management and administration.

Variable production overheads are defined as those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials and labour.

Key terms (cont'd)

Fixed production overheads must be allocated to items of inventory on the basis of the normal capacity of the production facilities. Normal capacity is the expected achievable production based on the average over several periods/seasons, under normal circumstances, and taking into account the capacity lost through planned maintenance. The standard makes the following additional points:

- If it approximates to the normal level of activity then the standard states that the **actual level of production** can be used.
- **Low production** or **idle plant** will *not* result in a higher fixed overhead allocation to each unit.
- **Unallocated overheads** must be recognised as an expense in the period in which they were incurred.
- In periods of abnormally high production, the fixed production overhead allocated to each unit will be decreased, so that inventories are not measured at more than cost.
- Variable production overheads are allocated to each unit on the basis of the **actual use** of production facilities.

When a production process results in the simultaneous production of more than one product, and the costs of conversion are not separately identifiable, they should be allocated between products on a rational and consistent basis. An example of an appropriate basis given in the standard is the sales value of each product when complete.

HKAS 2.15-17

1.4.3 Other costs

Other costs are included in the cost of inventories if they are incurred in bringing the inventories to their **present location and condition**. Examples of such costs are non-production overheads and the costs of designing products for specific customers. In limited circumstances, as identified by HKAS 23, borrowing costs are also included in the cost of inventories.

The standard lists types of cost which **would not be included** in cost of inventories but should be recognised as an **expense** in the period they are incurred:

(a) **Abnormal amounts** of wasted materials, labour or other production costs.

(b) **Storage costs** (except costs which are necessary in the production process before a further production stage).

(c) **Administrative overheads** not incurred to bring inventories to their present location and conditions.

(d) **Selling costs**.

Example: Cost of inventory

Highdef Co. manufactures component parts used in the production of televisions. The following details are relevant to a production run in August 20X4:

Cost of raw materials per unit	$85 after 15% trade discount
Import duty (raw materials)	5%
Labour costs per unit	$25
Production overheads	$400,000
Expected (normal) output	50,000 units
Actual output	40,000 units

The cost of each unit is therefore calculated as:

	$
Direct materials	85.00
Import duty (5% × $85)	4.25
Direct labour	25.00
Overheads allocation ($400,000/50,000)	8.00
Cost	122.25

HKAS 2.19

1.4.4 Cost of inventory of a service provider

Service providers sometimes have inventory, for example the work in progress of a lawyer. This work in progress should be measured at cost i.e. the costs of labour and attributable overheads, excluding any profit margin.

Labour and costs relating to sales and general administrative personnel and non-attributable overheads are not included in the cost of work in progress. They are expensed as incurred.

HKAS 2.21,22

1.5 Techniques for the measurement of cost

HKAS 2 allows that techniques for the measurement of cost may be used for convenience where these approximate to cost. The two methods mentioned within the standard are as follows:

(a) **Standard costs**, which take into account normal levels of raw materials used, labour time and so on. They are reviewed and revised on a regular basis.

(b) The **retail method**, which is often used in the retail industry where there are large numbers of items with a rapid turnover and similar margins. Here, the only practical method of inventory valuation may be to take the total selling price of inventories and deduct an overall average profit margin, thus reducing the value to an approximation of cost. The percentage must take into consideration reduced price lines. Sometimes different percentages are applied to different retail departments.

Example: Measurement of cost

Assume that a manufacturing company has a budgeted standard total production cost of $1 per unit for the year, based on a forecasted production of 1,000,000 units. There is no opening inventory and the year end accounts show actual production of 1,000,000 units, closing inventory of 200,000 units and an unfavourable cost variance of $100,000. The analysis shows that $80,000 of the variance comes from a charge in a purchase cost of goods resulting from a foreign currency alignment early in the year and the remaining $20,000 is from a labour strike mid-year.

The $20,000 unfavourable variance from the labour strike is a period cost wholly recognised as an expense since it was not incurred under normal operating conditions.

Unless the exchange movement happened under unusual circumstances, the price variance resulting from exchange difference is regarded as arising under normal operating conditions. To better reflect the cost of goods sold and the cost of closing inventory, the price variance will be allocated between inventories and cost of goods sold based on the closing inventories of $200,000 as a percentage of the total number of units produced. The closing inventories at standard cost of $200,000 are 20% of the actual production, so inventories will be allocated 20% of the $80,000 price variance i.e. $16,000. Cost of goods sold will be charged with the balance of $64,000. Closing inventories will therefore amount to $216,000.

HKAS 2.23,25-27

1.6 Cost formulae

Topic highlights

Where inventory is not interchangeable, cost should be specifically identified. Where inventories consist of interchangeable items, cost is assigned using the First in, First out (FIFO) or weighted average formula.

Where items of inventory are not normally interchangeable or goods or services are produced and segregated for specific projects, the cost of inventories should be specifically identified.

Where inventories consist of a number of interchangeable items, cost is assigned by using the **First In, First Out (FIFO)** or **weighted average** cost formulae. Last In, First Out (LIFO) is **not permitted.**

Under the weighted average cost method, a recalculation can be made after each purchase, **or alternatively only at the period end**.

HKAS 2 requires that an entity should use **the same cost formula for all inventories having similar nature and use to the entity**. For inventories with different nature or use (for example, certain commodities used in one business segment and the same type of commodities used in another business segment), different cost formulae may be justified. A difference in geographical location of inventories (and in the respective tax rules), by itself, is not sufficient to justify the use of different cost formulae.

Example: Inventory valuation (1)

Arneson Co. trades in widgets and has bought and sold the following inventory during the month of September 20X1:

Date		*Volume*	*Cost*
1 September	opening stock	100 units	$2.00 each
3 September	purchase	100 units	$2.30 each
5 September	sale	75 units	
10 September	purchase	50 units	$2.35 each
18 September	sale	80 units	
25 September	purchase	80 units	$2.40 each
29 September	sale	100 units	

What is the value of inventory at 30 September using

(a) FIFO
(b) Weighted average cost (period end)
(c) Weighted average cost (continuous)?

Solution

FIFO

		Sales	
Opening stock	100 × \$2.00	5 September	75 units
		18 September	25 units
3.9 Purchase	100 × \$2.30	18 September	55 units
		29 September	45 units
10.9 Purchase	50 × \$2.35	29 September	50 units
25.9 Purchase	80 × \$2.40	29 September	5 units
		Closing stock	75 units

Sales are matched to the earliest purchases such that closing stock is made up of 75 units purchased on 25 September. Closing stock is therefore measured at \$180 (75 units × \$2.40).

Weighted average (period end)

The weighted average cost of stocks during September is:

100 units × \$2.00	200.00
100 units × \$2.30	230.00
50 units × \$2.35	117.50
<u>80</u> units × \$2.40	<u>192.00</u>
330 units	739.50
	therefore weighted average cost per unit \$2.24

Closing stock is therefore measured at \$168 (75 units × \$2.24)

Weighted average (continuous)

Date	*Purchases*	*Sales*	*Balance*	*Weighted average price*
1.9	100 × \$2		100	\$2
3.9	100 × \$2.30		200	$\frac{(100\times\$2)+(100\times\$2.30)}{100+100}=\$2.15$
5.9		75	125	\$2.15
10.9	50 × \$2.35		175	$\frac{(50\times\$2.35)+(125\times\$2.15)}{50+125}=\$2.21$
18.9		80	95	\$2.21
25.9	80 × \$2.40		175	$\frac{(80\times\$2.40)+(95\times\$2.21)}{80+95}=\$2.30$
29.9		100	75	\$2.30

Therefore, closing stock is measured at \$172.50 (75 units × \$2.30)

HKAS 2.28-33

1.7 Net realisable value (NRV)

Topic highlights

NRV is the estimated selling price of an item of inventory less estimated costs to complete and sell it.

Prudence requires that assets are not overstated. In the case of inventories, this means that they should not be measured at an amount greater than the price that is expected to be realised from their sale.

In some cases the cost of inventory may be greater than the amount for which it can be sold, for example where:

- goods are damaged or obsolete
- the costs to completion have increased
- the selling price has fallen
- the goods are to be sold at a loss as part of a marketing strategy
- production errors have led to increased costs.

In these cases, inventory is carried at the NRV which is less than cost.

Inventory is normally written down on an item by item basis, but sometimes it may be appropriate to group similar or related items **together**. This grouping together is acceptable for, say, items in the same product line, but it is not acceptable to write down inventories based on a whole classification (e.g. finished goods) or a whole business.

The assessment of NRV should be based on the most reliable evidence available and should take place **at the same time** as estimates are made of selling price. Fluctuations of price or cost should be taken into account if they relate directly to **events after the reporting period**, which confirm conditions existing at the end of the period.

The reasons why inventory is held should also be taken into account. For example, where inventory is held to satisfy a firm contract, its NRV will be the **contract price**. Any additional inventory of the same type held at the period end will, in contrast, be assessed according to general sales prices when NRV is estimated.

At each period end, NRV must be reassessed and compared with cost. Where circumstances have changed since the end of the previous period and there is a clear increase in NRV, then the previous write down must be **reversed** to the extent that the inventory is then valued at the lower of cost and the new NRV. This situation may arise when selling prices have fallen in the past and then risen again.

On occasion a write down to NRV may be of such size, incidence or nature that it must be **disclosed separately**.

HKAS 2.34

1.8 Recognition as an expense

An expense related to inventory is recognised in profit or loss in the following circumstances:

(a) When inventories are sold, the carrying amount of those inventories is recognised as an expense.

(b) Any **write down of inventories** to NRV and all losses of inventories are recognised as an expense in the period the write down or loss occurs.

(c) Any **reversal of a previous write down of inventories**, arising from an increase in NRV, is recognised as a reduction in the amount of inventories recognised as an expense in the period in which the reversal occurs.

Example: Inventory valuation (2)

Given Co. has the following categories of inventory:

	Cost	*Selling price*	*Costs to sell*
	$m	$m	$m
Product A	4	6	0.5
Product B	10	11	1.5
Product C	8	12	2
Product D	14	16	3

Required

Determine the amount at which inventory should be valued.

Inventory must be valued line by line rather than as a whole, taking lower of cost and NRV in each case:

	$m
Product A (Cost)	4.0
Product B (NRV)	9.5
Product C (Cost)	8.0
Product D (NRV)	13.0
	34.5

Self-test question 1

Ramsbottom Co. is a manufacturer of components used in the motor industry. It makes two products, XX1 and ZZ2.

Certain parts of the production process give rise to indirect costs specifically identifiable with only one of these products, although other costs are not separately identifiable.

Budgeted cost information for March 20X1 is as follows:

	XX1	*ZZ2*	*Total*
Budgeted output	1,000 units	1,200 units	
	$	$	$
Direct cost	365,000	380,000	745,000
Indirect production overheads			
Identifiable	65,000	55,000	120,000
Other			80,000

During the month, costs were incurred in line with the budget, but due to a failure of calibration to a vital part of the process, only 1,050 units of ZZ2 could be taken into inventory. The remainder produced had to be scrapped, for zero proceeds.

Ramsbottom allocates indirect costs which are not specifically identifiable to an individual product by reference to relative selling prices. This results in 55% being allocated to XX1 and 45% to ZZ2.

Required

Calculate the cost attributable to each product.

(The answer is at the end of the chapter)

HKAS 2.36-39

1.9 Disclosure requirements

HKAS 2 requires the financial statements to disclose the following:

(a) The accounting policies adopted in measuring inventories, including the cost formula used

(b) The total carrying amount of inventories and the carrying amount in classifications appropriate to the entity

(c) The carrying amount of inventories carried at fair value less costs to sell

(d) The amount of inventories recognised as an expense during the period

(e) The amount of any write down of inventories to net realisable value recognised as expense and in the period

(f) The amount of any reversal of any write down of inventories to net realisable value recognised as reduction in "the amount of inventories recognised as an expense in the period"

(g) The circumstance or events that led to the reversal of a write down of inventories

(h) The carrying amount of inventories pledged as security for liabilities.

Information about the carrying amounts held in different classifications of inventories and the extent of the changes in these assets is useful to financial statement users. Common classifications of inventories are merchandise, production supplies, materials, work in progress and finished goods. The inventories of a service provider may be described as work in progress.

Some entities adopt a format for profit or loss that results in amounts being disclosed other than the cost of inventories recognised as an expense during the period. Under this format, an entity presents an analysis of expenses using a classification based on the nature of expenses. In this case, the entity discloses the costs recognised as an expense for raw materials and consumables, labour costs and other costs together with the amount of the net change in inventories for the period.

Topic recap

HKAS 2 Inventories

- Finished goods
- Work in progress
- Raw materials

Measure at the lower of:

Cost

Includes:
- Cost of purchase
- Direct costs of conversion
- Allocated overheads during conversion
- Costs of bringing the inventory to its present location and condition

Where inventory items are not interchangeable identify specific cost.

Where inventory items are interchangeable use cost formulae to assign cost to an item:

FIFO
Inventory is assumed to move "first in, first out" therefore cost allocated to inventory items is the most recent purchase prices.

Weighted average
A weighted average cost to be allocated to each item of inventory is calculated either on a periodic or continuous basis.

Net realisable value

Estimated selling price in the ordinary course of business less estimated costs of completion and estimated costs to make the sale.

Disclosures:
- Accounting policies and cost formulae used
- Carrying amount of inventories classified by type
- Carrying amount of inventories measured at fair value less costs to sell
- Inventories recognised as an expense in the period
- Inventory write downs / reversal of write downs recognised in the period and circumstances that led to the write down / reversal.
- Carrying amount of inventories pledged as security

Answer to self-test question

Answer 1

The total cost attributable to XX1 is calculated as:

$365,000 + $65,000 + (55% × $80,000) = $474,000

The cost per unit therefore being $474,000 / 1,000 = $474 each.

The total cost $474,000 attributable to XX1 can all be allocated to the inventories of XX1.

The total cost attributable to ZZ2 is:

$380,000 + $55,000 + (45% × $80,000) = $471,000

The cost per unit therefore being $471,000 / 1,200 = $392.50 each.

The allocation of the cost for ZZ2 is therefore:

$392.50 × 1,050 = $412,125 as inventories
$392.50 × 150 = $58,875 as an expense

The indirect costs not specifically identifiable with either product which are allocated to the scrapped ZZ2 cannot be recovered into the cost of XX1.

Exam practice

Lotto

9 minutes

After its end of year physical inventory count and valuation, the accounts staff of Lotto have reached a valuation of $153,699 at cost for total inventories held at the year end.

However, on checking the figures, the chief bookkeeper has come across the following additional facts.

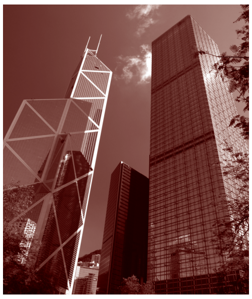
(a) The count includes damaged goods which originally cost $2,885. These could be repaired at a cost of $921 and sold for $3,600.

(b) The count excludes 300 units of item 730052 which were sold to a customer SC on a sale or return basis, at a price of $8 each. The original cost of the units was $5 each. SC has not yet indicated to Lotto whether these goods have been accepted, or whether they will eventually be returned.

(c) The count includes 648 units of item 702422. These cost $7.30 each originally but because of dumping on the market by overseas suppliers, a price war has flared up and the unit cost price of the item has fallen to $6.50. The price reduction is expected to be temporary, lasting less than a year or so, although some observers of the market predict that the change might be permanent. Lotto has already decided that if the price reduction lasts longer than six months, it will reduce its resale price of the item from $10.90 to about $10.

Required

Calculate the closing inventory figure for inclusion in the annual accounts of Lotto, making whatever adjustments you consider necessary in view of items (a) to (c). Explain your treatment of each item. **(5 marks)**


chapter 11

Provisions, contingent liabilities and contingent assets

Topic list

Learning focus

Accounting for uncertainty and contingencies requires some judgment and supporting evidence in applying the accounting standards. You must learn the recognition criteria for provisions and be able to apply them. You should also be able to advise the directors on the implications for the financial statements of the changes proposed.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
Account for transactions in accordance with Hong Kong Financial Reporting Standards		
3.16	**Provisions, contingent liabilities and contingent assets**	3
3.16.01	Define provisions, contingent liabilities and contingent assets within the scope of HKAS 37	
3.16.02	Distinguish provisions from other types of liabilities	
3.16.03	Explain the criteria for recognition of provisions and apply them to specific circumstances	
3.16.04	Apply the appropriate accounting treatment for contingent assets and liabilities	
3.16.05	Disclose the relevant information relating to contingent liabilities in the financial statements	
3.16.06	Account for decommissioning, restoration and similar liabilities and their changes	
3.16.07	Disclose the relevant information relating to contingent assets in the financial statements	

1 HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

Published financial statements must include **all the information necessary for a proper understanding of the company's financial position**.

In some cases this means that uncertain events must be reported. HKAS 37 provides guidance on accounting for uncertainty with the result that provisions, or uncertain liabilities, may be **included** in the statement of financial position and contingent assets and liabilities may be **disclosed**.

The provisions for liabilities covered by HKAS 37 are somewhat different from those "provisions" for depreciation and doubtful debts in your earlier studies.

There was no accounting standard dealing with provisions before the issue of HKAS 37. Provisions often known as "big bath" provisions are made by companies wanting to show their results in the most favourable way. They made large "one off" provisions in years where a high level of underlying profits was generated. These provisions were then available to conceal expenditure in future years when perhaps the underlying profits were not favourable.

That is to say, provisions were used to achieve profit smoothing. Since reported profits do not represent the level of actual profits achieved in the year, profit smoothing is viewed as misleading.

1.1 Objective

HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets* aims to make sure that provisions, contingent liabilities and contingent assets are being dealt with based on appropriate **recognition criteria** and **measurement bases**. In addition, **sufficient information should be** disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount.

HKAS 37.10

1.2 Definitions

The following definitions are provided within the standard:

Key terms

A **provision** is a liability of uncertain timing or amount.

A **liability** is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

A **contingent liability** is:

(a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity, or

(b) a present obligation that arises from past events but is not recognised because:

  (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

  (ii) the amount of the obligation cannot be measured with sufficient reliability.

A **contingent asset** is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

(HKAS 37.10)

We shall meet more definitions as we consider the accounting treatment of provisions and contingencies.

2 Provisions

Provisions are differentiated from other liabilities such as trade payables and accruals by the HKICPA. The main difference is that there is **uncertainty** about the timing or amount of the future expenditure for a provision. For certain accruals, uncertainty, though it exists, is generally much less than for provisions.

HKAS 37 includes the criteria for recognising a provision as a liability in the statement of financial position and also provides guidance for measuring such a provision. In addition, and due to the subjective nature of the topic matter, it gives examples of common situations in which a provision can be made.

HKAS 37.14

2.1 Recognising a provision

Topic highlights

Under HKAS 37, a **provision** should be recognised:

- When an entity has a **present obligation**, legal or constructive
- It is **probable** that a **transfer of economic benefits** will be required to settle it
- A **reliable estimate** can be made of its amount

HKAS 37 states that a provision should be **recognised** as a liability in the financial statements when:

- an entity has a **present obligation** (legal or constructive) as a result of a past event;
- it is probable that an **outflow of resources embodying economic benefits** will be required to settle the obligation; and
- a **reliable estimate** can be made of the obligation.

Some of these terms require further explanation, and this is given in the next two sections of the chapter.

HKAS 37.17-22

2.1.1 Obligation

A legal obligation is a fairly easy idea to understand: it is a duty to act in a certain way deriving from a contract, legislation, or some other operation of the law.

You should note that an event which does not currently give rise to a legal obligation may do so at a later date due to changes in the law. In this case the obligation arises when new legislation is virtually certain to be enacted as drafted; in many cases this is impossible to ascertain before actual enactment.

You may not know what a **constructive obligation** is.

Key term

HKAS 37 defines a **constructive obligation** as:

"An obligation that derives from an entity's actions where:

- By an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities, and
- As a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities."

The following question shows how this definition is applied and will help your understanding of a constructive obligation.

Self-test question 1

(a) Black Gold Oil Co. drills for oil in locations worldwide. Mindful of the public perception of such oil companies after recent disasters involving oil spills, Black Gold Oil Co. has recently used press and television advertisements to promote its green credentials, and in particular, has pledged to clean up any contamination that it causes.

In the year ended 31 December 2010, Black Gold Oil Co. causes extensive contamination in a country in which there is no environmental legislation.

Does a constructive obligation exist at 31 December 2010?

(b) A well-known retailer is under legal obligation to refund money to customers who return unwanted goods within a 28-day period. The retailer has announced a policy of extending this return period to 60 days, and accordingly has printed this promise on its carrier bags.

Does the retailer have a present obligation as a result of a past event?

(The answer is at the end of the chapter)

In some instances, for example when a court case is underway, it is not clear whether there is a present obligation. In these cases, all available evidence should be considered, and if it is more likely than not that a present obligation exists at the reporting date, then a present obligation as a result of a past event is deemed to exist.

HKAS 37.23-24

2.1.2 Probable transfer of economic benefits

A transfer of economic benefits is regarded as "probable" if the event is more likely than not to occur for the purpose of HKAS 37 so the probability that the event will occur is greater than the probability that it will not. The standard clarifies that the probability should be based on considering the population as a whole, rather than one single item, in situations where there are a number of similar obligations.

Illustration: Transfer of economic benefits

In the case of a warranty obligation of a company, though the probability of an outflow of economic resources (transfer of economic benefits) may be extremely small in respect of one specific item, the probability of some transfer of economic benefits is quite likely to be much higher when the population is considered as a whole. A **provision** should be made for the **expected amount** when there is a **greater than 50% probability** of some transfer of economic benefits.

HKAS 37.36-38, 41

2.2 Measuring a provision

Topic highlights

The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the year end. This may be calculated using expected values when the provision involves a large population of items.

The third criterion which must be met in order to recognise a provision is that a reliable estimate can be made of the obligation.

HKAS 37 provides detailed guidance on how this estimate should be made. The overriding requirement is that the amount recognised as a provision **shall be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period**.

The standard goes on to say that this is the amount that an entity would pay to settle the obligation or transfer it to a third party at the reporting date, even though a settlement or transfer at this time will often be impossible or prohibitively expensive.

The estimates will be determined by the **judgment** of the entity's management supplemented by the experience of similar transactions, and in some cases the reports from independent experts.

A provision should be measured before any related tax effect.

HKAS 37.40

2.2.1 Most likely outcome

Where a single obligation is being measured, the most likely outcome may be the best estimate of the liability. HKAS 37 does, however, stipulate that all possible outcomes are considered and where these are mostly higher (or mostly lower) than the expected outcome, the best estimate will be higher (or lower).

HKAS 37.39

2.2.2 Expected values

Where the provision being measured involves a large population of items, the obligation is estimated by weighting all possible outcomes by their associated probabilities, i.e. **expected value**.

Self-test question 2

Alice Co. sells goods with a warranty under which customers are covered for the cost of repairs of any manufacturing defect that becomes apparent within the first six months of purchase. The company's past experience and future expectations indicate the following pattern of likely repairs.

% of goods sold	*Defects*	*Cost of repairs if all goods suffered from the defect* $m
75	None	–
20	Minor	1.0
5	Major	4.0

What is the expected cost of repairs?

(The answer is at the end of the chapter)

HKAS 37.42-52

2.2.3 Other considerations when measuring a provision

HKAS 37 requires that the following are considered when measuring a provision:

Risks and uncertainties

Risks and uncertainties surrounding an event should be taken into consideration when making the best estimate of a provision required. Uncertainty does not, however, justify the creation of excessive provisions or an overstatement of liabilities.

Discounting

Where the effect of the time value of money is material, the amount of a provision should be the present value of the expenditure required to settle the obligation.

An appropriate discount rate should be used, and the standard requires this to be a pre-tax rate that reflects current market assessments of the time value of money. The discount rate(s) should not reflect risks for which future cash flow estimates have been adjusted.

Future events

Future events which may affect the amount required to settle the entity's obligation should be taken into account where there is sufficient evidence that they will occur.

These events may include future changes in technology or new legislation. The standard does, however state that in the case of new legislation, in most cases sufficient objective evidence will not exist until the legislation is actually enacted.

Expected disposal of assets

Gains from the expected disposal of assets should not be taken into account in measuring a provision, even if the expected disposal is closely linked to the event giving rise to the provision.

HKAS 37.53-57

2.3 Reimbursements

Some or all of the expenditure needed to settle a provision may be expected to be recovered from a third party through insurance contracts, indemnity clauses or supplier's warranties. These amounts may be reimbursed to the entity or paid directly to the party to who the amount is due.

If so, the **reimbursement shall be recognised when, and only when, it is virtually certain that reimbursement will be received if the entity settles the obligation**.

Generally, however, the entity will remain liable for the amount due, and would be required to pay all of this if the third party failed to pay. This is reflected in the accounting treatment:

- A provision is recognised for the full amount of the liability.
- The reimbursement should be treated as a separate asset, and the amount recognised should not be greater than the provision itself.
- The provision and the amount recognised for reimbursement may be netted off in the statement of profit or loss.

In some cases the entity will not be liable for the costs if the third party fails to pay. In this case these costs are not included in the provision.

HKAS 37.59-60

2.4 Changes in provisions

Provisions should be reviewed at each reporting date and adjusted to reflect the current best estimate. If it is no longer probable that a transfer of economic benefits will be required to settle the obligation, the provision should be reversed.

Where the effect of the time value of money is significant, so that a provision has been measured at present value, the discount is unwound each year with a resulting increase to the provision. This increase is recognised as a finance cost in profit or loss.

HKAS 37.61-62

2.5 Use of provisions

A provision should be used only to set off expenditure for which the provision was originally recognised.

It is not permitted to set off expenditure against a provision formerly organised for another purpose since this would conceal the impact of two different events.

HKAS 37.63-65

2.6 Common scenarios

2.6.1 Future operating losses

No provisions should be recognised for future operating losses which do not meet the definition of a liability and the general recognition criteria stated in the standard.

Expected future operating losses may, however, be indication of the impairment of assets related to that operation.

HKAS 37.66-68

2.6.2 Onerous contracts

Key term

An **onerous contract** is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it. *(HKAS 37.10)*

If an entity has a contract that is onerous, the present obligation under the contract should be recognised and measured as a provision.

A common example would be leasehold property which is vacated before the lease term ends. For the remaining years of the lease, the cost of the property (future lease payments) exceeds the benefits derived from the property (likely to amount to nil if it is to be left vacant). In this case, provision should be made for the future unavoidable lease payments as at the date on which the property is vacated. The provision is released as these payments are made in future years.

The provision is disclosed as current/non-current in accordance with HKAS 1. Practically this is likely to mean that the total provision is split between the amount payable within one year and the amount payable thereafter.

There is no obligation where cancellation of a contract does not result in the need to pay compensation to another party.

HKAS 37.70-83

2.6.3 Provisions for restructuring

One of the main purposes of HKAS 37 was to target abuses of provisions for restructuring. Accordingly, HKAS 37 lays down **strict criteria** to determine when such a provision can be made.

Key term

HKAS 37 defines a **restructuring** as:

A programme that is planned and controlled by management and materially changes either:

- the scope of a business undertaken by an entity, or
- the manner in which that business is conducted

(HKAS 37.10)

The HKAS gives the following **examples** of events that may fall under the definition of restructuring.

- The **sale or termination** of a line of business
- The **closure of business locations** in a country or region or the **relocation** of business activities from one country or region to another
- **Changes in management structure**, for example, the elimination of a layer of management
- **Fundamental reorganisations** that have a material effect on the **nature and focus** of the entity's operations

The question is whether or not an entity has an obligation at the year end. In respect of restructuring, the standard states that there is a constructive obligation if:

- the entity has a **detailed formal plan** for the restructuring, and
- the entity has **raised a valid expectation** in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

A mere management decision is not normally sufficient. Management decisions may sometimes trigger off recognition, but only if earlier events such as negotiations with employee representatives and other interested parties have been concluded subject only to management approval.

When the sale of an operation is involved in the restructuring, HKAS 37 states that no obligation is to be recognised until the entity has entered into a **binding sale agreement**. Until then, the entity will be able to alter its decision and withdraw from the sale even if its intentions have been announced publicly.

The HKAS states that a restructuring provision should include only the **direct expenditures** arising from the restructuring that are both:

- **necessarily entailed** by the restructuring, and
- not associated with the **ongoing activities** of the entity.

The following costs should specifically **not** be included within a restructuring provision:

- **Retraining** or relocating continuing staff
- **Marketing**
- **Investment in new systems** and distribution networks
- Future operating losses
- Losses or gains on the expected disposal of assets

HKAS 37 Appendix C

2.6.4 Other scenarios

(a) **Warranties**. A provision is appropriate where on past experience it is probable, i.e. more likely than not, that some claims will emerge. The provision must be estimated, however, on the basis of the class as a whole and not on individual claims. There is a clear legal obligation in this case.

(b) **Major repairs**. In the past it has been quite popular for companies to provide for expenditure on a major overhaul to be accrued gradually over the intervening years between overhauls. Under HKAS 37 this is not permissible as HKAS 37 would argue that this is a mere intention to carry out repairs, not an obligation. The entity can always sell the asset in the meantime. The only solution is to treat major assets such as aircraft, ships, furnaces etc. as a series of smaller assets where each part is depreciated over shorter lives. Therefore, any major overhaul may be argued to be replacement and therefore classified as capital rather than revenue expenditure.

(c) **Self insurance**. A number of companies have created a provision for self insurance based on the expected cost of making good fire damage and so on instead of paying premiums to an insurance company. Under HKAS 37 this provision is not justifiable as the entity has no obligation until a fire or accident occurs. No obligation exists until that time.

(d) **Environmental contamination**. If the company has an environment policy such that other parties would expect the company to clean up any contamination or if the company has broken current environmental legislation then a provision for environmental damage must be made.

(e) **Decommissioning or abandonment costs**. When an oil company initially purchases an oilfield it is put under a legal obligation to decommission the site at the end of its life. Prior to HKAS 37 most oil companies built up the provision gradually over the life of the field so that no one year would be unduly burdened with the cost.

HKAS 37, however, insists that a legal obligation exists on the initial expenditure on the field and therefore a liability exists immediately. This would appear to result in a large charge to profit or loss in the first year of operation of the field. However, the HKAS takes the view that the cost of purchasing the field in the first place is not only the cost of the field itself but also the costs of putting it right again. Therefore, all the costs of abandonment may be capitalised.

HKAS 37.84,85,92

2.7 Disclosure of provisions

Disclosures for provisions fall into two parts.

- Disclosure of details of the **change in carrying value** of a provision from the beginning to the end of the year, including:
  - carrying amount at the beginning and end of the period
  - additional provisions made in the period
  - amounts incurred and charged against the provision in the period
  - unused amounts reversed in the period

– the increase in the period in the discounted amount arising from the passage of time and effect of any change in the discount rate

Note that comparative information is not required.

- Disclosure of the **background** to the making of the provision and the uncertainties affecting its outcome, including for each class of provision:
  – a brief description of the nature of the obligation and expected timing of any resulting outflows of economic benefits
  – an indication of the uncertainties about the amount or timing of outflows
  – the amount of any expected reimbursement stating the amount of any asset that has been recognised for the expected reimbursement.

In very rare circumstances, such disclosure may prejudice seriously the position of the entity in a dispute with other parties on the subject matter of the provision. In this case disclosure of the above information is not required, however the following should be disclosed:

- the general nature of the dispute
- the fact that, and reason why, the information has not been disclosed.

3 Contingent liabilities and contingent assets

Topic highlights

An entity should not recognise a contingent liability, but they should be disclosed where there is a **possible** outflow of economic resources.

An entity should not recognise a contingent asset, but they should be disclosed where there is a **probable** inflow of economic resources.

Now you understand provisions it will be easier to understand contingent assets and liabilities.

HKAS 37.10

3.1 Contingent liabilities

We saw the definition of a contingent liability earlier in the chapter. To recap, a contingent liability is:

(a) A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the entity's control

(b) A present obligation that arises from past events but is not recognised because:

– it is not probable that a transfer of economic benefits will be required to settle the obligation

– the amount of the obligation cannot be measured with sufficient reliability

In other words, a contingent liability is an obligation that does not meet the HKAS 37 recognition criteria for a provision because there is no present obligation, or the transfer of resources is only possible or the amount cannot be measured reliably.

HKAS 37.27-28

3.1.1 Accounting treatment

Contingent liabilities **should not be recognised in financial statements** but they **should be disclosed,** unless the probability of an outflow of economic resources is remote.

HKAS 37.86-88,92

3.1.2 Disclosure: contingent liabilities

A **brief description** must be provided of all material contingent liabilities unless they are likely to be remote.

In addition, the following should be provided for each class of contingent liability, where practicable:

- An estimate of their **financial effect**
- Details of **any uncertainties** relating to the amount or timing of the outflow
- The possibility of any reimbursement

When determining classes of contingent liability, an entity should consider whether the nature of items is sufficiently similar for aggregated amounts to fulfil the disclosure requirements.

Where a provision and contingent liability result from the same circumstances, an entity should indicate the link between the provision and contingent liability.

In very rare circumstances, such disclosure may prejudice seriously the position of the entity in a dispute with other parties on the subject matter of the contingent liability. In this case disclosure of the above information is not required, however the following should be disclosed:

- The general nature of the dispute
- The fact that, and reason why, the information has not been disclosed.

3.2 Contingent assets

Earlier in the chapter we defined a contingent asset as a possible asset that arises from past events and whose existence will be confirmed by the occurrence of one or more uncertain future events not wholly within the entity's control.

HKAS 37.31,33,34

3.2.1 Accounting treatment

A contingent asset must not be recognised. Only when the realisation of the related economic benefits is **virtually certain** should recognition take place. At that point, **the asset is no longer a contingent asset**.

Where a contingent asset offers a probable inflow of resources, it should be disclosed.

HKAS 37.89,92

3.2.2 Disclosure: contingent assets

Contingent assets must only be disclosed in the notes if they are **probable**.

In that case the following should be provided:

- a brief description of the nature of the contingent asset
- an estimate of its likely financial effect, where practicable, or a statement to the effect that it is not practicable.

In very rare circumstances, such disclosure may prejudice seriously the position of the entity in a dispute with other parties on the subject matter of the contingent asset. In this case disclosure of the above information is not required, however the following should be disclosed:

- the general nature of the dispute
- the fact that, and reason why, the information has not been disclosed.

3.3 Summary

- The objective of HKAS 37 is to ensure that appropriate recognition criteria and measurement bases are applied to provisions and contingencies and that sufficient information is disclosed.
- The HKAS seeks to ensure that provisions are **only recognised** when a **measurable obligation** exists. It includes detailed rules that can be used to ascertain when an obligation exists and how to measure the obligation.
- The standard attempts to **eliminate** the "**profit smoothing**" which has gone on before it was issued.

Self-test question 3

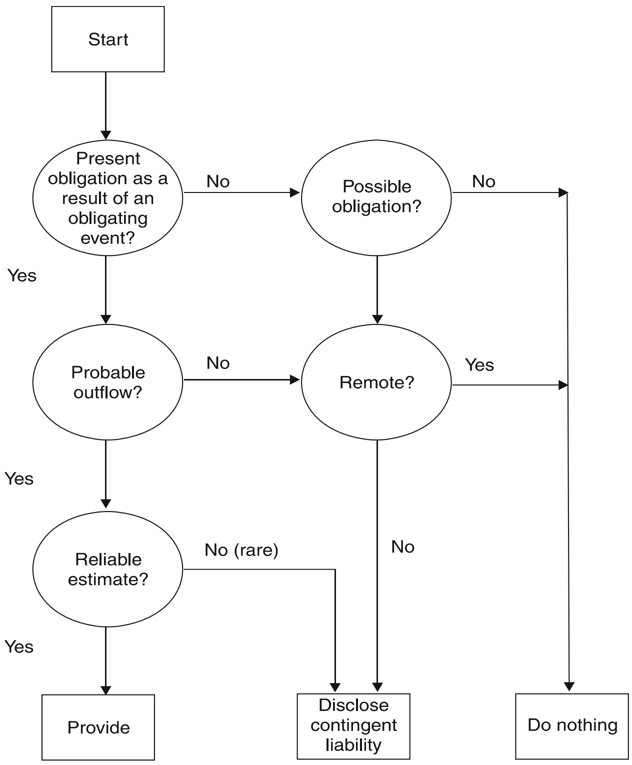
Explain the accounting treatment required in the following scenarios at 31 December 20X0:

(a) Rango Co., a healthcare provider, has been informed that due to upcoming legislation, it is required to fit carbon monoxide detectors in all of its properties at a cost of HK$40,000. Any failure to do so by 30 September 20X1 will result in penalties of $5,000. Rango has not undertaken the work by 31 December 20X0.

(b) Greenfingers Co. specialises in the sale of gardening equipment. As part of a strategy to streamline operations, the company has decided to divest its plant division. A probable purchaser has been identified, although no agreement has been reached by 31 December 20X0. Until an agreement has been formalised, the directors of Greenfingers will not advise their employees of the divestment. Redundancy costs associated with the restructuring are expected to be $120,000, and a further $50,000 will be spent on retraining certain staff members to work in the furniture division of the company.

(The answer is at the end of the chapter)

You may wish to study the flow chart below, taken from HKAS 37, which is a good summary of its requirements.



Self-test question 4

Cobo Co. manufactures goods which are sold with a one year warranty against defects.

(a) Should a provision be recognised for the cost of repairing faulty goods?

(b) Cobo Co.'s sales for the year are $40m. They anticipate that 60% of goods will not be faulty, 30% will need minor repairs that would cost $2m if all items were affected and 10% of goods will need major repairs that would cost $4m if all items were affected. How much should be provided for repairs?

(The answer is at the end of the chapter)

4 Interpretations relating to provision accounting

4.1 HK(IFRIC) Int-1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities*

4.1.1 The issue

HK(IFRIC) Int-1 applies where an entity has included decommissioning, restoration and similar costs within the cost of an item of property, plant and equipment under HKAS 16 and as a provision (liability) under HKAS 37.

An example would be a liability that was recognised by the operator of an oil rig for costs that it expects to incur in the future when the rig is shut down (decommissioned). Such a provision should be discounted to present value.

HK(IFRIC) Int-1 addresses changes in the value of the provision that may arise from:

(a) changes in the discount rate
(b) revised estimates of the timing and amount of costs

4.1.2 Required treatment

Where an entity applies the cost model to property, plant and equipment, these changes in value of the provision are required to be capitalised as part of the cost of the asset and depreciated over the remaining life of the item to which they relate.

Where an entity applies the revaluation model to property, plant and equipment, the changes in value of the provision must be recognised as follows:

(a) A decrease in the liability is recognised in other comprehensive income and accumulated within the revaluation surplus (other than where it reverses a revaluation deficit on the asset that was previously recognised in profit or loss)

(b) An increase in the liability is recognised in profit or loss (other than where a credit balance exists in the revaluation surplus in respect of that asset, in which case it is recognised in other comprehensive income and reduces the revaluation surplus).

HK(IFRIC) Int-1 also deals with an increase in the liability that reflects the passage of time – also referred to as the **unwinding of the discount**. This is **recognised in profit or loss** as a finance cost as it occurs.

4.2 HK(IFRIC) Int-5 *Rights to Interests from Decommissioning, Restoration and Environmental Rehabilitation Funds*

4.2.1 The issue

Some entities have an obligation to decommission assets or to perform environmental restoration. Such entities may make contributions to a fund which is established to reimburse those costs of decommissioning, restoration or rehabilitation when they are incurred. This fund may be set up to meet the decommissioning costs of one contributor or for a number of contributors.

Matters for discussion with reference to HK(IFRIC) Int-5 are:

(a) How should the interest in a fund be dealt with by a contributor?

(b) How should an obligation be accounted for when a contributor has an obligation to make additional contributions?

4.2.2 HK(IFRIC) Int-5 treatment

The following treatments are specified in HK(IFRIC) Int-5:

(a) If an entity recognises a decommissioning obligation under HKFRS and contributes to a fund to segregate assets to pay for the obligation, it should **apply HKFRS 10** *Consolidated Financial Statements,* **HKFRS 11** *Joint Arrangements* and **HKAS 28** *Investments in*

Associates and Joint Ventures, to determine whether decommissioning funds should be consolidated or accounted for under the equity method.

(b) When **a fund is not consolidated or accounted for under the equity method**, and that fund does not relieve the contributor of its obligation to pay decommissioning costs, the contributor should **recognise**:

   (i) its obligation to pay decommissioning costs as a liability

   (ii) its **rights to receive reimbursement** from the fund as a reimbursement under HKAS 37

(c) A right to reimbursement should **be measured** at the lower of the:

   (i) amount of the decommissioning obligation recognised

   (ii) contributor's share of the fair value of the net assets of the fund attributable to contributors

   Changes in the carrying amount of this right (other than contributions to and payments from the funds) should be recognised in profit or loss.

(d) When a contributor has an obligation to make potential additional contributions to the fund, that obligation is a **contingent liability** within the scope of HKAS 37. When it becomes probable that the additional contributions will be made, a provision should be recognised.

5 Current developments

The IASB and FASB added a project on Liabilities to their active agenda in 2002 and issued an Exposure Draft in 2005; the topic was re-exposed in 2010.

The ED proposed the following:

- The "probable" recognition criterion is removed, and instead uncertainty is reflected in the measurement of a liability i.e. through use of a probability-weighted average of the outflows for the range of possible outcomes.
- A liability is measured at the amount an entity would pay at the end of a reporting period to be relieved of the present obligation. This should be determined as:
  – the present value of the resources required to fulfil the obligation, or
  – the amount an entity would have to pay to cancel the obligation, or
  – the amount an entity would have to pay to transfer the obligation to a third party.
- If the liability is to pay cash to a counterparty, the outflows would be any expected cash payments plus associated costs.
- If the liability is to undertake a service at a future date, the outflows would be the amounts that the entity estimates it would pay a contractor at the future date to undertake the service on its behalf.

The effects of these proposals would include the recognition of far more provisions than at present, and where these are measured by reference to third party payment, a profit margin would be included so increasing the amount of the provision.

The project was deferred in 2010 and added to the IASB's research programme in 2012. The issues will now be considered in conjunction with the Conceptual Framework work on elements and measurement and a discussion paper is expected on this during the course of 2013.

Topic recap

HKAS 37 Provisions, Contingent Liabilities and Contingent Assets

= accounting for uncertainty

Provisions

Liability of uncertain timing and/or amount

Recognise if:
- present obligation (legal or constructive) as the result of a past event
- probable outflow of economic benefits
- reliable estimate can be made of the obligation

Measure at:
- best estimate of expenditure
- use expected values for a large population of items
- discount if the time value of money is material

Disclose:
- Reconciliation of the carrying value of provisions at the start of the period to that at the end
- Background to the provision

Contingencies

Liability of uncertain timing and/or amount

Possible obligation that arises from past events and whose existence will be confirmed by uncertain future events

Or

Present obligation arising from past events which is not recognised because:
- (i) outflow is not probable
- (ii) amount can't be reliably measured

Do not recognise

Disclose the following unless the outflow of resources is remote:
- Description of contingency
- Estimate of financial effect
- Details of uncertainties
- Possibility of reimbursement

Contingent asset

Possible asset arising from past events whose existence will be confirmed by uncertain future events

Do not recognise unless virtually certain (in which case not a contingent asset)

Disclose where **probable** inflow:
- description of contingency
- estimate of financial effect

Answers to self-test questions

Answer 1

(a) Black Gold Oil Co. has a constructive obligation, as the advertising campaign has created a valid expectation on the part of those affected by it that the entity will clean up the contamination it has caused.

(b) The retailer has a legal obligation to refund money for unwanted goods within a 28-day period after the sale, and a constructive obligation to provide refunds for 32 days beyond this.

The past event is the sale, and therefore the retailer has a present obligation as a result of a past event.

Answer 2

The cost is found using "expected values" (75% × $NIL) + (20% × $1.0m) + (5% × $4.0m) = $400,000

Answer 3

(a) At 31 December 20X0, there is no legal obligation to fit the carbon monoxide detectors, and therefore Rango should not make a provision for either the cost of doing so or the fines which would be incurred if it were in breach of the legislation.

If Rango has still not fitted the detectors at the 20X1 year end (i.e. when the legislation is in force), then it should make a provision for the penalty of $5,000 for which it is liable (rather than the $40,000 cost of fitting the detectors). This is because there is still no obligation for the costs of fitting detectors because no obligating event has occurred (the fitting of the detectors). However, an obligation might arise to pay fines or penalties under the legislation because the obligating event has occurred (the non-compliant operation of Rango).

(b) Greenfingers is planning a restructuring of its business. A provision in respect of restructuring can only be made when a year-end obligation is evidenced by a detailed formal plan and an expectation on the part of those affected that the restructuring will happen. As at 31 December 20X0, the employees of Greenfingers are unaware of the plan and therefore this criterion is not met. Therefore, no provision can be made.

If a provision could be made (i.e. if the sale had been announced to employees, so giving rise to a valid expectation that the restructuring will occur and thus creating a constructive obligation) then provision would be for the $120,000 redundancy costs but not the $50,000 retraining costs.

Answer 4

(a) Yes. Cobo Co. cannot avoid the expenditure on repairing faulty goods.
A provision should be made for the estimated cost of repairs.

(b) The cost of the provision is found using expected values: (60% × $0m) + (30% × $2m) + (10% × $4) = $1m.

Exam practice

Darren Company Limited

23 minutes

Darren Company Limited ("DCL") is engaged in the manufacture of batteries. On the unaudited statement of financial position as at 30 June 20X8, it has recognised the following provisions as current liabilities:

(a) **A provision for late delivery penalty**

In May 20X8, DCL received a sales order for 7,000,000 units of rechargeable batteries for which the agreed delivery date is 31 August 20X8. It is expected that DCL would earn a gross profit of $1 per unit. Due to a shortage in the supply of raw materials, at the reporting date, the management realised that they could only supply the goods at the earliest on 10 September 20X8. According to the sales contract, DCL would compensate the customer for late delivery at $0.01 per unit per day.

(b) **A provision for annual safety inspection of the production line**

The last inspection was carried out in June 20X7. Due to a large backlog of sales orders, the management decided to postpone the annual inspection until mid-September 20X8.

(c) **A provision for the loss on sales of aged finished goods**

The products were manufactured in late 20X6 with an expected normal usage period of two years from the date of production. Due to the short expiry period, they were sold at a price below cost in July 20X8.

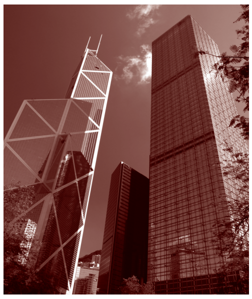
(d) **A provision for bonus payments to two executive directors**

In accordance with the directors' service contract, two executive directors are entitled to receive, in addition to monthly salaries, a bonus of equivalent to 5% of the profit before taxation and the accrued bonus.

Required

Discuss the appropriateness of the provisions recognised by DCL. **(13 marks)**

HKICPA February 2008 (amended)

chapter 12

Construction contracts

Topic list

Learning focus

Long-term contracts are an everyday part of business in many industry sectors, particularly construction. You should be able to advise a client how this type of contract is accounted for and why.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
Account for transactions in accordance with Hong Kong Financial Reporting Standards		
3.07	**Construction contracts**	3
3.07.01	Define a construction contract	
3.07.02	Explain when contract revenue and costs should be recognised in accordance with HKAS 11	
3.07.03	Explain how contract revenue and costs should be measured and apply these principles	
3.07.04	Account for the expected loss and changes in estimates	
3.07.05	Disclose information related to construction contracts in the financial statements	

1 HKAS 11 *Construction Contracts*

Topic highlights

A construction contract is a contract specifically negotiated for the construction of an asset or a combination of interrelated assets.

1.1 The accounting problem

Imagine that you are the accountant at a company which is building a hospital under contract with the government. The hospital will take four years to build and over that time your company will have to pay for costs such as workers' wages and building materials. The government will make periodic payments at pre-determined stages of construction.

How do you decide what amounts to include in the statement of profit or loss in each of the four years?

This is the problem addressed by HKAS 11 *Construction Contracts.*

Example: Construction contract

Suppose that a contract is started on 1 January 20X1, with an estimated completion date of 31 December 20X2. The final contract price is $2,000,000. In the first year, to 31 December 20X1:

(a) Costs incurred amounted to $800,000.

(b) Half the work on the contract was completed.

(c) Certificates of work completed have been issued, to the value of $1,000,000. (**Note.** It is usual, in a construction contract, for a qualified person such as an architect or engineer to inspect the work completed, and if it is satisfactory, to issue certificates. This will then be the notification to the customer that progress payments are due to the contractor. Progress payments are commonly the amount of valuation on the work certificates issued, minus a precautionary retention of 10%.)

(d) It is estimated with reasonable certainty that further costs to completion in 20X2 will be $800,000.

What is the contract profit in 20X1, and what entries would be made for the contract at 31 December 20X1 if:

(a) profits are deferred until the completion of the contract?
(b) a proportion of the estimated revenue and profit is credited to profit or loss in 20X1?

Solution

(a) If profits are deferred until the completion of the contract in 20X2, the revenue and profit recognised on the contract in 20X1 would be nil, and the value of work in progress on 31 December 20X1 would be the costs incurred of $800,000.

		$'000	$'000
DEBIT	Work-in-progress	800	
CREDIT	Cash		800

HKAS 11 takes the view that this policy is unreasonable, because in 20X2, the total profit of $400,000 would be recorded. Since the contract revenues are earned throughout 20X1 and 20X2, a profit of nil in 20X1 and $400,000 in 20X2 would be contrary to the accruals concept of accounting.

(b) **It is fairer to recognise revenue and profit throughout the duration of the contract.**

As at 31 December 20X1 revenue of $1,000,000 should be matched with cost of sales of $800,000 in the statement of profit or loss, leaving an attributable profit for 20X1 of $200,000.

		$'000	$'000
DEBIT	Account receivable	1,000	
	Cost of sales	800	
CREDIT	Sales		1,000
	Cash		800

The only entry in the statement of financial position as at 31 December 20X1 is a receivable of $1,000,000 recognising that the company is owed this amount for work done to date. No balance remains for work in progress, the whole $800,000 having been recognised in cost of sales.

1.2 Scope of the standard

Topic highlights

HKAS 11 applies to construction contracts which **span a period end**.

HKAS 11 is applied in accounting for **construction contracts** in the financial statements of contractors.

A construction contract within the scope of HKAS 11 does not have to last for a period of more than one year. The main point is that the contract activity **starts in one financial period and ends in another**, thus creating the problem: to which of two or more periods should contract income and costs be allocated?

Where the rendering of services is directly related to a construction contract, for example services provided by a project manager or architect, these services are also accounted for in accordance with HKAS 11. In all other cases, the rendering of services, even where a service contract spans a period end, is within the scope of HKAS 18.

HKAS 11.3-6

1.3 Definitions

HKAS 11 provides the following definitions.

Key terms

Construction contract. A contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.

A **fixed price contract** is a construction contract in which the contractor agrees to a fixed contract price, or a fixed rate per unit of output, which in some cases is subject to cost escalation clauses.

A **cost plus contract** is a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus a percentage of these costs or a fixed fee.

(HKAS 11)

The definition of a construction contract includes:

(a) contracts for the construction of single assets such as bridges or roads

(b) contracts for the construction of inter-related assets such as refineries or complex pieces of equipment

(c) contracts for services related to the construction of an asset such as project manager services

(d) contracts for the destruction or restoration of assets

Contracts are further broken down into fixed price and cost plus contracts. The distinction between these two types is relevant when accounting for construction contracts and is considered in section 2.1.

1.4 Contract revenue and contract costs

As well as the more formal definitions above, the standard includes detailed guidance on what amounts should be included in contract revenue and contract costs.

HKAS 11.11-15

1.4.1 Contract revenue

Contract revenue includes:

(a) the **initial amount** of revenue specified in the contract; and
(b) **variations** in contract work, claims and incentive payments:

Examples of variations:

1 A variation, or instruction by the customer for a change in the scope of work to be performed, may increase or decrease contract revenue.

2 A claim, being an amount that an entity seeks to collect from the customer as reimbursement for extra costs, may increase contract revenue.

3 Cost escalation clauses in a fixed price contract will increase contract revenue.

4 Incentive payments, being additional amounts paid to a contractor if specified standards are met or exceeded will increase contract revenue.

5 Penalties imposed on contractors due to delays will decrease contract revenue.

Variations are only included as part of contract revenue to the extent that:

(i) it is probable that they will result in revenue; and
(ii) they are capable of being reliably measured.

The result is that contract revenue is measured at the **fair value** of received or receivable revenue.

Example: Contract revenue

Loriload has a fixed price contract for $9 million to build a bridge. By the end of year 1 it is apparent that the associated costs have increased by around 5% and accordingly in year 2 the customer approves a variation of $500,000. The contract is completed in year 3.

What amount should be used as contract revenue in calculations in relation to the construction contract at the end of the three years?

Solution

Year 1	$9 million
Year 2	$9.5 million
Year 3	$9.5 million

HKAS 11.16-20

1.4.2 Contract costs

Contract costs consist of:

(a) costs that relate directly to the specified contract.

(b) costs that are attributable to contract activity in general and can be allocated to the contract

(c) such other costs as are specifically chargeable to the customer under the terms of the contract.

Costs that **relate directly** to a specific contract include the following:

- Site labour costs, including site supervision
- Costs of materials used in construction
- Depreciation of plant and equipment used on the contract
- Costs of moving plant, equipment and materials to and from the contract site
- Costs of hiring plant and equipment
- Costs of design and technical assistance that are directly related to the contract
- Estimated costs of rectification and guarantee work, including expected warranty costs
- Claims from third parties

Costs that are **attributable to general contract activity** and can be allocated to specific contracts include:

- insurance
- general costs of design and technical assistance
- construction overheads

These costs should be allocated **systematically and rationally**, and all costs with similar characteristics should be treated **consistently**. The allocation should be based on the **normal level** of construction activity. Borrowing costs may be attributed in this way (see **HKAS 23**: Chapter 17).

Some costs **cannot be attributed** to contract activity and so the following should be **excluded** from construction contract costs:

- **General administration costs** (unless reimbursement is specified in the contract)
- **Selling costs**
- **R&D** (unless reimbursement is specified in the contract)
- **Depreciation** of idle plant and equipment not used on any particular contract

Example: Contract costs

Alphabeta has commenced a contract on 1 August 20X1 for the construction of a motorway. Information on contract costs incurred in the year ended 31 December 20X1 is as follows:

	$'000
Surveyors' fees	12
Direct labour costs	134
Materials delivered to the site	250
Transport of heavy plant to site	10

The following information is also relevant:

- Overheads are to be apportioned at 35% of direct labour costs
- Inventory of materials on site at the 20X1 year end is $76,000
- The heavy plant was acquired at a cost of $90,000 two years ago and is being depreciated over 10 years on a straight line basis.

What are contract costs incurred as at 31 December 20X1?

Solution

	$'000
Surveyors' fees	12
Direct labour costs	134
Overheads (35% × $134,000)	46.9
Materials (250,000 – 76,000)	174
Transport of heavy plant to site	10
Depreciation of heavy plant (5/12 × 10% × $90,000)	3.75
	380.65

HKAS 11.7-9

1.5 Combining and separating construction contracts

HKAS 11 accounting rules are normally applied to each of an entity's construction contracts in turn. Sometimes, however, one contract is split into component parts and each is accounted for separately, or a group of contracts are grouped and accounted for together.

The construction of a **series of assets** under one contract should be treated as several contracts where:

- **separate proposals** are submitted for each asset.
- **separate negotiations** are undertaken for each asset; the customer can accept/reject each individually.
- **identifiable costs and revenues** can be separated for each asset.

A **group of contracts** should be treated as **one single construction contract where**:

- the group of contracts are negotiated as a **single package**.
- contracts are **closely interrelated**, with an overall profit margin.
- the contracts are performed **concurrently** or **in a single sequence**.

2 Accounting for construction contracts

Topic highlights

Revenue and costs associated with a contract should be recognised according to the stage of completion of the contract *when* the **outcome of the activity can be estimated reliably**. If a loss is predicted on a contract, then it should be recognised immediately.

HKAS 11.23,24

2.1 Reliable estimate of outcome

The accounting treatment applied to a construction contract depends on whether the outcome of the contract can be measured reliably. HKAS 11 provides guidance on when this is the case for both fixed price and cost plus contracts:

(a) **Fixed price contracts**

In the case of a fixed price contract, the outcome of a construction contract can be estimated reliably when all of the following conditions are satisfied:

(i) Total contract revenue can be reliably measured.

(ii) It is probable that economic benefits of the contract will flow to the entity.

(iii) Stage of contract completion at the period end and costs to complete the contract can be reliably measured.

(iv) Costs attributable to the contract can be identified clearly and be reliably measured so that actual costs can be compared to previous estimates.

(b) **Cost plus contracts**

In the case of a cost plus contract, the outcome of a construction contract can be estimated reliably when both of the following conditions are satisfied:

(i) it is probable that economic benefits of the contract will flow to the entity,

(ii) the costs attributable to the contract (whether or not reimbursable) can be identified clearly and be reliably measured.

HKAS 11.30

2.1.1 Determining the stage of completion

Topic highlights

The stage of completion of a contract is normally measured using the **costs basis**, **sales basis** or **physical completion basis**.

One of the criteria listed above which indicates that the outcome of a fixed price contract can be estimated reliably is that the stage of contract completion can be reliably measured.

How should you decide on the stage of completion of any contract? The standard lists several methods:

- **Proportion of contract costs incurred** for work carried out to date
- **Surveys** of work carried out
- **Physical proportion** of the contract work completed

The proportion that contract costs incurred for work performed to date bear to the estimated total contract costs:

$$\% \text{ on total costs} = \frac{\text{Costs incurred to date} - \text{WIP inventories}}{\text{Total costs} + \text{variation}} \times 100\%$$

Surveys of work performed, or physical proportion of the contract work completed:

$$\% \text{ on work performed} = \frac{\text{Work certified}}{\text{Total revenue} + \text{variation}} \times 100\%$$

2.2 Accounting treatment: outcome can be reliably estimated

HKAS 11.22,26

2.2.1 Profitable contract

Where the outcome of a contract can be reliably estimated and the contract is expected to be profitable based on contract revenue, costs to date and expected costs to complete, the percentage completion method is applied.

The **percentage of completion method** is an application of the accruals assumption. Contract revenue is matched to the contract costs incurred in reaching the stage of completion, so revenue, costs and profit are attributed to the proportion of work completed:

(a) **Contract revenue** is recognised as revenue in the accounting periods in which the work is performed.

(b) **Contract costs** are recognised as an expense in the accounting period in which the work to which they relate is performed.

(c) Where amounts have been recognised as contract revenue, but their **collectability** from the customer becomes doubtful, such amounts should be recognised as an expense, not a deduction from revenue.

Example: Profitable contract with reliably estimated outcome

Gosforth Construction assesses the stage of completion of its contracts by reference to costs incurred as a percentage of total costs. The company commenced Contract A in 20X1. The contract has a fixed price of $890,000, recorded costs during 20X1 are $389,000, of which $10,000 relates to unused inventory. Expected future costs are $150,000.

Required

How much profit should be reported in 20X1 in accordance with HKAS 11?

Solution

	$
Costs incurred to date (389 – 10)	379,000
Estimated future costs (150 + 10)	160,000
Total estimated costs	539,000

The contract is therefore 70.3% (379,000/539,000) complete

Revenue to be recognised: $890,000 × 70.3% = $625,670

The profit earned to date is therefore $246,670 ($625,670 – $379,000)

Example: Inclusion in financial statements

Discovery Construction commenced a $4 million contract to build a velodrome in the year ended 31 December 20X3. Details of the contract costs are as follows:

	31 Dec 20X3	*31 Dec 20X4*	*31 Dec 20X5*
Estimated total costs	$3.2 million	$3.3 million	$3.3 million
Costs incurred to date	$1.2 million	$2.475 million	$3.3 million

What amounts should be included in Discovery Construction's financial statements for each of these years?

Solution

1 Calculate expected profit

	20X3	*20X4*	*20X5*
	$'000	$'000	$'000
Contract price – estimated total costs	800	700	700
2 Calculate percentage of completion			
Costs incurred/total costs	37.5%	75%	100%
3 Calculate cumulative statement of profit or loss amounts			
Revenue (% complete × revenue)	1,500	3,000	4,000
Cost of sales (costs incurred)	(1,200)	(2,475)	(3,300)
Profit (% complete × expected profit)	300	525	700

4 Calculate statement of profit or loss amounts for each year (cumulative amounts minus amounts previously recognised)

	$'000	$'000	$'000
Revenue	1,500	1,500	1,000
Cost of sales	(1,200)	(1,275)	(825)
Profit	300	225	175

It is evident from the first example above that when the contract costs incurred to date is used to determine the stage of completion, then only the contract costs reflecting the work to date should be incorporated in costs incurred to date.

- Costs relating to **future activity**, e.g. cost of materials delivered but not yet used, are to be excluded.
- Payments in advance made to subcontractors are to be excluded.

HKAS 11.36,37

2.2.2 Loss-making contract

Topic highlights

When the outcome of a contract can be reliably estimated and the project is loss-making, the loss must be recognised in the current year in full.

Any loss on a contract should be **recognised as soon as it is foreseen**. The loss will be the amount by which total expected contract revenue is exceeded by total expected contract costs.

The amount of the loss is not affected by:

- whether work has started on the contract
- the stage of completion of the work
- profits on other contracts (unless they are related contracts treated as a single contract).

Example: Loss-making contract (1)

Randall has a contract to construct a new head office for a multinational company. The contract price has been agreed as $7 million. When Randall first signed the contract, the estimated total costs to completion were assessed as $6.2 million. By the end of the first year of the contract, however, price rises have meant that estimated total costs are now $7.1 million. The contract is assessed as 28% complete by the end of the first year, based on costs incurred.

What amounts should be recognised in profit or loss in the first year of the contract?

Solution

The expected loss of $100,000 must be recognised in full, and forms part of cost of sales. Therefore:

	$'000
Revenue (balancing figure)	1,988
Cost of sales (28% × $7.1m) + $100,000	(2,088)
Loss	(100)

HKAS 11.32-34

2.3 Accounting treatment: outcome cannot be reliably estimated

Topic highlights

When the outcome of a contract cannot be reliably estimated no profit or loss is recognised; revenue is recognised to the extent that recognised costs incurred are recoverable.

When the contract's outcome cannot be reliably estimated the following treatment should be followed:

1 Contract costs are recognised as an expense as incurred
2 Revenue is recognised to the extent that contract costs are recoverable

This **no profit/no loss approach** reflects the situation near the beginning of a contract, i.e. the outcome cannot be reliably estimated, but it is likely that costs will be recovered.

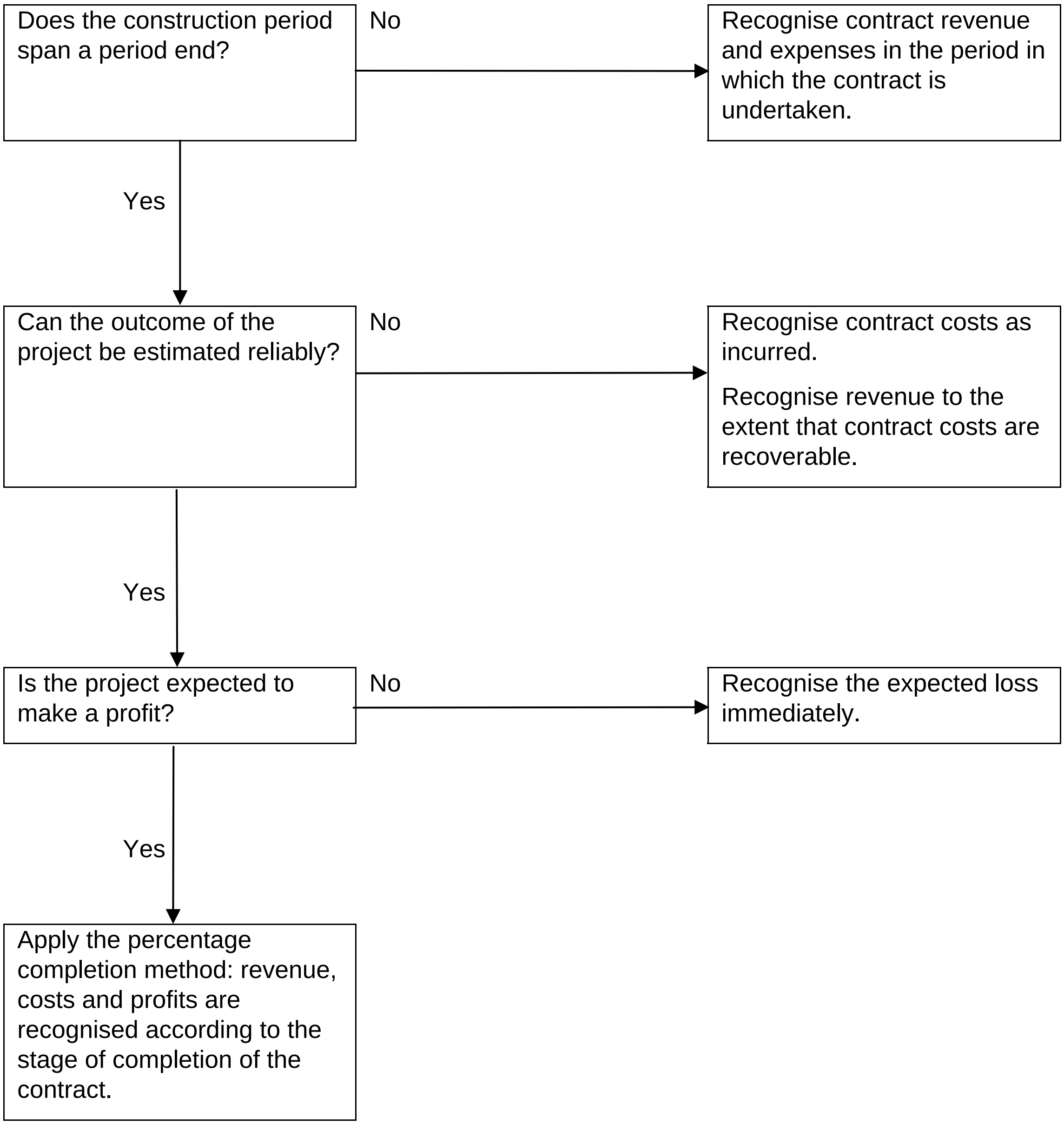
Contract costs which **cannot be recovered** should be recognised as an expense straight away. HKAS 11 lists the following situations where this might occur:

- The contract is **not fully enforceable**, i.e. its validity is seriously in question
- The completion of the contract is subject to the outcome of **pending litigation or legislation**
- The contract relates to properties which will probably be **expropriated or condemned**
- The customer is **unable to meet its obligations** under the contract
- The contractor **cannot complete** the contract or in any other way meet its obligations under the contract

Where these **uncertainties cease to exist,** contract revenue and costs should be recognised as normal, i.e. by reference to the stage of completion.

2.4 Summary of the treatment of construction contracts in the statement of profit or loss

The following flow chart will help to summarise the accounting treatment seen in sections 2.1 – 2.3 of the chapter.



HKAS 11.43,44

2.5 Construction contracts in the statement of financial position

The accounting treatment of construction contracts is profit or loss driven. Any amount included in the statement of financial position is a balancing amount, calculated as:

Contract costs incurred	X
Recognised profits less recognised losses	X/(X)
Progress billings	(X)
Amounts due from/to customers	X/(X)

- Where an amount due from customers is calculated, this is normally shown within inventories.
- Where an amount due to customers is calculated, this is normally shown as "payments on account" within payables.
- Any amount invoiced but unpaid is shown as a receivable.

Example: Loss-making contract (2)

Assume that in the previous example the customer had been billed a total of $1.5million, and had paid $1,280,000 of this.

The amounts reported in the statement of financial position would therefore be:

	$'000
Amounts due from customers (W)	388
Receivables	220

(W)	$'000
Contract costs incurred	1,988
Recognised profits less recognised losses	(100)
Progress billings	(1,500)
Amounts due from customers	388

HKAS 11.38

2.6 Changes in estimates

According to HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, the effect of any change in the estimate of contract revenue, costs or the outcome of a contract should be treated as a **change in accounting estimate**. In other words, the change is accounted for prospectively and does not affect amounts recognised in respect of previous years of a contract.

Example: Changes in estimates

Revenues and costs relating to a three-year contract commencing 1 January 20X5 are as follows:

	20X5	*20X6*	*20X7*
	$'000	$'000	$'000
Revenue per contract	1,200	1,200	1,200
Agreed variation	-	-	200
Total contract revenue	1,200	1,200	1,400
Contract costs incurred to date	263	700	1,320
Contract costs to completion	789	600	–
Total contract costs	1,052	1,300	1,320
Overall profit	148	(100)	80
% complete, using costs basis	25%	54%	100%

The 20X6 contract costs incurred to date include $200,000 which relates to additional work required for unforeseen extras. In 20X6 the contractor negotiated with the customer to recover the cost of this additional work, but it was not until 20X7 that it became probable that the customer would accept this contract variation.

Required

What amounts should be recognised in profit or loss in each of the three years?

Solution

		$'000
20X5	25% × expected profit of $148,000	37
20X6	Loss is expected and is recognised in full	(100)
	Less: profit previously recognised	(37)
	Loss recognised in 20X6	(137)
		$'000
20X7	Overall actual profit	80
	Add: cumulative loss previously recognised	100
	Profit recognised in 20X7	180

2.7 Section summary

A methodical approach is crucial for the valuation of long-term construction contracts and the other disclosure requirements under HKAS 11. The following method suggests a breakdown of the process into five logical steps, and is to be applied where the outcome of a contract can be estimated reliably.

1. The **contract value** is compared to the estimated **total costs** (costs to date plus estimated costs to completion) to be incurred on the contract. If a foreseeable loss on the contract is expected (that is, if the estimated total costs exceed the contract value), then this loss must be charged against profits. If a loss has already been charged previously, then only the difference between this loss and the loss currently estimated needs to be charged.
2. Apply the percentage of completion to date (or other formula given in the question) to the calculation of the sales revenue attributable to the contract for the period (for example, percentage of completion × total contract value, less revenue already recognised in previous periods).
3. **Calculate the cost of sales** on the contract for the period.

	$
Total contract costs × percentage complete (or follow instructions in question)	X
Less any costs charged in previous periods	(X)
	X
Add foreseeable losses in full (not previously charged)	X
Cost of sales on contract for the period	X

4. **Deduct the cost of sales** for the period as calculated above (including any foreseeable loss) from the sales revenue calculated at step 2 to give profit (loss) recognised for the period.

5 **Calculate amounts due to/from customers for inclusion in the statement of financial position**

	$
Contract costs incurred to date	X
Recognised profits/(losses) to date	X
	X
Progress billings to date	(X)
Amounts due from/(to) customers	X

Note. The progress billings figure above represents the total billed revenue. Unpaid billed revenue will be shown under trade receivables.

HKAS 11.39,40,42

2.8 Disclosures

The following should be disclosed in respect of construction contracts:

- The amount of contract revenue recognised as revenue in the period
- The methods used to determine the contract revenue recognised in the period
- The methods used to determine the stage of completion of contracts in progress

In addition, the following should be disclosed for contracts in progress at the reporting date:

- The aggregate amount of costs incurred and recognised profits (less recognised losses) to date
- The amount of advances received (amounts received before the related work is performed)
- The amount of retentions (amounts billed but unpaid until defects are rectified or conditions specified in the contract are met)

An entity should also present:

- The gross amount due from customers for contract work as an asset
- The gross amount due to customers for contract work as a liability.

Self-test question 1

At the start of 20X1 Globalle Company negotiated a fixed price contract of $14.0 million with Oceanic for the construction of a container port. Globalle had estimated the costs of the contract to be $13.3 million. Globalle estimates the stage of completion on its construction contracts by reference to the physical proportion of the work completed.

During 20X1 the contract suffered protracted delays and difficulties, such that Globalle concluded that there would be material cost overruns. It negotiated with Oceanic to try to get some recompense for these unexpected difficulties in the form of contract variations, but without success. At 31 December 20X1 when the contract was 30% physically complete, the costs incurred amounted to $4.9 million and the costs to complete were estimated at $11.2 million.

Throughout 20X2 Globalle continued to try to win recompense from Oceanic, but without success. At 31 December 20X2 when the contract was 80% physically complete, the costs incurred amounted to $12.6 million and the costs to complete were estimated at $3.5 million. On that day and after these figures had been drafted, Oceanic suddenly agreed in principle to a contract variation of $3.5 million, provided that Globalle agreed to pay Oceanic a penalty for late completion of $280,000. Globalle agreed to these terms and the relevant adjustments were made to the draft figures.

Required

Determine the following amounts in respect of the container port contract in Globalle's financial statements according to HKAS 11 *Construction Contracts*.

(a) The profit or loss to be recognised in the year ended 31 December 20X1
(b) The revenue to be recognised in the year to 31 December 20X2
(c) The profit or loss to be recognised in the year ended 31 December 20X2

(The answer is at the end of the chapter)

Self-test question 2

Aero Company has the following information in respect of a construction contract:

Total contract price	$100,000
Cost incurred to date	$48,000
Estimated cost to completion	$32,000
Progress billings (of which $50,000 has been received)	$58,000
Percentage complete (cost basis)	60%

Required

(a) Prepare relevant extracts from the statement of profit or loss and statement of financial position.

(b) Show how the statement of financial position would differ if progress billings were $64,000 (of which $50,000 received).

(The answer is at the end of the chapter)

3 Current developments

The IASB and FASB issued an Exposure Draft in relation to revenue recognition in June 2010. It is proposed that the resulting standard will replace both IAS 18 *Revenue* and IAS 11 *Construction Contracts* (and so their HKAS equivalents).

A revised exposure draft on the topic of revenue from contracts with customers was issued in November 2011, which simplifies a number of the original proposals. A final standard is expected during the course of 2013.

This project is considered in more detail in Chapter 14.

Topic recap

HKAS 11 Construction Contracts

Cost plus contract: contract in which the contractor is reimbursed for costs plus a percentage of costs or fixed fee

Contract specifically negotiated for the construction of an asset or combination of interrelated assets

Fixed price contract: contract with a fixed price sometimes subject to cost escalation clauses

HKAS 11 applies where a contract spans the period end

For a cost plus contract:
- Probable economic benefits will flow to the entity
- Contract costs can be clearly identified and measured

Accounting treatment depends on whether the outcome of the contract can be reliably estimated

For a **fixed price contract:**
- Contract revenue can be reliably measured
- Probable economic benefits will flow to entity
- Stage of completion of contract reliably measured
- Costs to complete reliably measured
- Contract costs can be clearly identified and measured

Can be reliably measured

Can't be reliably measured

Profitable contract

Loss-making contract

Revenue, costs and profit are recognised based on stage of completion

Loss is recognised in full as soon as it is foreseen

No profit or loss is recognised. Revenue is recognised to the extent that recognised costs incurred are recoverable

Disclose:
- Revenue recognised in period
- Methods to determine revenue recognised
- Methods to determine stage of completion
- Costs incurred plus recognised profits (less recognised losses) to date
- Advances received
- Retentions
- Amounts due from/to customers:

Costs incurred	x
Recognised profits/losses	x/(x)
Progress billings	(x)
	x/(x)

Answers to self-test questions

Answer 1

(a) $(2,100,000)
(b) $9,576,000
(c) $2,996,000

Profit / loss on contract

	20X1	*20X2*
	$'000	$'000
Contract price	14,000	14,000
Variation	–	3,500
Penalty	–	(280)
	14,000	17,220
Costs incurred to date	(4,900)	(12,600)
Estimated costs to completion	(11,200)	(3,500)
Profit / loss on contract	(2,100)	1,120

Amounts to be recognised	*20X1*	*20X2 cumulative*	*20X2 (cum – 20X1)*
	$'000	$'000	$'000
Revenue (30% × $14m / 80% × $17.22m)	4,200	13,776	9,576
Costs (β)	(6,300)		6,580
Loss (in full)	(2,100)		
Profit (80% × $1.12m)		896	2,996

At 31 December 20X1 the expected loss must be recognised immediately.

Under the agreement made on 31 December 20X2, the contract revenue is increased by the variation and reduced by the penalty.

The profit for the year ended 31 December 20X2 is the profit to date, PLUS the loss recognised in 20X1.

Answer 2

(a) STATEMENT OF PROFIT OR LOSS (EXTRACTS)

	$
Revenue (60% × 100,000)	60,000
Expenses (60% × 80,000)	(48,000)
Profit	12,000

STATEMENT OF FINANCIAL POSITION (EXTRACTS)

Current assets

Gross amounts due from customers	
Contract costs incurred to date	48,000
Recognised profits	12,000
	60,000
Less: progress billings to date	(58,000)
	2,000
Trade receivables	
Progress billings to date	58,000
Less: cash received	(50,000)
	8,000

WORKING

Overall expected profitability	$
Total revenue	100,000
Total expected costs (48,000 + 32,000)	(80,000)
Overall expected profit	20,000

(b) STATEMENT OF FINANCIAL POSITION (EXTRACTS)

	$
Current assets	
Trade receivables	
Progress billings to date	64,000
Less: cash received	(50,000)
	14,000
Current liabilities	
Gross amounts due to customers	
Contract costs incurred to date	48,000
Recognised profits	12,000
	60,000
Less: progress billings to date	(64,000)
	(4,000)

Exam practice

Construction contracts

22 minutes

(a) "It is not prudent to recognise profit on outstanding work in progress in construction contracts. Revenue and cost should only be recognised upon the completion of the construction work." Discuss. **(5 marks)**

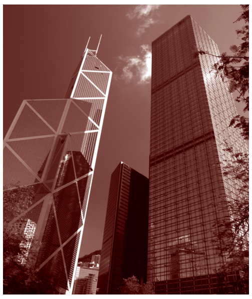
(b) At 30 June 20X9, Vertical Construction Company ("VC") had a fixed price construction contract in progress, named Waterfall Golf Villa, a project to construct 80 condominium units. 60 units have been completed and the remaining 20 units are expected to be completed in the last quarter of 20X9. A survey of completed construction work will be carried out upon completion of all units. Construction was begun in April 20X8 and the outcome of the contract could not be estimated reliably at 30 June 20X8. According to the original bid estimate, VC would have a profit margin of 20%. Based on the actual costs incurred and the latest information, there will be an increase in the estimated total costs because of a 15% increase in the price of construction material. However, a loss is not anticipated. An instalment contract sum for the construction has been received by VC in accordance with the contracted payment schedule.

Required

Explain how VC should account for this construction contract in the financial statements for the year ended 30 June 20X9. **(7 marks)**

(Total = 12 marks)

HKICPA May 2009



chapter 13

Share-based payment

Topic list

1 HKFRS 2 *Share-Based Payment*
- 1.1 Introduction
- 1.2 Objective and scope
- 1.3 Definitions

2 Recognition and measurement of share-based payments
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Learning focus

Share-based payment is a controversial area. It is, however relevant, as share option schemes are common.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
Account for transactions in accordance with Hong Kong Financial Reporting Standards		
3.05	**Share-based payment**	2
3.05.01	Identify and recognise share-based payment transactions in accordance with HKFRS 2	
3.05.02	Account for equity-settled and cash-settled share-based payment transactions	
3.05.03	Account for share-based payment transactions with cash alternatives	
3.05.04	Account for unidentified goods or services in a share-based payment transaction	
3.05.05	Account for group and treasury share transactions	
3.05.06	Disclosure requirement of share option	

1 HKFRS 2 *Share-Based Payment*

Topic highlights

Share-based payment transactions are those transactions where an entity receives goods or services in return for its own equity instruments or an amount of cash related to the value of its equity instruments.

1.1 Introduction

It is increasingly common for entities to issue shares or share options to other parties, such as suppliers or employees, in return for goods or services received. In some instances neither shares nor share options are issued, but cash consideration is promised at a later date, measured in relation to share price. All of these transactions are examples of share-based payments.

Share option schemes are a common feature of directors' remuneration packages and many organisations also use such schemes to reward other employees. Share-based payments are also a very common form of consideration for internet businesses which are notoriously loss making in early years and therefore cash poor.

1.1.1 The accounting problem

Prior to the issue of HKFRS 2, no accounting guidance existed in relation to share-based payments. This resulted in inconsistent treatment of expenses: those paid in cash were recognised in profit or loss while those involving a share-based payment were not, because share options initially had no value (since the exercise price is generally more than the market price of the share on the date the option is granted).

As we shall see in this chapter, the issue of HKFRS 2 meant that companies were required to recognise an expense in relation to share-based payments. As a result those companies which made share-based payments saw a reduction in earnings, in some cases of a significant amount. For this reason, HKFRS 2 remains controversial in practice.

HKFRS 2.1-6

1.2 Objective and scope

HKFRS 2 requires an entity **to reflect in its profit or loss and financial position the effects of share-based payment transactions**, including expenses associated with transactions in which share options are granted to employees.

The standard must be applied to all share-based payment transactions whether or not the goods or services received under the share-based payment transaction can be individually identified, including:

(a) **Equity-settled share-based payment transactions**

(b) **Cash-settled share-based payment transactions**

(c) Transactions in which the entity receives or acquires goods or services and the terms of the arrangement provide either the entity or the supplier of those goods or services with a choice of whether the entity settles the transaction in cash (or other assets) or by issuing equity instruments.

The standard also applies to group-settled share-based transactions. That is where one group entity receives goods or services and another entity within the group settles the share-based payment transaction. In this case HKFRS 2 applies to both entities.

Certain transactions are **outside the scope** of the HKFRS:

(a) Transactions with employees and others in their capacity as a holder of equity instruments of the entity (for example, where an employee receives additional shares in a rights issue to all shareholders)

(b) The issue of equity instruments in exchange for control of another entity in a business combination, or business under common control or the contribution of a business on the formation of a joint venture.

HKFRS 2, Appendix A

1.3 Definitions

The standard provides the following definitions.

Key terms

Share-based payment transaction is a transaction in which the entity:

(a) receives goods or services from the supplier of those goods or services (including an employee) in a share-based payment arrangement, or

(b) incurs an obligation to settle the transaction with the supplier in a share-based payment arrangement when another group entity receives those goods or services.

Share-based payment arrangement is an agreement between the entity (or another group entity) and another party (including an employee) that entitles the other party to receive:

(a) cash or other assets of the entity for amounts that are based on the price (or value) of equity instruments (including shares or share options) of the entity or another group entity, or

(b) equity instruments (including shares or share options) of the entity or another group entity provided the specified vesting conditions are met.

Equity instrument is a contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Equity instrument granted is the right (conditional or unconditional) to an equity instrument of the entity conferred by the entity on another party, under a share-based payment arrangement.

Share option is a contract that gives the holder the right, but not the obligation, to subscribe to the entity's shares at a fixed or determinable price for a specified period of time.

Fair value is the amount for which an asset could be exchanged, a liability settled, or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm's length transaction.

Grant date is the date at which the entity and another party (including an employee) agree to a share-based payment arrangement, being when the entity and the other party have a shared understanding of the terms and conditions of the arrangement. At the grant date the entity confers on the other party (the counterparty) the right to cash, other assets, or equity instruments of the entity, provided the specified vesting conditions, if any, are met. If that agreement is subject to an approval process (for example, by shareholders), the grant date is the date when that approval is obtained.

Intrinsic value is the difference between the fair value of the shares to which the counterparty has the (conditional or unconditional) right to subscribe or which it has the right to receive, and the price (if any) the other party is (or will be) required to pay for those shares. For example, a share option with an exercise price of $15 on a share with a fair value of $20, has an intrinsic value of $5.

Key terms (cont'd)

Measurement date is the date at which the fair value of the equity instruments granted is measured. For transactions with employees and others providing similar services, the measurement date is grant date. For transactions with parties other than employees (and those providing similar services), the measurement date is the date the entity obtains the goods or the counterparty renders service.

Vest means to become an entitlement. Under a share-based payment arrangement, a counterparty's right to receive cash, other assets, or equity instruments of the entity vests when the counterparty's entitlement is no longer conditional on the satisfaction of any vesting conditions.

Vesting conditions are 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 condition.

Vesting period is the period during which all the specified vesting conditions of a share-based payment arrangement are to be satisfied.

Note that the definition of fair value within HKFRS 2 differs from that within HKFRS 13 *Fair Value Measurement*. When applying HKFRS 2, the definition contained within that standard should be used rather than HKFRS 13.

2 Recognition and measurement of share-based payments

HKFRS 2.7-8

The basic principle presented in HKFRS 2 with regard to recognition is that an entity should recognise goods or services received or acquired in a share-based payment transaction when it obtains the goods or as the services are received.

The goods or services received should be recognised as an expense, or asset where appropriate.

The corresponding accounting entry depends on whether the share-based payment will be equity or cash-settled.

HKFRS 2.10

2.1 Equity settled share-based payment transactions

Topic highlights

Equity-settled share-based payment transactions with parties other than employees are measured at the fair value of the goods or services received and recognised in equity, normally immediately.

Equity settled share-based payment transactions with employees are measured at the fair value of the equity instruments on the grant date and recognised in equity over the vesting period.

Goods or services received or acquired in an **equity-settled share-based payment transaction** should be recognised in equity:

DEBIT Expense / asset
CREDIT Equity

Before considering when this accounting entry is made, we must consider how an equity settled share-based payment is measured.

HKFRS 2.11-13

2.1.1 Measurement of equity-settled share-based payment transactions

The general principle in HKFRS 2 is that an entity should measure a share-based payment transaction at the **fair value of the goods or services received**.

In the case of equity-settled transactions, the application of this rule depends on who the transaction is with:

(a) Where the transaction is with **employees** and forms part of their remuneration package, it is not normally possible to measure directly the services received. Therefore the transaction is measured by reference to the fair value of the equity instruments granted at the grant date (the indirect method).

(b) Where the transaction is with **parties other than employees**, there is a rebuttable presumption that the fair value of the goods or services received can be estimated reliably, and therefore the transaction is measured at this amount (the direct method).

(c) Where this is not the case, the entity should measure the transaction's value using the indirect method.

Where the indirect method (by reference to the fair value of the equity instruments granted) is adopted to measure a transaction, fair value is based on the **market prices**, if available, taking into consideration the terms and conditions upon which those equity instruments were granted.

In the absence of market prices, the fair value of the equity instruments granted should be approximated using a **valuation technique**. (These are not within the scope of this exam.)

Example: Measurement of equity-settled share-based transactions

Barbar Co. issues 100 share options to each of its 1,000 employees on 1 July 20X1.

The fair value of the share options is $8 on grant date.

Required

How is the share-based transaction measured?

Solution

Equity-settled transactions with employees are measured by reference to the fair value of the equity instruments granted on the grant date.

Therefore 100 options × 1,000 employees × $8 = $800,000

HKFRS 2.14,15

2.1.2 Recognition of equity-settled share-based payment transactions

Where the equity instruments granted vest immediately i.e. the recipient party becomes entitled to them immediately, then the transaction is accounted for in full on the grant date. This is normally the case with transactions with parties other than employees, which are:

- measured at the fair value of the goods or services received, and
- recognised when the goods or services are provided.

Where the counterparty to the transaction has to meet specified conditions before they are entitled to the equity instruments, and these are to be met over a specified vesting period, the expense is spread over this vesting period. This is normally the case with transactions with employees, discussed in more detail in the next section.

HKFRS 2.14,15

2.1.3 Transactions with employees

Where the equity instruments granted to employees **vest immediately** (i.e. the employee is not required to complete a specified period of service before becoming unconditionally entitled to the equity instruments), it is presumed that the services have already been received (in the absence of evidence to the contrary). The entity should therefore recognise the transaction in full on the grant date, by recognising the fair value of the equity instruments granted as an expense and a corresponding increase in equity.

Where the equity instruments granted do not vest until the counterparty completes a specified period of service, the entity should account for those services as they are rendered by the employee during the vesting period. For example, if an employee is granted share options on condition that he or she completes three years' service, then the services to be rendered by the employee as consideration for the share options will be received in the future, over that three-year vesting period. Therefore, the fair value of the equity instruments granted should be spread over the three years, with an expense and corresponding increase in equity recognised in each year.

The expense recognised in each year of the vesting period should be based on the best available estimate of the number of equity instruments expected to vest. That estimate should be revised if subsequent information indicates that the number of equity instruments expected to vest differs from previous estimates.

On the vesting date, the entity should revise the estimate to equal the number of equity instruments that actually vest.

Once the goods and services received and the corresponding increase in equity have been recognised, the entity should make no subsequent adjustment to total equity after the vesting date.

Example: Equity-settled share-based payment transaction – vesting period (1)

Continuing with the example above:

(a) Assume that the share options issued by Barbar Co. to its employees vest immediately and there is a three-year period over which the employees may exercise the share options. Employees are entitled to exercise the options regardless of whether or not they remain in the entity's employment during the period of exercise.

(b) Assume that the share options issued by Barbar Co. on 1 July 20X1 do not vest until 1 July 20X3, and this is conditional upon the individual employees remaining in employment with the company. It is not anticipated that any employees will leave before this date. This assumption is confirmed at 1 July 20X3 when all 1,000 employees remain in employment.

Required

When is the transaction recognised in each instance assuming a year end of 30 June?

Solution

As we saw earlier, the total fair value for the share options issued at grant date is:

$8 × 1,000 employees × 100 options = $800,000

(a) In this situation the options vest immediately i.e. the employees are immediately entitled to them. It is therefore assumed that Barbar has already benefited from the services provided by the employees in exchange for the options. Barbar Co. should therefore charge $800,000 to profit or loss as employee remuneration on 1 July 20X1 and the same amount will be recognised as part of equity on that date.

(b) In the second situation, the options do not vest until two years have passed, and they only vest for those employees who continue to work for Barbar at this date.

It is assumed that all employees will continue to work for Barbar.

Therefore in this case the $800,000 is spread over the two years ended 30 June 20X2 and 20X3 with $400,000 recognised as an expense and in equity in each year:

	20X2	*20X3*
	$	$
Remuneration expense in profit or loss	400,000	400,000
Equity	400,000	800,000

This ensures that the expense associated with the share-based payment is matched to the period in which Barbar benefits from the employees' services.

We shall consider in later examples how this might differ if some employees left Barbar Co. before the vesting date.

Example: Equity-settled share-based payment transaction – vesting period (2)

Whiston Co. provides each of 200 managers with 500 share options on 1 January 20X1. Each option has a fair value of $8 at the grant date, $10 on 1 January 20X2, $13 on 1 January 20X3 and $12 on 31 December 20X3.

The options do not vest until 31 December 20X3 and are dependent on continued employment. All 200 managers are expected to remain with the company.

Required

Explain the accounting treatment of the share options in each of the years 20X1, 20X2 and 20X3.

Solution

The total expense to be recognised over the three-year vesting period is:

$200 \times 500 \times \$8 = \$800,000$

Note that the changes in the value of the options after grant date do not affect the charge to profit or loss for equity-settled transactions.

The remuneration expense should be recognised over the vesting period of three years. An amount of $266,667 should be recognised for each of the three years 20X1, 20X2 and 20X3 in profit or loss with a corresponding credit to equity.

Example: Equity-settled share-based payment transaction – vesting period (3)

The circumstances are as in the example above, however managers are expected to leave the company as follows:

- At 31 December 20X1, it is estimated that 10% of managers will have left by the end of 20X3.
- At 31 December 20X2, it is estimated that 14% of managers will have left by the end of 20X3.
- By the end of 20X3, 20% of the original managers awarded share options have actually left.

Required

Explain the accounting treatment in each of the years 20X1, 20X2 and 20X3.

Solution

The expense to be recognised in each year in relation to the share options over the vesting period is based on the estimated number of shares expected to vest. As options held by employees who leave the company will not vest, these must be excluded from the amount recognised. Therefore:

		Total expense
20X1	200 managers × 90% × 500 options × $8 fair value	$720,000
This is divided by the three-year vesting period to give an annual expense in 20X1 of		$240,000
20X2	200 managers × 86% × 500 options × $8 fair value	$688,000
To date two years of expense should have been recognised i.e. $688,000 × 2/3		$458,667
As $240,000 was recognised in 20X1, the 20X2 expense is $458,667 – $240,000		$218,667
20X3	200 managers × 80% × 500 options × $8 fair value	$640,000
All expense should now have been recognised as the vesting period is complete.		
Therefore in 20X3 the expense is $640,000 – $240,000 – $218,667		$181,333

Self-test question 1

Armley Co. issues 10,000 options to each of the 50 directors and senior managers on 1 July 20X1.

The exercise price of the options is $4.50 per share. The scheme participants have to stay with the company for four more years before being able to exercise their options.

At 31 December 20X1, it is estimated that 75% of the current directors and senior managers will remain with the company for four years or more. The estimated figure is 70% by 31 December 20X2.

The fair value of an option is $3 at the grant date.

Required

Show how the option scheme would be reflected in the financial statements for the years ended 31 December 20X1 and 31 December 20X2.

(The answer is at the end of the chapter)

Self-test question 2

An entity grants 100 share options on its $1 shares to each of its 500 employees on 1 January 20X5. Each grant is conditional upon the employee working for the entity over the next three years. The fair value of each share option as at 1 January 20X5 is $15.

On the basis of a weighted average probability, the entity estimates on 1 January that 20% of employees will leave during the three-year period and therefore forfeit their rights to share options.

Required

Show the accounting entries which will be required over the three-year period in the event of the following:

- 20 employees leave during 20X5 and the estimate of total employee departures over the three-year period is revised to 15% (75 employees)
- 22 employees leave during 20X6 and the estimate of total employee departures over the three-year period is revised to 12% (60 employees)

- 15 employees leave during 20X7, so a total of 57 employees left and forfeited their rights to share options. A total of 44,300 share options (443 employees × 100 options) are vested at the end of 20X7.

(The answer is at the end of the chapter)

2.1.4 Multiple vesting dates

In the share-based payment schemes seen in the above examples, there is one date on which the share options vest. It may, however, be the case that there are a number of vesting dates within one scheme. In this case, the options relating to each vesting date should be accounted for separately.

Example: Equity-settled share-based payment transaction – multiple vesting dates

On 1 January 20X0, Newsome Co. granted 4,000 options to each of the four directors of the company. Half of these vest on 31 December 20X1 and half on 31 December 20X2 on the condition that the directors continue to be employed by Newsome Co. on the relevant vesting date.

It was expected that all of the directors would continue to be employed to 31 December 20X2. However on 31 March 20X1, one of the directors left the company. This departure did not alter expectations with regards to the remaining directors continuing in employment. All directors in receipt of vested options exercised these options at the first opportunity.

On 1 January 20X0, the fair value of each option was estimated to be HK$50.

Required

Show the accounting treatment in each of the years ended 31 December 20X0, 20X1 and 20X2.

Solution

Although the 4,000 options are within the same scheme, they have different vesting dates: 2,000 vest in 20X1 and 2,000 vest in 20X2. In effect, these are two separate types of options and need to be considered separately.

Options vesting in 20X1

Y/e 31 Dec	*Options expected to vest*	*FV of option* HK$			*Charge to profit or loss* HK$
20X0	2,000 × 4 = 8,000	× 50	= 400,000	×1yr/2yrs	200,000
20X1	2,000 × 3 = 6,000	× 50	= 300,000		300,000
					(200,000)
					100,000

Options vesting in 20X2

Y/e 31 Dec	*Options expected to vest*	*FV of option* HK$			*Charge to profit or loss* HK$
20X0	2,000 × 4 = 8,000	× 50	= 400,000	× 1yr/3yrs	133,333
20X1	2,000 × 3 = 6,000	× 50	= 300,000	× 2yrs/3yrs	200,000
					(133,333)
					66,667
20X2	2,000 × 3 = 6,000	× 50	= 300,000		300,000
					(200,000)
					100,000

The expense in relation to the share-based payment scheme is recognised by (HK$):

			$	$
20X0	DEBIT	Directors' remuneration (200,000 + 133,333)	333,333	
	CREDIT	Share-based payment reserve		333,333
20X1	DEBIT	Directors' remuneration (100,000 + 66,667)	166,667	
	CREDIT	Share-based payment reserve		166,667
20X2	DEBIT	Directors' remuneration	100,000	
	CREDIT	Share-based payment reserve		100,000

HKFRS 2.31,32

2.2 Cash-settled share-based payment transactions

Topic highlights

Cash-settled share-based payment transactions are recognised as a liability and measured at the fair value of that liability. They are remeasured at the end of each reporting period.

The following may be included as cash-settled share-based payment transactions:

- The grant of share appreciation rights to employees: instead of the entitlement to an equity instrument, the employees are entitled to a future cash payment which is based on the increase in the entity's share price from a specified level over a specified period of time, or
- The grant to its employees of a right to receive a future cash payment by giving them **a right to shares that are redeemable**

A liability should be recognised where goods or services are received or acquired in a **cash-settled share-based payment transaction**. It is recorded by a debit to an expense or asset account and a credit to a liability account.

DEBIT Expense/asset
CREDIT Liability

HKFRS 2.30

2.2.1 Measurement of cash-settled share-based payment transactions

The primary principle is that the **fair value of the liability** is used to measure the goods or services acquired and the liability incurred by the entity.

The fair value of the liability should be reassessed **at each reporting date** till its settlement and also **at the date of settlement**. Any changes in fair value are recorded as profit or loss for the period.

HKFRS 2.32

2.2.2 Recognition of cash-settled share-based payment transactions

The services received from the employees, and a liability to pay for those services should be recognised as services are rendered. For example, if a specified period of service has to be completed by the employees before share appreciation rights are vested, the services received and the related liability should then be recognised over that period.

Example: Cash-settled share-based payment transaction

Arthing Co. has provided a share incentive scheme to a number of its employees on 1 January 20X1. This allows for a cash payment to be made to the individuals concerned equal to the share price at the end of a three-year period subject to the following conditions.

1 Vesting will be after three years
2 The share price must exceed $4
3 The employee must be with the company on 31 December 20X3

Each scheme issued will result in payment, subject to the conditions outlined, equal to the value of 10 shares at the end of the three-year period if the conditions are satisfied. The payments, once earned, are irrevocable.

The Chief Operating Officer has been issued 20 such schemes.

The share prices over the next three years were as follows:

31 December 20X1	$4.20
31 December 20X2	$3.80
31 December 20X3	$4.40

Required

(a) Prepare the journal entries for the transactions of the share incentives issued to the Chief Operating Officer.

(b) Assuming that on 1 January 20X1 four other individuals were also granted equivalent rights to the Chief Operating Officer and that on 1 January 20X2, two of those individuals left the company, prepare the journal entries for the transactions relating to the incentive schemes.

Solution

(a) Journal entries for transactions: Chief Operating Officer

The transactions are settled in cash and hence liabilities are created.

31 December 20X1		$	$
DEBIT	Remuneration expense	280	
CREDIT	Remuneration liability		280

It is assumed that the current share price is the best estimate of the final share price.

(calculation note: 20 × 10 × $4.20 × 1/3 = $280)

31 December 20X2			
DEBIT	Remuneration liability	280	
CREDIT	Remuneration expense		280

Reverses entries for 20X1 as share price is less than minimum

31 December 20X3			
DEBIT	Remuneration expense	880	
CREDIT	Remuneration liability		880
DEBIT	Remuneration liability	880	
CREDIT	Cash		880

(calculation note: 20 × 10 × $4.40 × 3/3 = $880)

(b) Journal entries for transactions: all individuals

31 December 20X1		$	$
DEBIT	Remuneration expense	1,400	
CREDIT	Remuneration liability		1,400

(calculation note: 20 × 10 × 5 × $4.20 × 1/3 = $1,400)

31 December 20X2:			
DEBIT	Remuneration liability	1,400	
CREDIT	Remuneration expense		1,400

31 December 20X3			
DEBIT	Remuneration expense	2,640	
CREDIT	Remuneration liability		2,640
DEBIT	Remuneration liability	2,640	
CREDIT	Cash		2,640

(calculation note: 20 × 10 × 3 × $4.40 × 3/3 = $2,640)

2.3 Share-based payments with a choice of settlement

Topic highlights

Where there is a choice of settlement and the counterparty has that choice, both a debt and equity component of the share-based transaction is identified and accounted for separately.

Where there is a choice of settlement and the entity has that choice, a liability must be recognised to the extent there is an obligation to deliver cash.

Accounting for share-based transactions with a choice of settlement depends on which party has the choice.

- Where the counterparty has a choice of settlement, the entity is deemed to have granted a compound instrument, and a liability component and an equity component are identified.
- Where the entity has a choice of settlement, the whole transaction is treated either, as cash-settled or as equity-settled, depending on whether the entity has an obligation to settle in cash.

HKFRS 2.35,36,38

2.3.1 Counterparty has choice of settlement

Where the counterparty to the transaction has a choice of settlement, a compound instrument has been granted i.e. a debt and equity component must be identified.

Where the transaction is with parties other than employees and the fair value of the goods or services received is measured directly, the entity shall measure the equity component of the compound financial instrument as the **difference between the fair value of the goods or services received and the fair value of the debt component**, at the date when the goods or services are received.

Where the transaction is with employees, the fair value of the compound instrument is estimated as a whole. The debt and equity components must then be valued separately. Normally transactions are structured in such a way that the fair value of each alternative settlement is the same.

The entity is required to account separately for the goods or services received or acquired in respect of each component of the compound financial instrument. The debt component is accounted for in the same way as a cash-settled share-based payment. The equity component is recognised in the same way as an equity-settled share-based payment.

HKFRS 2.41-43

2.3.2 Entity has choice of settlement

Where the entity chooses what form the settlement will take, a liability should be recognised to the extent that there is a present obligation to deliver cash.

This is the case where, for example, the entity is prohibited from issuing shares or where it has a stated policy, or past practice, of issuing cash rather than shares.

Where a present obligation exists, the entity should record the transaction as if it is a cash-settled share-based payment transaction.

If no present obligation exists, the entity should treat the transaction as if it was purely an equity-settled transaction. On settlement, if the transaction was treated as an equity-settled transaction and cash was paid, the cash should be treated as if it was a repurchase of the equity instrument by a deduction against equity.

Example: Choice of settlement

On 1 January 20X7 an entity grants an employee a right under which he can, if he is still employed on 31 December 20X9, elect to receive either 10,000 shares or cash to the value, on that date, of 9,000 shares.

The market price of the entity's shares is $310 at the date of grant, $370 at the end of 20X7, $430 at the end of 20X8 and $520 at the end of 20X9, at which time the employee elects to receive the shares. The entity estimates the fair value of the share route to be $290. Show the accounting treatment.

Solution

This arrangement results in a compound financial instrument.

The fair value of the cash route is:

9,000 × $310 = $2.79m

The fair value of the share route is:

10,000 × $290 = $2.90m

The fair value of the equity component is therefore:

$110,000 ($2,900,000 less $2,790,000)

The share-based payment is recognised as follows:

		Liability	*Equity*	*Expense*
		$	$	$
20X7	1/3 × 9,000 × $370	1,110,000		1,110,000
	$110,000 × 1/3		36,667	36,667
20X8	2/3 × 9,000 × $430	2,580,000		1,470,000
	$110,000 × 1/3		36,667	36,667
20X9	9,000 × $520	4,680,000		2,100,000
	$110,000 × 1/3		36,666	36,666

As the employee elects to receive shares rather than cash, $4,680,000 is transferred from liabilities to equity at the end of 20X9. The balance on equity is $4,790,000.

2.4 Section summary

Equity-settled share-based payment transactions

- Total expenses on equity settlement is expensed to statement of profit or loss:

$$\frac{\text{Number of shares granted} \times \text{Fair value of options on grant date}}{\text{Vesting period (years)}}$$

- Corresponding entry to equity
- Expensed annually over the vesting period
- No adjustment even though fair value of option changes

Cash-settled share-based payment transactions

- Total expenses on liability settlement expensed to statement of profit or loss:

$$\frac{\text{Number of shares granted} \times \text{Fair value of options at each reporting date}}{\text{Vesting period (years)}}$$

- Corresponding entry to liability
- Only the residual amount is expensed to statement of profit or loss
- Expensed annually over the vesting period

Choice of settlement – counterparty's choice

- Compound instrument is split into debt and equity components
- Debt component is accounted for as a cash-settled transaction
- Equity component is accounted for as an equity-settled transaction

Choice of settlement – entity's choice

- Account for as cash-settled if there is an obligation to deliver cash
- Account for as equity-settled otherwise

3 Share-based payment transactions – further issues

Topic highlights

An entity that receives goods or services in a share-based payment transaction must account for those goods or services no matter which entity in the group settles the transaction, and no matter whether the transaction is settled in shares or cash.

3.1 Group cash-settled share-based payment transactions

Amendments to *HKFRS 2 Share-based Payment: Group Cash-Settled Share-Based Payment Transactions*, which are effective for periods beginning on or after 1 January 2010 clarify how an individual subsidiary in a group should account for some share-based payment arrangements in its own financial statements.

HKFRS 2.43A-D

3.1.1 Share-based payment transactions among group entities

HKFRS 2 applies when an entity enters into a share-based payment transaction regardless of whether the transaction is to be settled by the entity itself, or by another group member on behalf of the entity.

The amendments to HKFRS 2 clarify the classification of share-based payment transactions for both the entity that receives the goods or services, and the entity that settles the share-based payment transaction.

The entity receiving the goods or services will recognise the transaction as an equity-settled share-based payment transaction only if:

- the awards granted are its own equity instruments
- it has no obligation to settle the transaction

In all other circumstances, the entity will measure the transaction as a cash-settled share-based payment.

Subsequent remeasurement of such equity-settled transactions will only be carried out for changes in non-market vesting conditions.

The entity responsible for settling the transaction will recognise it as an equity-settled share-based payment only if the transaction is settled in its own equity instruments. In all other circumstances, the transaction will be recognised by the entity that settles the award as a cash-settled share-based payment.

The guidance can be illustrated for the most commonly occurring scenarios as follows.

			Classification	
Entity receiving goods and services	Obligation to settle share-based payment transaction	How is it settled?	Subsidiary's individual financial statements	Consolidated financial statements
Subsidiary	Subsidiary	Equity of the subsidiary	Equity	Equity
Subsidiary	Subsidiary	Cash	Cash	Cash
Subsidiary	Subsidiary	Equity of the parent	Cash	Equity

Entity receiving goods and services	Obligation to settle share-based payment transaction	How is it settled?	Classification	
			Subsidiary's individual financial statements	Consolidated financial statements
Subsidiary	Parent*	Equity of the parent	Equity	Equity
Subsidiary	Parent*	Cash	Equity	Cash

*The same classification will result if the settlement obligation lies with the shareholders or another group entity (e.g. a fellow subsidiary).

As the classification may be different at the subsidiary and parent level, the amount recognised by the entity receiving the goods or services may differ from the amount recognised by the entity settling the transaction and in the consolidated financial statements.

Intragroup repayment arrangements will not affect the application of the principles described above for the classification of group-settled share-based payment transactions.

Example: group cash-settled share-based transaction

On 1 January 20X1, Principal Co. implemented a share incentive scheme for the five members of senior management at its subsidiary Sublime Co..

Principal will make a cash payment to the senior managers on 31 December 20X2 based on the price of Sublime's shares at that date, provided that the managers remain in service.

Ten share appreciation rights (SARs) are granted to each senior manager on 1 January 20X1, each with a fair value of $80. The fair value of each SAR at 31 December 20X1 is $70 and at 31 December 20X2 is $90.

All five senior managers are expected to remain in employment until the settlement date.

Required

What entries are required to record this transaction in the financial statements of Principal, Sublime and the Group?

Solution

Principal

Principal is the entity responsible for settling the transaction. As the transaction will not be settled in Principal's own equity instruments it must be recognised as a cash-settled share-based payment transaction.

On initial recognition of the liability based on the fair value of the SARs at the *grant date*, a debit is made to the cost of investment in Sublime. Remeasurements of the liability due to subsequent movements in the fair value of the SARs are recognised in profit or loss. The reason for this will become apparent shortly.

			$	$
20X1	DEBIT	Cost of investment in Sublime	2,000	
		(5 × 10 SARs × $80)/2 years		
	CREDIT	Remuneration liability		2,000
	To record the liability after one year's service based on initial fair value of the SARs.			
	DEBIT	Remuneration liability	250	
		$2,000 – (5 × 10 SARs × $70)/2 years		
	CREDIT	Profit or loss		250
	To remeasure the liability based on the period end fair value of the SARs.			

			$	$
20X2	DEBIT	Cost of investment in Sublime		
		(5 × 10 SARs × $80) – 2,000	2,000	
	CREDIT	Remuneration liability		2,000

To record the liability after two years' service based on initial fair value of the SARs.

		$	$
DEBIT	Profit or loss	750	
	(5 × 10 SARs × $90) – $3,750		
CREDIT	Remuneration liability		750

To remeasure the liability prior to settlement based on the period end fair value of the SARs.

DEBIT	Remuneration liability	4,500	
CREDIT	Cash		4,500

To record the settlement of the transaction.

Sublime

Sublime is the entity receiving the services of the five senior managers. It has no obligation to settle the transaction itself and therefore it must be recognised as an equity-settled share-based payment transaction:

			$	$
20X1	DEBIT	Remuneration expense (5 × 10 SARs × $80)/2 years	2,000	
	CREDIT	Equity		2,000

To record the first year's service expense and corresponding increase in equity.

20X2	DEBIT	Remuneration expense (5 × 10 SARs × $80) – $2,000	2,000	
	CREDIT	Equity		2,000

To record the second year's service expense and corresponding increase in equity.

As the transaction is treated as equity-settled in Sublime's financial statements, no re-measurement takes place.

Group

The Principal Group as the receiving entity has the obligation to settle in cash and therefore in the consolidated accounts the transaction is accounted for as cash-settled:

			$	$
20X1	DEBIT	Expense (5 × 10 SARs × $70)/2 years	1,750	
	CREDIT	Remuneration liability		1,750

To recognise the liability at the end of the first year of service based on the fair value of the SARs at this date.

20X2	DEBIT	Expense (5 × 10 SARs × $90) – $1,750	2,750	
	CREDIT	Remuneration liability		2,750

To remeasure the liability at the settlement date based on the fair value of the SARs at this date.

		$	$
DEBIT	Remuneration liability	4,500	
CREDIT	Cash		4,500

To record the settlement of the transaction.

It should now be apparent why the entries in Principal's records are split between amounts related to the initial fair value of the SARs (debited to Cost of Investment) and subsequent remeasurements (debited/credited to profit or loss).

On consolidation the cost of investment in Principal must be cancelled against the equity and reserves in Sublime. As HKFRS 2 requires that the movement in equity in Sublime's accounts is based on the $80 fair value at the grant date, and not remeasured, it follows that the movement in the cost of investment in Principal's accounts must be based on the same amount. Therefore, any remeasurements must be dealt with separately through profit or loss.

3.2 Treasury share transactions

Where a company holds a number of its own shares, those shares are known as "Treasury shares".

Guidance on treasury share transactions previously contained within HK(Int)IFRIC 11 is incorporated into HKFRS 2 with effect from 1 January 2010.

Where an entity grants rights to its own equity instruments to employees, and then either chooses or is required to buy those equity instruments from another party, in order to satisfy its obligations to its employees under the share-based payment arrangement, the transaction is accounted for as an equity-settled transaction.

4 Disclosure of share-based payment transactions

HKFRS 2.44

HKFRS 2 has extensive disclosure requirements including:

(a) Information that enables users of the financial statements to understand the nature and extent of share-based payment arrangements that existed during the period.

(b) Information that enables users of the financial statements to understand how the **fair value** of the goods or services received, or the fair value of the **equity instruments granted**, during the period was determined.

(c) Information that enables users of the financial statements to understand the effect of **share-based payment transactions** on the entity's profit or loss for the period and on its financial position.

HKFRS 2.45

4.1 Nature and extent of share-based payment arrangements

Information which aids an understanding of the nature and extent of share-based payment arrangements includes the following:

(a) A description of each type of **share-based payment arrangement** that existed at any time during the period.

(b) The number and weighted average exercise priced of share options outstanding at the beginning of the period, granted during the period, forfeited during the period, exercised during the period, expired during the period, outstanding at the end of the period and exercisable at the end of the period.

(c) For **share options** exercised during the period, the weighted average share price at the date of exercise.

(d) For **share options** outstanding at the end of the period, the range of exercise prices and weighted average remaining contractual life.

HKFRS 2.47-49

4.2 Determination of fair value

Information which enables an understanding of how fair value is determined includes the disclosures below:

(a) If the entity has measured directly the **fair value** of goods or services received during the period, the entity shall disclose how that fair value was determined.

(b) If the entity has rebutted the presumption that goods or services from parties other than employees can be measured reliably, it shall disclose that fact, and give an explanation of why the presumption was rebutted.

(c) If the entity has measured the **fair value** of goods or services received as consideration for **equity instruments** of the entity indirectly, by reference to the fair value of the **equity instruments granted**:

- For **share options** granted during the period, the weighted average fair value of those options at the **measurement date** and information on how that fair value was measured.
- For other equity instruments granted during the period (i.e. other than share options), the number and weighted average fair value of those equity instruments at the measurement date, and information on how that fair value was measured.

HKFRS 2.50,51

4.3 Effect on profit or loss and financial position

Information which enables an understanding of the effect of share-based payment transactions on profit or loss and financial position includes the following:

(a) The total expense recognised for the period arising from **share-based payment transactions** in which the goods or services received did not qualify for recognition as assets and hence were recognised immediately as an expense, including separate disclosure of that portion of the total expense that arises from transactions accounted for as **equity-settled share-based payment transactions**.

(b) The total carrying amount of liabilities arising from share-based payment transactions at the end of the period and the total **intrinsic value** at the end of the period of liabilities for which the counterparty's right to cash or other assets had vested by the end of the period.

5 Share-based payment transactions and deferred tax

Topic highlights

A share-based payment will result in a deductible temporary difference and so deferred tax asset.

HKAS 12.68A-C

As we have seen, an entity is required to recognise an expense in relation to share options over the vesting period. The related tax deduction is not, however, received until the options are exercised. In addition, the accounting expense is based on the fair value of the options at the grant date, whereas the tax allowable expense is based on the share price at the exercise date.

There is therefore a deferred tax implication. This is also true of other forms of share-based payments where the tax deduction differs from the cumulative remuneration expense.

5.1 Measurement of temporary difference

The deductible temporary difference is measured as:

Carrying amount of share-based payment expense	X
Less: tax base of share-based payment expense (estimated amount tax authorities will permit as a deduction in future periods, based on year end information)	(X)
Temporary difference	(X)
Deferred tax asset at X%	X

If the amount of the tax deduction (or estimated future tax deduction) exceeds the amount of the related cumulative remuneration expense, this indicates that the tax deduction relates also to an equity item.

The excess is therefore recognised directly in equity.

Example: Deferred tax implications of share-based payment

Lamar Co. has the following share option scheme at 31 December 20X1:

Director's name	*Grant date*	*Options granted*	*Fair value of options at grant date*	*Exercise price*	*Vesting date*
			$	$	
N Yip	1 January 20X0	20,000	2.50	3.75	12/20X1
D Chan	1 January 20X1	90,000	2.50	5.00	12/20X3

The price of the company's shares at 31 December 20X1 is $7 per share and at 31 December 20X0 was $7.50 per share.

The directors must be working for Lamar on the vesting date in order for the options to vest.

No directors have left the company since the issue of the share options and none are expected to leave before December 20X3. The shares can be exercised on the first day of the month in which they vest.

In accordance with HKFRS 2 an expense of $25,000 has been charged to profits in the year ended 31 December 20X0 in respect of the share option scheme. The cumulative expense for the two years ended 31 December 20X1 is $110,000.

Tax allowances arise when the options are exercised and the tax allowance is based on the option's intrinsic value at the exercise date.

Assume a notional tax rate of 16%.

Required

What are the deferred tax implications of the share option scheme?

Solution

Year to 31 December 20X0

Deferred tax asset:

	$
Fair value (20,000 × $7.50 × 1/2)	75,000
Exercise price of option (20,000 × $3.75 × 1/2)	(37,500)
Intrinsic value (estimated tax deduction)	37,500
Tax at 16%	6,000

The cumulative remuneration expense is $25,000, which is less than the estimated tax deduction of $37,500. Therefore:

- a deferred tax asset of $6,000 is recognised in the statement of financial position
- there is deferred tax income of $4,000 (25,000 × 16%)
- the excess of $2,000 goes to equity

Year to 31 December 20X1

Deferred tax asset:

	$
Fair value	
(20,000 × $7.50)	150,000
(90,000 × $7 × 1/3)	210,000
	360,000
Exercise price of options	
(20,000 × $3.75)	(75,000)
(90,000 × $4.50 × 1/3)	(135,000)
Intrinsic value (estimated tax deduction)	150,000
Tax at 16%	24,000
Less: previously recognised	(6,000)
	18,000

The cumulative remuneration expense is $110,000, which is less than the estimated tax deduction of $150,000. Therefore:

- a deferred tax asset of $24,000 is recognised in the statement of financial position at 31 December 20X1
- there is potential deferred tax income of $18,000 for the year ended 31 December 20X1
- of this, $13,600 (16% ($110,000 – $25,000)) is recognised in the statement of profit or loss
- the remainder ($4,400) is recognised in equity.

6 Modifications to the terms and conditions on which equity instruments were granted, including cancellations and settlements

Topic highlights

An entity might modify the terms and conditions on which the equity instruments were granted.

For example, it might reduce the exercise price of options granted to employees (i.e. reprice the options), which increases the fair value of those options. The requirements to account for the effects of modifications are expressed in the context of share-based payment transactions with employees. However, the requirements shall also be applied to share-based payment transactions with parties other than employees that are measured by reference to the fair value of the equity instruments granted.

HKFRS 2.27-29

6.1 Measurement in modification

The entity shall recognise, as a minimum, the services received measured at the grant date fair value of the equity instruments granted, unless those equity instruments do not vest because of failure to satisfy a vesting condition (other than a market condition) that was specified at grant date.

This applies irrespective of any modifications to the terms and conditions on which the equity instruments were granted, or a cancellation or settlement of that grant of equity instruments. In addition, the entity shall recognise the effects of modifications that increase the total fair value of the share-based payment arrangement or are otherwise beneficial to the employee.

If a grant of equity instruments is cancelled or settled during the vesting period (other than a grant cancelled by forfeiture when the vesting conditions are not satisfied):

(a) **Cancellation**

The entity shall account for the cancellation or settlement as an acceleration of vesting, and shall therefore **recognise immediately** the amount that otherwise would have been recognised for services received over the remainder of the vesting period.

(b) **Payment made**

Any payment made to the employee on the cancellation or settlement of the grant shall be accounted for as the **repurchase of an equity interest**, i.e. as a deduction from equity, except to the extent that the payment **exceeds the fair value** of the equity instruments granted measured at the repurchase date. Any such excess shall be recognised as an **expense**. However, if the share-based payment arrangement included liability components, the entity shall remeasure the fair value of the liability at the date of cancellation or settlement. Any payment made to settle the liability component shall be accounted for as an extinguishment of the liability.

(c) **New equity instruments are granted**

If new equity instruments are granted to the employee and, on the date when those new equity instruments are granted, the entity identifies the new equity instruments granted as replacement equity instruments for the cancelled equity instruments, the entity shall account for the granting of replacement equity instruments in the same way as a modification of the original grant of equity instruments. The incremental fair value granted is the difference between the fair value of the replacement equity instruments and the net fair value of the cancelled equity instruments, at the date the replacement equity instruments are granted.

The net fair value of the cancelled equity instruments is their fair value, immediately before the cancellation, less the amount of any payment made to the employee on cancellation of the equity instruments that is accounted for as a **deduction from equity**.

If the entity does not identify new equity instruments granted as replacement equity instruments for the cancelled equity instruments, the entity shall account for those new equity instruments as a new grant of equity instruments.

If an entity or counterparty can choose whether to meet a non-vesting condition, the entity shall treat the entity's or counterparty's failure to meet that non-vesting condition during the vesting period as a cancellation.

If an entity repurchases vested equity instruments, the payment made to the employee shall be accounted for as a deduction from equity, except to the extent that the payment exceeds the fair value of the equity instruments repurchased, measured at the repurchase date. Any such excess shall be recognised as an expense.

Example: Cancellation

Flummery Co. granted 3,000 share options to each of its 50 managers on 1 January 20X1. The options only vest if the managers are still employed by the entity on 31 December 20X3.

The fair value of the options was estimated at $12 on the grant date and the entity estimated that the options would vest with 48 managers.

In 20X2 the entity decided to base all incentive schemes around the achievement of performance targets and as a result the existing share option scheme was cancelled on 30 June 20X2 when the fair value of the options was $28 and the market price of the entity's shares was $45. Compensation was paid to the 49 managers in employment at that date, at the rate of $36 per option.

Required

How should the entity recognise the cancellation?

Solution

The original cost to the entity for the share option scheme was:

3,000 shares × 48 managers × $12 = $1,728,000

This was being recognised at the rate of $576,000 in each of the three years.

At 30 June 20X2 the entity should recognise a cost based on the amount of options it had vested on that date. The total cost is:

3,000 × 49 managers × $12 = $1,764,000

After deducting the amount recognised in 20X1, the 20X2 charge to profit or loss is $1,188,000.

The compensation paid is:

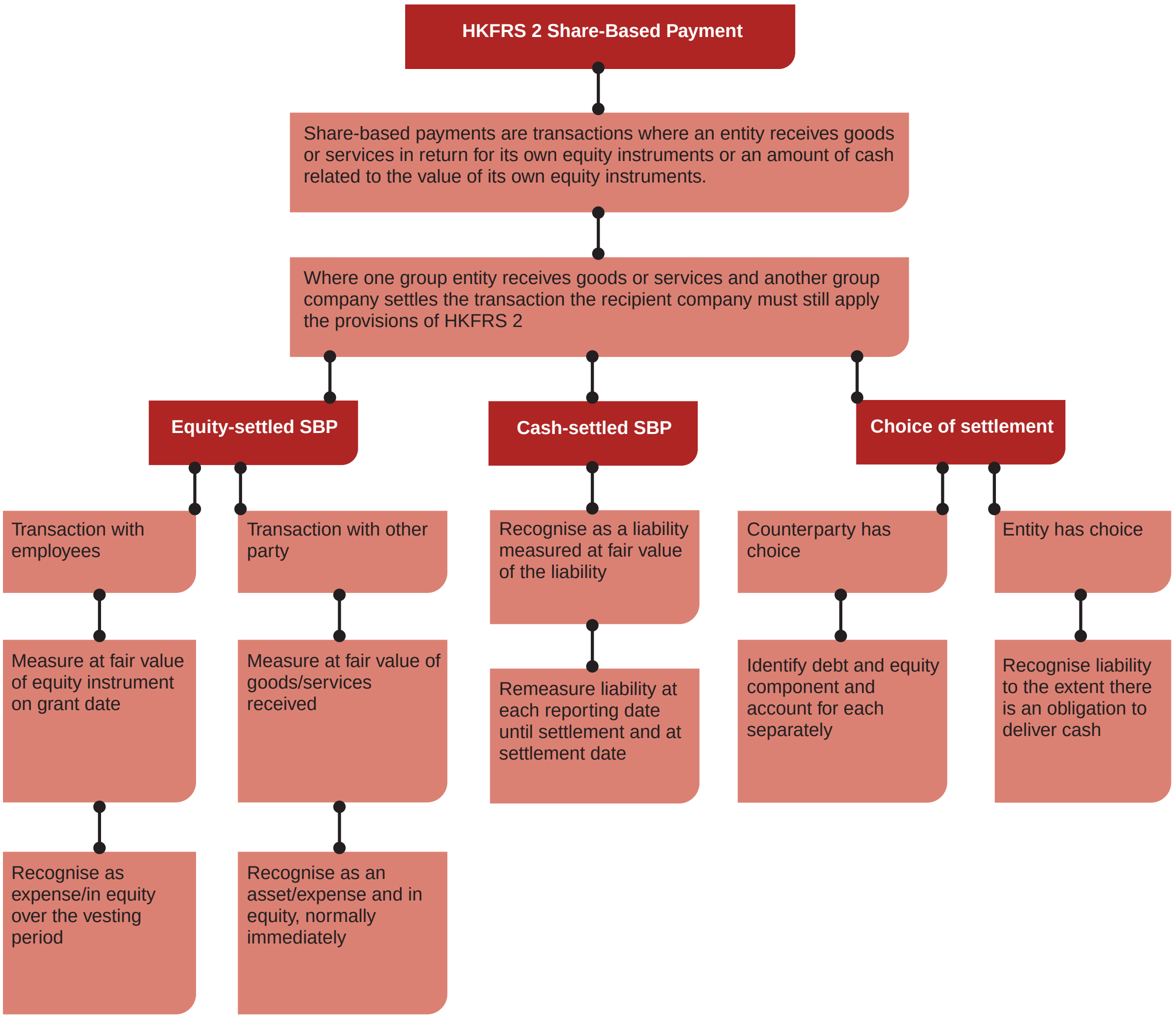
3,000 × 49 × $36 = $5,292,000

Of this, the amount attributable to the fair value of the options cancelled is:

3,000 × 49 × $28 (the fair value of the option, not of the underlying share) = $4,116,000

This is deducted from equity as a share buyback. The remaining $1,176,000 ($5,292,000 less $4,116,000) is charged to profit or loss.

Topic recap



Modifications

- On cancellation or settlement the amount that would have been recognised over the remainder of the vesting period is measured immediately
- If payment is made to the other party on cancellation or settlement this is accounted for as the repurchase of an equity interest (and expense where the payment exceeds fair value of the equity instruments)/extinguishment of liability.

Disclosures:

- Information about the nature and extent of share-based payment arrangements
- Information to enable users to understand how fair values were determined
- Information to enable users to determine the effect on profit or loss and financial position

Share-based payments and deferred tax

A share-based payment results in a deductible temporary difference and so a deferred tax asset

Answers to self-test questions

Answer 1

The remuneration expense in respect of the options for the year ended 31 December 20X1 is calculated as follows:

Fair value of options expected to vest at grant date:

(75% × 50 employees) × 10,000 options × $3 =$1,125,000

Annual charge to profit or loss therefore $1,125,000 / 4 years = $281,250

Charge to profit or loss for y/e 31 December 20X1 = $281,250 × 6/12 months = $140,625

The accounting entry for the year ending 31 December 20X1 is:

		$	$
DEBIT	Remuneration expense	140,625	
CREDIT	Equity		140,625

In 20X2 the remuneration charge is for the whole year, and is calculated as:

(70% × 50 employees) × 10,000 options × $3 =	$1,050,000
Charge to date is $1,050,000 × 1.5/4 years =	$393,750

Therefore charge for the year is $393,750 – $140,625 = $253,125

The accounting entry is:

DEBIT	Remuneration expense	253,125	
CREDIT	Equity		253,125

Answer 2

20X5	$
Equity c/d and P/L expense ((500 – 75) × 100 × $15 × 1/3)	212,500

		$	$
DEBIT	Expenses	212,500	
CREDIT	Equity		212,500

20X6	$
Equity b/d	212,500
∴Profit or loss expense	227,500
Equity c/d ((500 – 60) × 100 × $15 × 2/3) =	440,000

		$	$
DEBIT	Expenses	227,500	
CREDIT	Equity		227,500

20X7	$
Equity b/d	440,000
∴Profit or loss expense	224,500
Equity c/d (443 × 100 × $15) =	664,500

		$	$
DEBIT	Expenses	224,500	
CREDIT	Equity		224,500

Exam practice

Nextap Company Limited

18 minutes

Nextap Company Limited (NCL) granted each of its 240 managerial staff 20,000 share options on 1 July 20X1. Each option entitles the holder to subscribe to one share of NCL at HK$7.5. 8,000 share options (Type A) were immediately vested. The remaining 12,000 share options (Type B) do not vest until 30 June 20X3 and are conditional upon the continued employment of the staff on that day. The market price of NCL's shares at 1 July 20X1 was HK$8. NCL estimated that the fair value of the Type B share option is HK$1.5 and 15% of the managerial staff will leave during the two-year period and therefore forfeit their rights to the share options. During the financial year ended 30 June 20X2, 22 managerial staff had left the company and 10 exercised the Type A option to subscribe to the shares on 30 April 20X2. NCL has not revised its estimate of the total managerial staff departures over the two-year period.

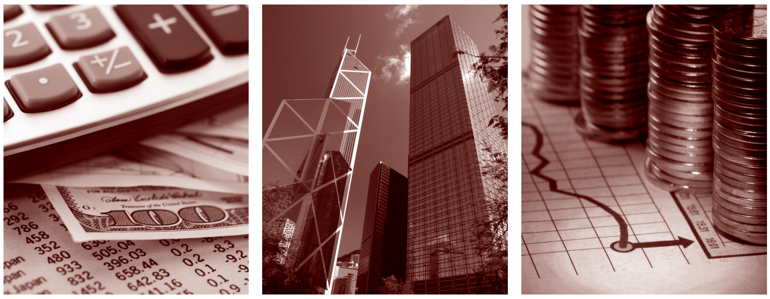
Required

(a) Prepare the journal entries for the share options issued by NCL during the year ended 30 June 20X2. **(7 marks)**

(b) Explain how the estimate of the total number of managerial staff departures will affect the accounting for the share-based payment. **(3 marks)**

(Total = 10 marks)

HKICPA December 2012



chapter 14

Revenue

Topic list

Learning focus

Revenue is an important part of any commercial organisation's financial statements. You should therefore be able to explain the recognition and measurement criteria of HKAS 18 and apply them in practice.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
Account for transactions in accordance with Hong Kong Financial Reporting Standards		
3.02	**Revenue**	3
3.02.01	Define revenue and identify revenue within the scope of HKAS 18	
3.02.02	Measure revenue at the fair value of consideration received	
3.02.03	Identify revenue transaction including multiple element arrangements	
3.02.04	Determine the recognition criteria for specified types of revenue items including sales of goods, rendering of services and interest, royalties and dividends	
3.02.05	Disclose revenue as appropriate in the financial statements	
3.02.06	Explain the recognition and measurement principles	

1 Revenue recognition

Topic highlights

Revenue recognition is straightforward in most business transactions, but can be complicated in some situations.

1.1 Accrual accounting

Accrual accounting is the fundamental concept which underpins the financial statements. This requires that **costs are matched with the revenue they generate**.

Therefore the point at which revenue is recognised must be identified so that the correct treatment can be applied to the related costs. A simple example involves buying goods for resale: the cost of the purchases should be carried as an asset in the statement of financial position until such time as they are sold; they should then be written off as a charge to the trading account.

The decision has a **direct impact on profit** since under the prudence concept it would be unacceptable to recognise the profit on sale until a sale had taken place in accordance with the criteria of revenue recognition.

1.2 Recognition at point of sale

In most circumstances revenue should be recognised as **earned at the point of sale**, because at that point four criteria will generally have been met.

1. The product or service has been **provided to the buyer**.
2. The buyer has **recognised his liability** to pay for the goods or services provided. The converse of this is that the seller has recognised that ownership of goods has passed from himself to the buyer.
3. The buyer has indicated his **willingness to hand over cash** or other assets in settlement of his liability.
4. The **monetary value** of the goods or services has been established.

Therefore, as you will be aware, the normal moment at which revenue should be recognised in the statement of profit or loss is when the goods are sold.

Before the point of sale, there is not normally firm evidence that the above criteria will be met, in particular:

- Until the production process is complete, there is a risk that a flaw or error in the process will result in goods being written off.
- Even when the product is complete there is no guarantee that a buyer will be found.

If revenue is recognised **after the point of sale**, for example when cash is received, costs may already have been charged and so will not necessarily be matched to revenue in the same period. Furthermore, revenue recognition would then depend on fortuitous circumstances, such as the cash flow of a company's customers, and might fluctuate misleadingly from one period to another.

1.3 Recognition at other times

There are times when revenue is **recognised at other times than at the completion of a sale,** for example in the recognition of profit on long-term construction contracts. Under HKAS 11 *Construction Contracts* contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the year end, once the outcome on the contract can be estimated reliably.

(a) Owing to the length of time taken to complete such contracts, to defer taking profit into account until completion may result in the statement of profit or loss reflecting, not so much a fair presentation of the activity of the company during the year, but rather the results relating to contracts which have been completed by the year end.

(b) Revenue in this case is recognised when production on, say, a section of the total contract is complete, even though no sale can be made until the whole is complete.

2 HKAS 18 *Revenue*

Topic highlights

HKAS 18 *Revenue* is concerned with the **recognition of revenues** arising from fairly common transactions.

- The sale of goods
- The rendering of services
- The use by others of entity assets yielding interest, royalties and dividends

Income, as defined by the HKICPA's *Framework* document, includes both revenues and gains. Revenue is income arising in the ordinary course of an entity's activities and it may be called different names, such as sales, fees, interest, dividends or royalties.

HKAS 18 governs the recognition of revenue in specific (common) types of transaction, being:

- the sale of goods
- the rendering of services
- interest income
- royalty income
- dividend income

The standard also includes an appendix which provides examples of the measurement and recognition rules in particular circumstances.

HKAS 18.1-6

2.1 Scope

HKAS 18 covers the revenue from specific types of transaction or events:

- **Sale of goods** (manufactured products and items purchased for resale)
- **Rendering of services**
- Use by others of entity assets yielding **interest, royalties and dividends**

Interest, royalties and dividends are included as income because they arise from the use of an entity's assets by other parties.

Various types of revenue arising from leases, changes in value of financial instruments or other current assets, insurance contracts, natural increases in agricultural assets and mineral ore extraction, are covered by other standards and are therefore specifically excluded from this standard. Reference can be made to the other specific standards for the accounting treatment of these types of revenue.

HKAS 18.7,8

2.2 Definitions

The following definitions are given in the standard.

Key terms

Revenue is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. *(HKAS 18)*

Revenue does not include items which do not represent a flow of economic benefit into the entity, e.g. sales taxes, value added taxes or goods and service taxes which are only collected for third parties. The same should apply to revenues collected by an agent on behalf of a principal. Revenue for the agent is only the commission earned from the principal for acting as an agent.

HKAS 18.9,10

2.3 Measurement of revenue

Topic highlights

Revenue is measured at the fair value of consideration received or receivable.

Revenue shall be measured at the fair value of the consideration received or receivable, taking into account the amount of any trade discounts and volume rebates allowed by the entity.

This is usually decided by agreement between the buyer and seller.

HKAS 18.11

2.3.1 Deferred consideration

When consideration is deferred, the fair value of the amount receivable may be less than the nominal amount of cash receivable.

In this case, the arrangement effectively constitutes a financing transaction resulting in both revenue (sales) income and interest income. The fair value of sales consideration is determined by discounting all amounts receivable using an imputed rate of interest. This is the more clearly determinable of either:

- the prevailing rate for a similar instrument of an issuer with a similar credit rating; or
- a rate of interest that discounts the nominal amount of the instrument to the current cash sales price of the goods or services.

The difference between the fair value and nominal amount of consideration is recognised as interest revenue.

Example: Sofa Co.

Sofa Co. manufactures and sells furniture. It provides all customers with two years' "interest free credit". On 31 March 20X9, the last day of the accounting year, Sofa Co. made sales of $790,000, with all customers taking advantage of the interest free credit option.

Sofa Co. has an imputed rate of interest of 6%.

What amounts are recorded in the financial statements of Sofa Co. in respect of the above sale in the years ended 31 March 20X9, 20Y0 and 20Y1?

Solution

Sofa Co. must discount the $790,000 before recording revenue in respect of the sales:

$\$790,000 \times 1/1.06^2 = \$703,097$

This discounted amount is recognised as revenue in the year ended 31 March 20X9 and as a receivable:

		$	$
DEBIT	Receivable	703,097	
CREDIT	Revenue		703,097

In the year ended 31 March 20Y0, the discount is unwound and the receivable increased by $42,186 (6% × $703,097) to $745,283. This amount is also recognised as interest income:

DEBIT	Receivable	42,186	
CREDIT	Equity		42,186

In the year ended 31 March 20Y1, the discount is again unwound by $44,717 (6% × $745,283):

DEBIT	Receivable	44,717	
CREDIT	Interest income		44,717

The receivable is now recorded at $790,000, and therefore when cash payment is received, it is recorded by:

DEBIT	Cash	790,000	
CREDIT	Receivable		790,000

HKAS 18.12

2.3.2 Exchanges of goods and services

Where goods and services are exchanged for other goods and services of a similar nature and value, the transaction is not considered to generate revenue.

Where goods and services are exchanged for dissimilar goods or services, the transaction is regarded as generating revenue, and the revenue is measured at the fair value of the goods or services received (less any cash or cash equivalents paid).

Where the fair value of the goods or services received cannot be reliably measured, revenue is measured at the fair value of goods or services given up (less any cash transfer).

HKAS 18.13

2.4 Identification of the transaction

Each transaction will usually be recognised in the financial statements as a whole. However, it may be necessary to break a complicated transaction into its component parts. For example, a sale may include both a transfer of goods and the provision of future services. The revenue from the latter should be deferred and recognised as income over the period in which the service is performed.

Example: Component parts of transaction

On 1 March 20X4 Mainframe Co. contracted to deliver a customer a computer system on that date and provide support and maintenance services for the following three years. The price of the contract to provide both the computer system and support and maintenance services is $800,000. The cost of providing support and maintenance services is $50,000 per annum and Mainframe charges a standard 50% profit mark-up

What revenue is recognised in the financial statements of Mainframe in the year ended 31 December 20X4?

Solution

The revenue must be broken down into that relating to the provision of the computer system and that relating to the three years of support and maintenance.

The revenue relating to the support and maintenance is calculated based on the profit mark-up of 50%:

3 years × $50,000 × 150% = $225,000

Therefore, the revenue relating to the supply of the system is the balance of $800,000 – $225,000 = $575,000.

Revenue recognised in the year ended 31 December 20X4 is $637,500 ($575,000 + 10/36 × $225,000).

Conversely, **seemingly separate transactions must be considered together** if apart they lose their commercial meaning. An example would be to sell an asset and at the same time enter into an agreement to buy it back at a later date. The second transaction negates the substance of the first and so both must be considered together. This sale and repurchase situation is considered in more detail in section 2.9 of this chapter.

HKAS 18.14

2.5 Recognition: sale of goods

Topic highlights

Generally revenue is recognised on the sale of goods when the entity has transferred to the buyer the **significant risks and rewards of ownership** and when the revenue can be **measured reliably**.

All of the following five conditions have to be fulfilled before revenue from the sale of goods can be recognised:

(a) The entity has transferred to the buyer the significant risks and rewards of ownership of the goods

(b) The entity retains neither continuing managerial involvement to the degree usually associated with ownership, nor effective control over the goods sold

(c) The amount of revenue can be measured reliably

(d) It is probable that the economic benefits associated with the transaction will flow to the entity

(e) The costs incurred or to be incurred in respect of the transaction can be measured reliably

HKAS 18.15-17

2.5.1 Transfer of risks and rewards

The transfer of risks and rewards can only be decided by examining each transaction. Usually, the transfer occurs at the same time as either the **transfer of legal title**, or the **passing of possession** to the buyer. This is what happens when you buy something in a shop – both title and possession pass from the seller to the purchaser when the purchaser buys the goods and leaves the shop with them.

If **significant risks and rewards remain with the seller**, then the transaction is *not* a sale and revenue cannot be recognised yet, for example if the receipt of the revenue from a particular sale depends on the buyer receiving revenue from his own sale of the goods.

It is possible for the seller to retain only an **"insignificant" risk of ownership** and for the sale and revenue to be recognised. The main example here is where the seller retains title only to ensure collection of what is owed on the goods. This is a common commercial situation, and when it arises the revenue should be recognised on the date of sale.

HKAS 18.18,19

2.5.2 Probable economic benefits

Revenue can only be recognised once the inflow of economic benefits to the seller is probable, thus the probability of the entity receiving the revenue arising from a transaction must be assessed. It may only become probable that the economic benefits will be received when an uncertainty is removed, for example government permission for funds to be received from another country. Only when the uncertainty is removed should the revenue be recognised.

This is in contrast with the situation where revenue has already been recognised but where the **collectability of the cash** is now brought into doubt. Where recovery has ceased to be probable, the amount should be recognised as an expense, *not* an adjustment of the revenue previously recognised. These points also refer to services and interest, royalties and dividends in section 2.7 below.

Revenue and expenses relating to the same transaction should be recognised at the same time (an application of the **matching** concept). It is usually possible to estimate such expenses reliably at the date of sale (e.g. warranty costs, shipment costs, etc.). Where they cannot be estimated reliably, then revenue cannot be recognised; any consideration which has already been received is treated as a liability.

2.6 Recognition: rendering of services

When the outcome of a transaction involving the rendering of services can be **estimated reliably**, the associated revenue should be recognised by reference to the **stage of completion** of the transaction at the reporting date.

HKAS 18.20,23

2.6.1 Estimated reliably

The outcome of a transaction can be estimated reliably when *all* of the following conditions are satisfied:

(a) The amount of revenue can be measured reliably.

(b) It is probable that the economic benefits associated with the transaction will flow to the entity.

(c) The stage of completion of the transaction at the reporting date can be measured reliably.

(d) The costs incurred for the transaction and the costs to complete the transaction can be measured reliably.

The parties to the transaction will normally have to agree the following before an entity can make reliable estimates.

(a) Each party's **enforceable rights** regarding the service to be provided and received by the parties

(b) The **consideration** to be exchanged

(c) The **manner and terms of settlement**

HKAS 18.24,25

2.6.2 Stage of completion

There are various possible methods of determining the stage of completion of a transaction, including:

- surveys of work performed
- services performed to date as a percentage of total services to be performed
- costs incurred to date as a percentage of total estimated costs

For practical purposes, when services are performed by an indeterminate number of acts over a period of time, revenue should be recognised on a **straight line basis** over the period, unless there is evidence for the use of a more appropriate method. If one act is of more significance than the others, then the significant act should be carried out *before* revenue is recognised.

HKAS 18.26-28

2.6.3 Outcome cannot be estimated reliably

In uncertain situations, when the outcome of the transaction involving the rendering of services cannot be estimated reliably, the standard requires that revenue **is recognised only to the extent of the expenses recognised that are recoverable**.

This is particularly likely during the **early stages of a transaction**, but it is still probable that the entity will recover the costs incurred. So the revenue recognised in such a period will be equal to the expenses incurred, with no profit.

If the costs are not likely to be reimbursed, then they must be recognised as an expense immediately. **When the uncertainties cease to exist**, revenue should be recognised as laid out in the first paragraph of section 2.6.

HKAS 18.29

2.7 Recognition: interest, royalties and dividends

Revenue arising from the use by others of the entity's assets yielding interest, royalties and dividends is recognised when:

(a) it is probable that the economic benefits associated with the transaction will flow to the entity, and

(b) the amount of the revenue can be measured reliably

Once again, the points made above about **probability and collectability** on sale of goods also apply here.

HKAS 18.30,32

2.7.1 Interest

Interest is recognised on a time proportion basis that takes into account the effective yield on the asset.

The **effective yield** is the rate of interest required to discount the stream of future cash receipts expected over the life of the asset to equate to the initial carrying amount of the asset.

When unpaid interest has accrued before an interest-bearing investment is acquired, the subsequent interest received is allocated between pre and post acquisition periods. Only that amount allocated to the post acquisition period is recognised as revenue.

HKAS 18.30,33, Illustrative Guidance 20

2.7.2 Royalties

Royalties are recognised on an accruals basis in accordance with the substance of the relevant agreement.

Royalties are usually recognised on the same basis that they accrue **under the relevant agreement**. Practically this is often on a straight line basis over the life of the agreement. Sometimes the true substance of the agreement may require some other systematic and rational method of recognition.

Where rights are assigned for a fixed amount, the licensee is permitted to exploit those rights freely and the licensor has no remaining obligations to perform, then the assignment is in effect a sale and revenue should be recognised immediately. An example of this situation is a licensing agreement to use software which is immediately downloaded by the purchaser.

In some cases the receipt of a royalty is contingent on a future event. Here revenue is recognised only when it is probable that the royalty will be received. This is normally when the event has occurred.

2.7.3 Dividends

Dividends are recognised when the shareholder's right to receive payment is established.

HKAS 18, Illustrative Guidance 21

2.8 Determining whether an entity is an agent or principal

Rules for determining whether an entity is acting as an agent were amended in 2009. In an agency relationship, the gross inflows of economic benefits include amounts collected on behalf of the principal and which do not result in increases in equity for the entity. The amounts collected on behalf of the principal are not revenue. Instead, revenue is the amount of commission.

An entity is acting as a principal when it has exposure to the significant risks and rewards associated with the sale of goods or the rendering of services. Features that indicate that an entity is acting as a principal include:

(a) the entity has the primary responsibility for providing the goods or services to the customer or for fulfilling the order, for example by being responsible for the acceptability of the products or services ordered or purchased by the customer;

(b) the entity has inventory risk before or after the customer order, during shipping or on return;

(c) the entity has latitude in establishing prices, either directly or indirectly, for example by providing additional goods or services; and

(d) the entity bears the customer's credit risk for the amount receivable from the customer.

An entity is acting as an agent when it does not have exposure to the significant risks and rewards associated with the sale of goods or the rendering of services. One feature indicating that an entity is acting as an agent is that the amount the entity earns is predetermined, being either a fixed fee per transaction or a stated percentage of the amount billed to the customer.

HKAS 18,Illustrative examples

2.9 Revenue recognition: examples

The appendix to HKAS 18 provides a number of examples of the application of the recognition criteria. These examples assume that the amount of revenue can be measured reliably, it is probable that economic benefits will flow to the entity and costs can be measured reliably.

The following transactions are common in practice.

2.9.1 Consignment sales

Consignment sales are transactions whereby one entity (the seller) sells goods to another (the buyer) and that entity undertakes to sell the goods to a third party on behalf of the seller. The goods which are transferred are often referred to as consignment inventory. The seller normally retains legal title to the goods until such time as they are sold on to a third party.

This form of arrangement is common in the motor trade whereby a manufacturer sells cars to a dealer who sells them on to the ultimate customer. Often where an onward sale is not achieved, the dealer can return the cars to the manufacturer.

In this situation, the risks and rewards are not deemed to have passed from the seller (the manufacturer) to the buyer (the dealer) until such time as an onward sale is made. Therefore, the manufacturer does not record a sale until a car is sold to a third party. In the meantime, although the cars are in the dealer's showroom, they remain the inventory of the manufacturer.

2.9.2 Bill and hold sales

Bill and hold sales refer to those sales where the buyer requests that delivery of goods purchased is delayed, however in the meantime accepts legal title and billing.

In these circumstances, revenue is recognised when the buyer takes title, provided that:

(a) it is probable that delivery will be made
(b) the goods are available for delivery
(c) the buyer acknowledges the delayed delivery
(d) normal payment terms apply

2.9.3 Sale and repurchase agreements

A sale and repurchase agreement refers to a transaction where one party sells an asset to another, but the terms of the sale provide for the asset to be repurchased by the seller at a later date under certain conditions.

This form of arrangement is common amongst whisky distillers, who sell their stocks to banks while they mature. When the whisky has matured, it is re-purchased by the distillery. The whisky is not, in the meantime physically transferred to bank premises, but remains on site at the distillery. In this case, the substance of the transaction is obviously a secured loan: the bank is effectively lending money to the distillery secured on the whisky.

These arrangements should be accounted for in accordance with their commercial substance. Not all situations will be as straightforward as the whisky example, and the appendix to HKAS 18 states that consideration should be given as to whether the risks and rewards of ownership have been transferred to the buyer (regardless of legal title). Where this is the case, a sale should be recorded.

HKAS 18.35,36

2.10 Disclosure

The following items should be disclosed.

(a) The **accounting policies** adopted for the recognition of revenue, including the methods used to determine the stage of completion of transactions involving the rendering of services.

(b) The amount of each **significant category of revenue** recognised during the period including revenue arising from:

   (i) the sale of goods
   (ii) the rendering of services
   (iii) interest
   (iv) royalties
   (v) dividends

(c) The amount of revenue arising from **exchanges of goods or services** included in each significant category of revenue.

Any **contingent gains or losses**, such as those relating to warranty costs, claims or penalties should be treated according to HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (covered earlier).

Self-test question 1

Consider the following scenarios and discuss how HKAS 18 should be applied to each

(a) Bradley Co. owns an office building which cost $5m and has a market value of $7m. On 1 April 20X2, Bradley Co. sold the building to Beck Co., a finance company, for $5.5m. Bradley Co. has entered into an agreement to repurchase the building in three years' time for $7m and Bradley Co. will continue to occupy the building after sale.

(b) Marianne Alltraders entered into a six-month contract to undertake accountancy training for a customer over the period 1 September 20X2 to 28 February 20X3. The value of services performed to the year end amounts to $45,000 out of a total contract value of $60,000. All costs are expected to be recoverable.

(c) Maximum Velocity sold some bicycles to a customer for $15,000 on 1 October 20X2. The customer has the right to return any unsold bikes before 30 April 20X3 for a full refund.

(d) Admen performed advertising services for a customer costing $4,450 relating to a fixed price $20,000 contract covering the period 1 December 20X2 to 31 March 20X3. Due to fluctuating advertising costs, the expected total cost cannot be reliably measured at the year end, but Admen is certain that the customer will pay the costs incurred to date.

The year end in all cases is 31 December 20X2.

(The answer is at the end of the chapter)

3 Interpretations related to revenue recognition

Topic highlights

Three Interpretations are relevant to revenue recognition:

- HK(IFRIC) Int-12 *Service Concession Arrangements*
- HK(IFRIC) Int-13 *Customer Loyalty Programmes*
- HK(IFRIC) Int-15 *Agreements for the Construction of Real Estate*

3.1 HK(IFRIC) Int-12 *Service Concession Arrangements*

3.1.1 What is a service concession arrangement?

Key term

Service concession arrangements are arrangements whereby a government or other body grants contracts for the supply of public services – such as roads, energy distribution, prisons or hospitals – to private operators. The objective of this project of the HK(IFRIC) is to clarify how certain aspects of existing HKICPA literature are to be applied to service concession arrangements. *(HK(IFRIC) Int-12)*

3.1.2 Two types of service concession arrangements

HK(IFRIC) Int-12 identifies two types of service concession arrangement:

(a) One in which the operator has a contractual right to receive cash or another financial asset from the government

(b) One in which the operator receives an **intangible asset** being the right to charge for access to the public sector asset that it constructs or upgrades.

HK(IFRIC) Int-12 allows for the possibility that **both types of arrangement may exist within a single contract**: to the extent that the government has given an unconditional guarantee of payment for the construction of the public sector asset, the operator has a financial asset; to the extent that the operator has to rely on the public using the service in order to obtain payment, the operator has an intangible asset.

3.1.3 Accounting – Financial asset model

For the first type of arrangement the operator recognises a **financial asset** measured at fair value to the extent that it has an unconditional contractual right to receive cash or another financial asset from or at the direction of the grantor for the construction services.

The operator has an unconditional right to receive cash if the grantor contractually guarantees to pay the operator:

(a) specified or determinable amounts;

(b) the shortfall, if any, between amounts received from users of the public service and specified or determinable amounts, even if payment is contingent on the operator ensuring that the infrastructure meets specified quality or efficiency requirements.

3.1.4 Accounting – Intangible asset model

The operator recognises an **intangible asset** measured at fair value to the extent that it receives a right (a licence) to charge users of the public service.

3.1.5 Operating revenue

The operator of a service concession arrangement recognises and measures revenue in accordance with HKAS 11 and 18 for the services it performs.

Example: Electricity Co.

Electricity Co. is a private sector entity, which has entered into an arrangement with government to supply a minimum quantity of electricity for 30 years to the public within a specific district. Electricity Co. designs and builds a power plant on government land to produce the needed electricity and maintains control over all significant aspects of operating the power plant within the terms of the agreement. The agreement provides for the following:

- The legal title to the power plant will be transferred to the government body at the end of the arrangement.
- Electricity Co. is responsible for repairs, maintenance, and capital expenditure related to the power plant.
- Electricity Co. must stand ready to deliver a minimum quantity of electricity each month.
- Electricity Co. is paid by the public directly, charge is based primarily on their own usage.
- The government regulates the prices that Electricity Co. may charge to the public such that Electricity Co.'s return is capped by reference to operating costs and capital investment. The government does not guarantee any minimum level of income for Electricity Co.

How should the above transaction be accounted for?

Solution

The transaction illustrates certain characteristics of a service concession arrangement that falls within the scope of HK(IFRIC) 12:

- The arrangement is between a public sector entity (the government) and an entity from the private sector (Electricity Co.);
- An infrastructure asset is constructed by Electricity Co. for the purpose of the arrangement, and is used to supply electricity to public;
- The government (the grantor) has control over the use of the power plant through the following means:
  - The government specifies the goods to be delivered (electricity) and to whom the electricity should be provided (the public in the specified district); and
  - The income that Electricity Co. needs to generate to cover both its operating costs and the initial capital outlay from constructing the facility is wholly dependent on the user's demand for the electricity, the demand risk borne by Electricity Co.. However, the arrangement still falls within the scope of HK(IFRIC) 12 as the government controls the pricing through a capping mechanism (provided the cap is considered to be substantive) and controls the residual interest in the facility, through the agreement specifying that the facility must revert to government at the end of the concession period.

Electricity Co. provides construction services to the grantor by constructing the facility. However, instead of receiving an unconditional right to receive cash, it has obtained a right to charge the public for electricity usage, i.e. it has obtained an intangible asset.

As stated in HK(IFRIC) 12, Electricity Co. does not recognise the facility as its own property, plant and equipment, even though it is fully exposed to demand risk in respect of the electricity users.

During the construction phase:

DEBIT Intangible asset
CREDIT Construction revenue

Being the fair value of construction service provided under development

DEBIT Construction cost
CREDIT Cash

Being construction costs incurred

During the operating phase:

DEBIT Cash
CREDIT Operating revenue

Being electricity charges levied on the users

DEBIT Operating costs
CREDIT Cash

Being operating cost incurred (e.g. fuel, employee cost etc.)

DEBIT Operating costs
CREDIT Intangible asset

Being amortisation and/or impairment of the intangible asset during the year

If the government had guaranteed that Electricity Co. would receive a minimum amount, i.e. had agreed to top up a short-fall in receipts from the public, Electricity Co. would recognise a financial asset to the extent that it had an unconditional contractual right to receive cash (or another financial asset) and an intangible asset for the right to receive cash from users above the guaranteed minimum.

3.2 HK(IFRIC) Int-13 *Customer Loyalty Programmes*

3.2.1 The issue

Customer loyalty programmes are programmes whereby customers who buy goods or services are awarded credits by an entity. These may include reward points or travel miles and can be redeemed in the future for free or discounted goods.

HK(IFRIC) Int-13 *Customer Loyalty Programmes* addresses accounting for such arrangements by the entities which grant the credits.

The deferred amount is recognised as revenue only when the entity has fulfilled its obligations by supplying the awards itself or paying a third party to do so.

3.2.2 Key provisions

The Interpretation requires that the proceeds of the initial sale are split between:

- revenue, and
- deferred revenue associated with the credits awarded

The proceeds recognised as deferred revenue are measured by reference to the fair value of the credits awarded. The fair value of award credits should take into account:

- the amount of discounts or incentives that would otherwise be offered to customers who have not earned award credits from an initial sale; and
- the proportion of award credits that are not expected to be redeemed by customers (any expected forfeitures), If customers can choose from a range of different awards, the fair value of the award credits will reflect the fair values of the range of available awards, weighted in proportion to the frequency with which each award is expected to be selected.

The deferred amount is recognised as revenue only when the entity has fulfilled its obligations by supplying the awards itself or paying a third party to do so.

HK(IFRIC) Int-13 gives a choice as to whether the amount allocated to the award credits should be:

(a) Equal to their fair value (irrespective of the fair values of the other components); or

(b) A proportion of the total consideration based on the fair value of the award credits relative to the fair values of the other components of the sale.

In developing the HK(IFRIC) Int-13, it was decided that it should not be more prescriptive than HKAS 18 *Revenue,* which does not specify which of the above should be used.

If at any time the expected costs of meeting the obligation exceed the consideration received, the entity has an onerous contract for which HKAS 37 would require recognition of a liability.

If HK(IFRIC) Int-13 causes an entity to change its accounting policy for customer loyalty awards, HKAS 8 applies.

Example: Loyalty points

Loyalty points can arise in one of two ways – either by the entity implementing its own loyalty programmes (e.g. Park-N-Shop) or by a third party applying such loyalty programmes (e.g. HSBC credit card providing the programme for the retailers who participate in its programme). The entity can also recognise this deferred revenue by either allocating the deferred revenue systematically (amortisation) or on a sale-by-sale basis. The following examples are shown on a sale-by-sale basis for convenience.

Case 1 is easy, according to paragraph 7 of the Interpretation:

If the entity supplies the awards itself, it shall recognise the consideration allocated to award credits as revenue when award credits are redeemed and it fulfils its obligations to supply awards. The amount of revenue recognised shall be based on the number of award credits that have been redeemed in exchange for awards, relative to the total number expected to be redeemed.

What that essentially means is this: take Park-N-Shop for example, who award one point for every \$100 that a customer spends: every 100 points can be redeemed for goods with a retail price of \$100. The accounting entries following a sale of goods for \$200 would be:

		$	$
DEBIT	Cash/credit card receivables	200	
CREDIT	Deferred revenue – Loyalty points (\$200/\$100 × 1 point)		2
	Revenue		198

A portion of the consideration paid by the customer will be allocated to deferred revenue as above, measured as the fair value of the points awarded. Then when the customer utilises their points the next time they spend:

		$	$
DEBIT	Cash/credit card receivables	98	
	Deferred revenue	2	
CREDIT	Revenue		100

So in essence a proportion of revenue is deferred until later.

Case 2 refers to paragraph 8 of the Interpretation:

If a third party supplies the awards, the entity shall assess whether it is collecting the consideration allocated to the award credits on its own account (i.e. as the principal in the transaction) or on behalf of the third party (i.e. as an agent for the third party).

(a) If the entity is collecting the consideration on behalf of the third party, it shall:

(i) measure its revenue as the net amount retained on its own account, i.e. the discounts or incentives that otherwise would be offered to customers that have not earned the award credits; and

(ii) **recognise this net amount as revenue when the third party becomes obliged to supply the awards and entitled to receive consideration for doing so. These events may occur as soon as the award credits are granted. Alternatively, if the customer can choose to claim awards from either the entity or a third party, these events may occur only when the customer chooses to claim awards from the third party.**

(b) **If the entity is collecting the consideration on its own account, it shall measure its revenue as the gross consideration allocated to the award credits and recognise the revenue when it fulfils its obligations in respect of the awards.**

In paragraph 8(a)(i) and (ii) of the Interpretation the entity supplying the award credits is acting as an **agent** of the third party supplying the awards, which may be the case with airline loyalty programmes where retailers or other service firms pay the airline a cost per mile for using their loyalty programmes. However in case (b) the reference is to a similar programme but where the retailer acts as a **principal** on their own account.

Look first at the accounting entries in the situation of Paragraph 8(a). Say that a retailer has a loyalty programme arrangement with an airline such that, for every $10 that the customer spends with the retailer, he is awarded one point which can be redeemed for one mile.

The face value of each point is $1. For each point issued, the retailer will pay $0.8 to the airline.

If the retailer makes a sale of $200 the accounting entries would be:

		$	$
DEBIT	Cash/credit card receivables	200	
CREDIT	Commission income (20 × $0.2)		4
	Liability to airline (20 × $0.8)		16
	Revenue		180

The retailer acts as an agent of the airline and earns commission of $0.2 per point issued. A sale of $200 leads to the issue of 20 points and commission income of 20 × $0.2 = $4.

The benefits of such a scheme to the retailer are that they do not have to incur resources to administer the scheme (the airline administers the redemptions) and they can exit the scheme at any time with no obligation for the outstanding points.

If the retailer has collected the consideration allocated to the points on its own account, i.e. acting as a principal rather than as an agent, then it is entitled to measure its income from the points as the gross $20 in the example above, but must separately recognise the $16 payable to the airline as an expense. In either case the net income of $4 is ultimately recognised from the transaction.

		$	$
DEBIT	Cash/credit card receivables	200	
CREDIT	Income from loyalty programme (20 x $1)		20
	Revenue		180
And			
DEBIT	Loyalty programme expense (20 x $0.8)	16	
CREDIT	Liability to airline		16

3.3 HK(IFRIC) Int-15 *Agreements for the Construction of Real Estate*

HK(IFRIC) Int-15 *Agreements for the Construction of Real Estate* is effective for annual periods beginning on or after 1 January 2009.

3.3.1 Reasons for issuing HK(IFRIC) Int-15

The issues addressed in the Interpretation were first published in a draft Interpretation D21 **Real Estate Sales** in July 2007. In response to concerns expressed in relation to improving the articulation between HKAS 11 *Construction Contracts* and HKAS 18 *Revenue* and providing additional guidance on how to account for revenue in HKAS 18, the Hong Kong Financial Reporting Interpretations Committee (HK(IFRIC)) provides guidance on the following two issues in HK(IFRIC) Int-15:

- Determining whether an agreement for the construction of real estate is within the scope of HKAS 11 or HKAS 18
- When revenue from the construction of real estate should be recognised

The Interpretation standardises accounting practice across jurisdictions for the recognition of revenue among real estate developers for sales of units, such as apartments or houses, "off plan", that is, before construction is complete.

3.3.2 Main features of HK(IFRIC) Int-15

The detailed guidance in HK(IFRIC) Int-15 assumes that the entity has previously analysed the agreement for the construction of real estate and any related agreements and concluded that it will retain neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the constructed real estate to an extent that would preclude recognition of some or all of the consideration as revenue. If recognition of some of the consideration as revenue is precluded, the following discussion applies only to the part of the agreement for which revenue will be recognised.

In some circumstances, agreements may need to be split into separately identifiable components, with each such component being accounted for separately and the fair value of the total consideration received or receivable for the agreement allocated to each component. The seller then applies the requirements of HK(IFRIC) Int-15 to any components for the construction of real estate in order to determine whether each component is within the scope of HKAS 11 or HKAS 18.

3.3.3 Determining whether the agreement is within the scope of HKAS 11 or HKAS 18

HKAS 11 applies when the agreement meets the definition of a construction contract set out in paragraph 3 of HKAS 11. An agreement for the construction of real estate meets the definition of a construction contract when the buyer is able to specify:

(a) the major structural elements of the design of the real estate before construction begins, and/or

(b) major structural changes once construction is in progress (whether or not it exercises that ability).

In contrast, if construction could take place independently of the agreement and buyers have only limited ability to influence the design of the real estate, the agreement will be for the sale of goods or the rendering of services and within the scope of HKAS 18.

3.3.4 Accounting for revenue from construction of real estate

Construction contracts (within the scope of HKAS 11)

Where the agreement is a construction contract under HKAS 11, and the outcome of the contract can be estimated reliably, revenue is recognised by reference to the stage of completion of the contract activity in accordance with HKAS 11. HK (IFRIC) Int-15 has not introduced any new requirements or guidance that will affect such contracts.

Agreements for the rendering of services (HKAS 18)

Where the agreement falls within the scope of HKAS 18, and the entity is not required to acquire and supply construction materials, it may be only an agreement for the rendering of services. This may arise, for example, in arrangements where the customer acts in essence as its own general contractor and enters into agreements with individual suppliers for specific goods and services. Where the entity is responsible only for assembling materials supplied by others (i.e. it has no inventory risk for the construction materials), the agreement is an agreement for the rendering of services.

In such circumstances, if the criteria in HKAS 18 are met, revenue is recognised by reference to the stage of completion of the transaction using the percentage of completion method.

The requirements of HKAS 11 are generally applicable to the recognition of revenue and the associated expenses for such a transaction.

Agreements for the sale of goods (HKAS 18)

An agreement for the construction of real estate will be an agreement for the sale of goods under HKAS 18 if it involves the provision of services together with construction materials. For such contracts, the applicable recognition criteria are those set out in HKAS 18.

The Interpretation focuses on the criteria that revenue can only be recognised when the entity has transferred to the buyer control and the significant risks and rewards of ownership of the goods, and distinguishes between circumstances in which these criteria are met "at a single point in time" and "continuously as construction progresses".

If transfer of control and the significant risks and rewards of ownership of the real estate in its entirety occurs at a single point of time (e.g. at completion, upon or after delivery), revenue is recognised only when all the criteria in HKAS 18 are satisfied. Assuming that all of the other criteria in HKAS 18 are met, this will be upon the occurrence of that single critical transfer of control and the significant risks and rewards of ownership.

The Interpretation also envisages that the entity may transfer to the buyer control and the significant risks and rewards of ownership of the work in progress in its current state as construction progresses. In this case, if all of the criteria in HKAS 18 are met continuously as construction progresses, revenue is recognised by reference to the stage of completion using the percentage of completion method. The requirements of HKAS 11 are generally applicable to the recognition of revenue and the associated expenses for such a transaction.

3.3.5 Disclosures

When an entity recognises revenue using the percentage of completion method for agreements that meet all the criteria in HKAS 18 continuously as construction progresses (see above), the following disclosures are required:

- How the entity determines which agreements meet all the criteria in HKAS 18 continuously as construction progresses
- The amount of revenue arising from such agreements in the period
- The methods used to determine the stage of completion of agreements in progress

For any such agreements that are in progress at the reporting date, the following disclosures are also required:

- The aggregate amount of costs incurred and recognised profits (less recognised losses) to date
- The amount of advances received

Consequential amendments to the Appendix in HKAS 18

HK(IFRIC) Int-15 superseded the real estate guidance (Example 9) in HKAS 18.

Additional guidance

HK(IFRIC) Int-15 is accompanied by an information note which, although not part of the Interpretation, summarises its requirements in the form of two flowcharts, which are reproduced in the Appendix.

In addition, three illustrative examples designed to assist in the application of the Interpretation accompany HK(IFRIC) Int-15.

Effective date and transition

HK(IFRIC) Int-15 is effective for annual periods beginning on or after 1 January 2009. Earlier application is permitted. If an entity applies the Interpretation for a period beginning before 1 January 2009, that fact should be disclosed.

Changes in accounting policy resulting from the adoption of the Interpretation are required to be accounted for retrospectively in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Therefore, entities will be required to re-examine and, where applicable, retrospectively restate the revenue recognition for agreements that are in progress as at the opening date of the earliest period presented for comparative purposes.

Example: Apartment purchase

An entity is developing residential real estate and starts marketing individual units (apartments) while construction is still in progress. Buyers enter into a binding sale agreement that gives them the right to acquire a specified unit when it is ready for occupation. They pay a deposit that is refundable only if the entity fails to deliver the completed unit in accordance with the contracted terms. Buyers are also required to make progress payments between the time of the initial agreement and contractual completion.

The balance of the purchase price is paid only on contractual completion, when buyers obtain possession of their unit. Buyers are able to specify only minor variations to the basic design but they cannot specify or alter major structural elements of the design of their unit. In the jurisdiction, no rights to the underlying real estate asset transfer to the buyer other than through the agreement. Consequently, the construction takes place regardless of whether sale agreements exist.

How should the above transaction be accounted for?

Solution

In this transaction, the terms of the agreement and all the surrounding facts and circumstances indicate that the agreement is not a construction contract. The agreement is a forward contract that gives the buyer an asset in the form of a right to acquire, use and sell the completed real estate at a later date and an obligation to pay the purchase price in accordance with its terms.

Although the buyer might be able to transfer its interest in the forward contract to another party, the entity retains control and the significant risks and rewards of ownership of the work in progress in its current state until the completed real estate is transferred. Therefore, revenue should be recognised only when all the criteria of HKAS 18 are met (at completion in this example).

Alternatively, assume that, in the jurisdiction, the law requires the entity to transfer immediately to the buyer ownership of the real estate in its current state of completion and that any additional construction becomes the property of the buyer as construction progresses.

The entity would need to consider all the terms of the agreement to determine whether this change in the timing of the transfer of ownership means that the entity transfers to the buyer control and the significant risks and rewards of ownership of the work in progress in its current state as construction progresses. For example, the fact that if the agreement is terminated before construction is complete, the buyer retains the work in progress and the entity has the right to be paid for the work performed, might indicate that control is transferred along with ownership. If it does, and if all the criteria in HKAS 18 are met continuously as construction progresses, the entity recognises revenue by reference to the stage of completion using the percentage of completion method taking into account the stage of completion of the whole building and the agreements signed with individual buyers.

Self-test question 2

(a) Realbuild operates in the house building sector and currently does not report under HKFRS. In the market in which Realbuild operates, the custom is to sign a contract which includes a completion date when funds are transferred and the keys passed to the buyer. Realbuild's accounting policy is to recognise revenue on signing the contract. Where there is still building work to be completed after the keys are passed to the buyer, Realbuild delays revenue recognition until the completion of the work.

(b) BCN Productions is a film production house. The company licenses one of its new films to a distributor in a foreign country over which BCN Productions has no control. The film is expected to appear before the public over a period of six months and BCN Productions intends to recognise the revenue over this period.

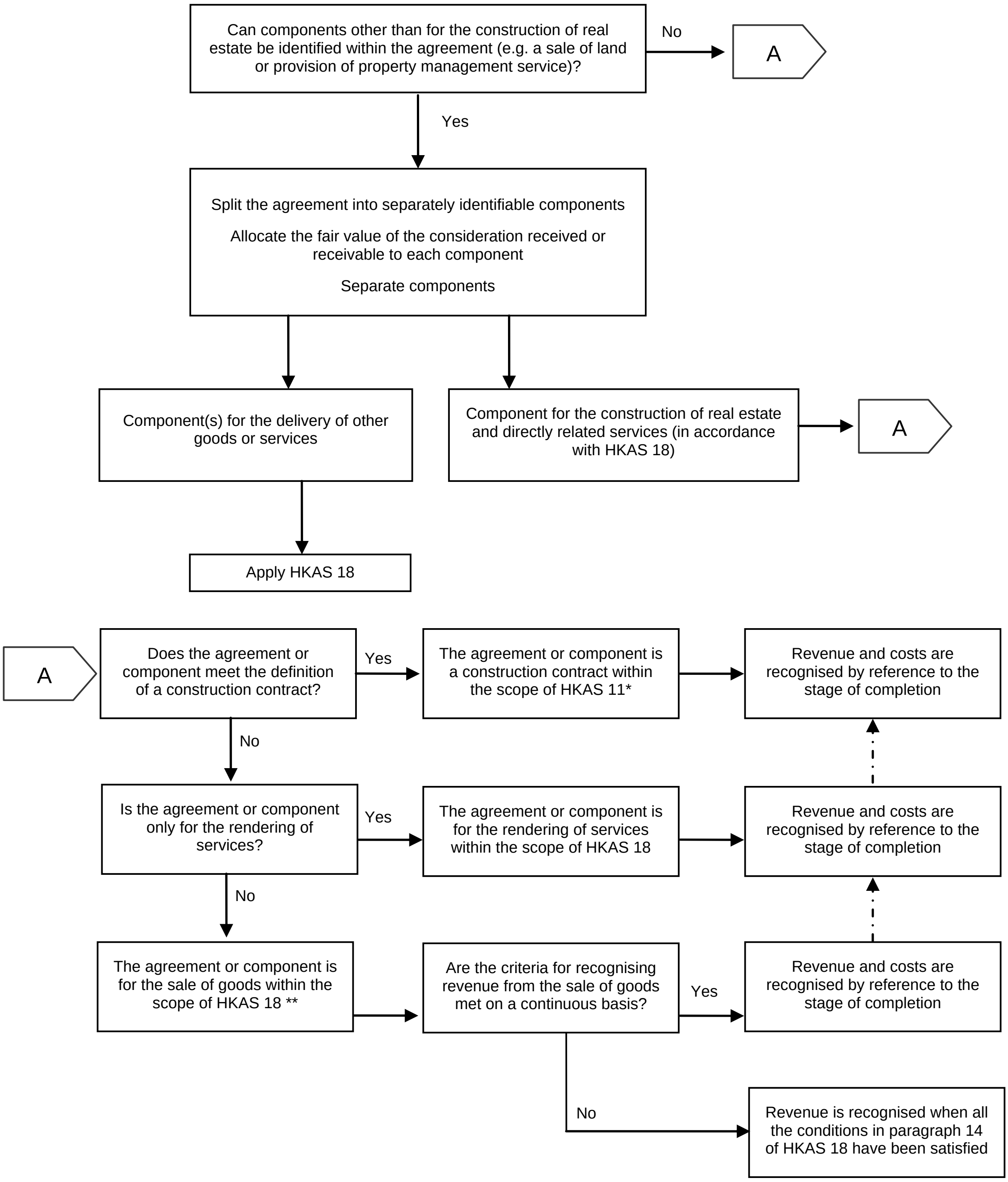
(c) KSoft is a start-up company that will develop bespoke software systems for corporate clients. The company's policy is to invoice fixed amounts which include the software development and fees for ongoing post-delivery support while the new software system is implemented. KSoft intends to recognise the revenue for both elements on installation of the software.

Required

Advise the directors as to the acceptability of the above accounting policies for revenue recognition under HKAS 18 *Revenue*.

(The answer is at the end of the chapter)

Analysis of a single agreement for the construction of real estate



* The construction contract may need to be segmented in accordance with paragraph 8 of HKAS 11
** Directly related services may need to be separated in accordance with paragraph 13 of HKAS 18

4 Current developments

The IASB and FASB issued an Exposure Draft (ED) in relation to revenue recognition in June 2010. A revised exposure draft on the topic of revenue from contracts with customers was issued in November 2011, which simplifies a number of the original proposals. A new standard is expected during the course of 2013 and this will replace both IAS 18 *Revenue* and IAS 11 *Construction Contracts* (and so their HKAS equivalents).

The proposals would require an entity to:

1 Identify a contract with a customer.

2 Identify separate performance obligations in the contract (such that if more than one good or service is promised, each is accounted for separately only if it could be sold separately or the customer could benefit from the good or service either alone or together with resources which are readily available).

3 Determine the transaction price as the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties.

4 Allocate the transaction price to the separate performance obligations in proportion to the standalone selling price of the goods or services underlying each performance obligation.

5 Recognise revenue when each performance obligation is satisfied by the transfer of the promised good or service to the customer.

The ED also proposes that the costs of obtaining a contract are recognised as an asset if the entity expects to recover those costs.

Costs of fulfilling a contract which are not eligible for capitalisation in accordance with another standard would be capitalised only if they:

- relate directly to a contract
- generate or enhance resources which will be used to satisfy future performance obligations, and
- are expected to be recovered.

For many companies this new approach will not result in a significant change to the amount or timing of revenue recognised. In other cases there will be a change, for example, when a mobile phone contract is sold and a handset is provided free of charge, the standard would now require separate up front recognition of revenue relating to the handset.

Topic recap

HKAS 18 Revenue Recognition

Measure at the fair value of consideration received or receivable.
Discount deferred consideration; difference between cash receivable and discounted amount is interest receivable.

Sale of goods

Recognise when:
- significant risks and rewards transferred to buyer
- no retention of managerial involvement / effective control
- revenue can be measured reliably
- probable economic benefits will flow
- costs can be measured reliably

Examples:
- Consignment sales recognised as revenue when goods sold on to third party
- Bill and hold sales revenue recognised when buyer takes title provided that the goods are available, payment terms are normal, delayed delivery is acknowledged and delivery is probable.
- Sale and repurchase agreements may in substance be secured loans.

Provision of services

Recognise when:
- revenue can be measured reliably
- probable economic benefits will flow
- stage of completion can be measured reliably
- costs can be measured reliably

Interest, royalties and dividends

Recognise when:
- probable economic benefits will flow to the entity
- revenue can be measured reliably

Disclose:
- Accounting policies
- The amount of each significant category of revenue
- The amount of revenue arising from exchanges of goods or services in each category.

HK (IFRIC) Interpretations

HK(IFRIC) Int-12 *Service Concession Arrangements*

Recognise when:
- financial asset model applies where unconditional contractual right to receive cash
- intangible asset model applies to extent there is right to charge users of service
- HKAS 11/18 may be applied.

HK(IFRIC) Int-13 *Customer Loyalty Programmes*

Where a customer is awarded "credits" when making a purchase, sales proceeds are split between
- immediate revenue
- deferred revenue associated with the credits

HK(IFRIC) Int-15 *Agreements for Construction of Real Estate*

HKAS 11 applies where the buyer can specify major structural elements of design before construction begins / major structural changes once construction is in progress.

Otherwise HKAS 18 applies.

Answers to self-test questions

Answer 1

(a) There are a number of factors that suggest the substance of this transaction is different to its legal form. First, the building has a market value of $7m and is being sold for less than market value, which immediately looks odd. Second, there is an agreement for Bradley Co. to repurchase the assets in the future. If it were a genuine sale, this would be an unlikely clause. Third, Bradley Co. retains occupancy of the building – again, if this were a genuine sale it would be very unlikely that an asset would be sold and not occupied or used by the purchaser.

Therefore, it seems obvious that the substance of this transaction is a secured loan. Bradley Co. should continue to recognise the building in the statement of financial position as they have the risks and rewards of ownership. The cash received from Beck Co. should be recorded as a non-current liability and the finance on the loan should be charged in the statement of profit or loss over the three-year period. The finance charge could be calculated as the difference between the "sale" proceeds and the repurchase amount.

(b) Revenue should be accrued by Marianne Alltraders based on value of work performed rather than accrued on a time apportioned basis in accordance with HKAS 18. Revenue recognised is therefore $45,000.

(c) Maximum Velocity should not recognise any revenue in respect of the bicycles as the significant risks and rewards of ownership have not been transferred at the year end. The bikes remain in Maximum Velocity's inventories until confirmation has been received from the customer that they have been sold on and any money received from him is treated as a payment in advance.

(d) Since the outcome of the service transaction cannot be reliably measured at the year end, only $4,450 is recognised as revenue by Admen rather than on a time apportioned basis. This matches with the costs recognised ensuring that no profit is recorded until the outcome can be reliably measured.

Answer 2

(a) The general rule under HKAS 18 *Revenue* is that revenue is recognised when the significant risks and rewards of ownership have been transferred and there is no continuing managerial involvement or effective control.

HK(IFRIC) 15 provides additional guidance regarding real estate sales and states that revenue is recognised when the entity transfers control as well as the risks and rewards of ownership, i.e. when the legal completion occurs and the keys are handed over in this case. Realbuild's current policy recognises the revenue before this is the case: revenue should be recognised on the contract completion date rather than on signing the contract.

Where there is continuing building work to be undertaken, revenue can be recognised provided the property has been delivered, so Realbuild's policy needs to be amended here as well. However, a provision is also required to be recognised for the cost of work yet to be performed and this is charged to profit or loss at the same time as the revenue is recognised, i.e. on delivery of the property.

Note. A house-builder such as Realbuild selling to the general public is entering into contracts to sell goods rather than a construction contract, as the buyer is not able to specify the major structural elements of the design, which would be an indication of a construction contract.

(b) Licence fees (and royalty income) are normally recognised straight line over the life of the agreement. However, where the licensee has no remaining obligations to perform, or, as in this case, no control over the use of the images once licensed, the substance of the transaction is a sale, and revenue should be recognised at the time of sale, so BCN Productions' policy is not appropriate.

(c) HKAS 18 provides guidance on the recognition of revenue from the development of customised software: it should be recognised by reference to the stage of completion of the development including completion of the services provided for post-delivery support.

Consequently, it is not appropriate to recognise the revenue on installation: it should be recognised over the period of development and support (although not necessarily straight line as can be matched to the level of work done in each period).

Exam practice

Nero Fashion

29 minutes

Nero Fashion Limited (NFL) is a clothing manufacturer in mainland China and distributes its products through the following channels:

- Counter sales at department stores – walk-in customers purchase and collect the goods upon the issue of an invoice by and make cash or credit card payments to the department stores. In accordance with the consignment contract signed between the department store and NFL, the selling price is determined and inventory is managed by NFL, the sales teams are employed by NFL while the cashier service is provided by the department stores. The department stores pay 80% of the retail price of the goods sold to NFL on a monthly basis. The department stores accept returns or exchanges of goods within 7 days of the invoice date and all these items are returned to NFL and the amounts deducted from the total remitted to NFL.
- Distributors – NFL ships the goods to the designated location in accordance with the instructions of the distributors, including the items and quantity requested. Distributors can open their own retail store to sell the goods, but NFL will determine the retail prices for the goods, which are normally the same as the prices offered in counter sales at department stores. Goods are not returnable except for items with quality problems which can be returned within 7 days of delivery. The distributors have to sign and return an acceptable confirmation at the completion of quality inspection or 7 days of delivery, whichever is earlier. NFL will issue an invoice to the distributors at 50% of the pre-determined retailing price of items delivered on a monthly basis.

Based on the past three years historical data, less than 0.1% of sales were returned from customers of department stores within the 7-day period and around 5% of sales were returned from distributors before signing the confirmation under the above return policies.

Required

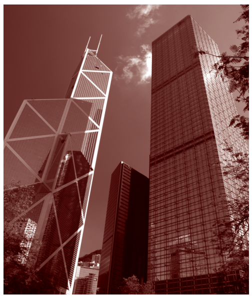
(a) Discuss how NFL should account for the sales revenue through these channels, with reference to HKAS 18 *Revenue*.

(i) Counter sales at department stores **(7 marks)**
(ii) Distributors **(6 marks)**

(b) Discuss how NFL should account for monthly revenue if it will give a 10% discount of the invoiced amount to the distributors when the respective annual quantity delivered is above 100,000 pieces. **(3 marks)**

(Total = 16 marks)

HKICPA June 2012 (amended)


chapter 15

Income taxes

Learning focus

Tax in one form or another is relevant to all organisations. You should therefore ensure that you fully understand its operation in the financial statements. Hence this topic may appear with other topics. You must study it and understand its relationship with other assets and liabilities. Of course, in a business situation, the deferred tax consideration is always an important topic as it may change the investment decision.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
Account for transactions in accordance with Hong Kong Financial Reporting Standards		
3.18	**Income taxes**	2
3.18.01	Account for current tax liabilities in accordance with HKAS 12	
3.18.02	Record entries relating to income tax in the accounting records	
3.18.03	Identify temporary differences (both inside and outside difference) and calculate deferred tax amounts	
3.18.04	Account for tax losses and tax credits	
3.18.05	Identify initial recognition exemption for assets and liabilities	
3.18.06	Account for deferred tax relating to investments in subsidiaries, associates and joint ventures	
3.18.07	Determine when tax assets and liabilities can be offset	
3.18.08	Disclose relevant information with regard to income taxes	

1 Current tax

Topic highlights

Taxation consists of **two components**:

- Current tax
- Deferred tax

HKAS 12 *Income Taxes* covers both current and deferred tax.

- **Current tax** is the amount *actually payable* to the tax authorities in relation to the trading activities of the entity during the period.
- **Deferred tax** is an *accounting measure*, used to match the tax effects of transactions with their accounting impact and thereby produce less distorted results.

The parts of the standard relating to current tax are fairly brief, because this is the simple and uncontroversial area. This section of the chapter deals with current tax and we come on to deferred tax in section 2.

HKAS 12.5

1.1 Definitions

These are some of the definitions given in HKAS 12. We will look at the rest later.

Key terms

Accounting profit. Profit or loss for a period before deducting tax expense.

Taxable profit/(tax loss). The profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable).

Tax expense/(tax income). The aggregate amount included in the determination of profit or loss for the period in respect of current tax and deferred tax.

Current tax. The amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period. *(HKAS 12)*

HKAS 12.12,13

1.2 Recognition of current tax liabilities and assets

Topic highlights

Current tax is the amount payable to the tax authorities in relation to the trading activities during the period. It is generally straightforward.

The amount of tax payable (or receivable) must be calculated and then charged (or credited) to profit or loss for the period and shown in the statement of profit or loss and other comprehensive income.

Any **unpaid tax** in respect of the current or prior periods must be recognised as a **liability**.

Conversely, any **excess tax** paid in respect of current or prior periods over what is due should be recognised as an **asset**.

1.2.1 Over and underprovisions

The year end tax liability (or asset) is generally an estimated amount, not settled until a later date. It is often the case, therefore, that the liability (or asset) recognised is not equal to the amount eventually paid (or recovered):

- Where the estimated tax liability exceeds the tax later paid to the authorities, tax has been **overprovided.**
- Where the estimated tax liability is less than the tax later paid to the authorities, tax has been **underprovided.**

This under- or over-provision must be adjusted for in the following year's tax charged to profit or loss:

	$
Estimated current year tax charge	X
Under/over provision in respect of prior year	X/(X)
Income tax charge for the year	X

Self-test question 1

Moorland operates in Hong Kong and is subject to a 16.5% tax rate. In the year ended 31 December 20X1, the company had tax-adjusted profits of $760,000. In the year ended 31 December 20X0, a current year tax liability of $130,000 was recognised; tax subsequently paid in respect of the year was $126,700.

(a) What amounts are recognised in Moorland's financial statements in respect of tax in the year ended 31 December 20X1?

(b) How does your answer change if the tax paid in respect of 20X0 was $131,000?

(The answer is at the end of the chapter)

HKAS 12.14

1.2.2 Tax losses carried back

HKAS 12 also requires recognition as an asset of the benefit relating to any tax loss that can be **carried back** to recover current tax of a previous period. This is acceptable because it is probable that the benefit will flow to the entity *and* it can be reliably measured. In Hong Kong, tax losses carried back are not allowed from the tax perspective.

Example: Tax losses carried back

Dredger operates in a jurisdiction where trading losses may be carried back one year to offset against trading profits for the purposes of tax. In the year ended 31 December 20X1, Dredger had tax-adjusted profits of $126,000; in the following year, the company reported a tax-adjusted loss of $46,000. Dredger pays tax at 20%.

Required

Calculate the tax effect and prepare the corresponding journal entry for 20X2.

Solution

Tax due on profits in 20X1 is $25,200 ($126,000 × 20%)

Tax repayment due on losses in 20X2 is $9,200 ($46,000 × 20%)

The taxable profits of 20X1 are sufficient to absorb the losses of 20X2 and therefore a repayment for the full $9,200 can be claimed.

The double entry will be:

		$	$
DEBIT	Tax receivable (statement of financial position)	9,200	
CREDIT	Tax repayable (statement of profit or loss and other comprehensive income)		9,200

The tax receivable will be shown as an asset until the repayment is received from the tax authorities.

HKAS 12.46

1.3 Measurement of current tax

The measurement of current tax liabilities (assets) for the current and prior periods is straightforward. Their measurement is the amount expected to be paid (or recovered from) the tax authorities. The enacted (or substantively enacted) tax rates (and tax laws) at the end of reporting period should be used.

HKAS 12.58,61A

1.4 Recognition of current tax

Current tax payable or repayable is recognised in profit or loss in the period to which it relates.

There are three exceptions to this rule:

(a) Tax arising from a **business combination** which is an acquisition (refer to sections 10 and 10.4 of this chapter).

(b) Tax arising from a transaction or event recognised in **other comprehensive income**

(c) Tax arising from a transaction or event recognised **directly in equity**

If a transaction or event is charged or credited to other comprehensive income or directly to equity, it is logical to show its related tax in other comprehensive income or equity.

An example of this is where, under HKAS 8, a change in accounting policy that is applied retrospectively, or a correction of a material prior period error is adjusted to the opening balance of the retained earnings.

HKAS 12.77

1.5 Presentation of current tax

Tax assets and liabilities should be disclosed distinctly from other assets and liabilities in the statement of financial position of an entity.

The **tax expense (income)** relating to the current period should be presented on the face of the statement of profit or loss and other comprehensive income.

HKAS 12.71

1.5.1 Offsetting current tax assets and liabilities

Current tax assets and liabilities can be **offset**, but this should happen only when certain conditions apply.

(a) The entity has a **legally enforceable right** to set off the recognised amounts.

(b) The entity intends to settle the amounts on a **net basis**, or to realise the asset and settle the liability at the same time.

An entity may have a right to set off a current tax asset against a current tax liability when they relate to income taxes levied by the same taxation authority and the taxation authority permits the entity to make or receive a single net payment. The tax expense (income) related to the profit or loss from ordinary activities should be shown in the statement of profit or loss and other comprehensive income.

2 Introduction to deferred tax

Topic highlights

Deferred tax is an accounting measure, used to match the tax effects of transactions with their accounting impact. It is quite complex.

Deferred tax is an accounting measure which recognises the future tax impact of assets and liabilities currently held in the statement of financial position. It is important to realise that deferred tax is not an amount currently payable to the tax authorities, or relevant to tax practitioners; it is quite simply an accounting adjustment.

For example, if an entity holds an asset in its statement of financial position, it is reasonable to assume that at some point in the future that asset will be realised (for example, an amount owed will be received). At such a time as the asset is realised, tax will be payable on the related income (assuming that tax arises on the cash receipt rather than when the asset is recognised for accounting purposes). This tax payable at some point in the future is referred to as a **deferred tax liability**.

Example: Deferred tax liability

Lightning Co. owns a non-current asset that cost $300 and has a carrying amount of $200. Cumulative depreciation for tax purposes (sometimes known as capital allowances) is $180 and the tax rate is 16.5%.

What is the deferred tax impact?

Solution

To date Lightning Co. has claimed tax depreciation on the asset of $180, and so received tax relief for this amount.

In the future, as Lightning Co. continues to use the asset, it will recover the $200 carrying amount of the asset (i.e. it will earn that $200 in revenue – and probably more besides).

Also in the future Lightning Co. will be able to claim a further $120 of tax depreciation ($300 original cost less the $180 tax relief already claimed). This value for tax purposes is known as the "tax base".

The net effect in the future is $80 taxable income ($200 carrying amount – $120 tax base). This is known as a "taxable temporary difference".

When applying a tax rate of 16.5%, tax payable in the future on the net taxable income amounts to $13.20.

Lightning Co. therefore recognises a deferred tax liability of $13.20.

Equally, if an entity has a liability, and tax relief is provided when payment is actually made to settle the liability (rather than when the liability is recognised for accounting purposes), then there is a future **tax benefit**, known as a **deferred tax asset**.

Example: Deferred tax asset

Monarchy Co. operates in a jurisdiction where general provisions for bad debts recognised in the statement of financial position do not benefit from tax relief until such time as they are certified as a bad debt. Monarchy Co. recognises such a provision in 20X1 for $200,000. It expects to be certified as a bad debt in two years' time. The company has always paid tax on all income at 16.5% and does not believe that this will change in the near future.

What is the deferred tax impact?

Solution

- In 20X1, Monarchy recognises a provision for a bad debt (a liability balance and corresponding accounting expense) of $200,000.
- When the balance is certified as a bad debt (e.g. because the client's company is liquidated) Monarchy will be able to reduce taxable profits by the $200,000. This is not expected to happen until 20X3.

- When the $200,000 is included as an allowable expense within taxable profits, it will result in a reduction in tax payable of $33,000 ($200,000 × 16.5%).
- The $33,000 is not recognised as a current tax asset (i.e. a receivable) as the benefit is not yet virtually certain.
- Instead, a deferred tax asset of $33,000 may be recognised in respect of the doubtful debt.
- This asset is only recognised if Monarchy Co. expects to have sufficient profits in two years' time against which the bad debt expense may be relieved.

The remainder of this section of the chapter provides an overview of the process to recognise and measure deferred tax. Later sections then consider each of the stages in the process in more detail.

2.1 Calculation of deferred tax

The HKAS 12 method of calculating deferred tax assets and liabilities is as follows. It is referenced to the examples in the above section in order to aid understanding:

		Asset	General provision for bad debt
1	What is the carrying value of the item in the statement of financial position? Note that for the purposes of this exercise, liabilities should be regarded as negative amounts.	$200 asset	($200,000) provision
2	What is the "**tax base**" of the item? Tax base is defined in the next section, but in simple terms think of it as the carrying value of the item in a tax version of the statement of financial position.	$120 asset	Nil (there is no liability / expense from the tax perspective until the case is certified as bad debt)
3	What is the difference between carrying value and tax base – known as **temporary difference**?	$80	($200,000)
4	What type of temporary difference? A **taxable temporary difference** arises where carrying value > tax base. A **deductible temporary difference** arises where tax base > carrying value	Taxable	Deductible
5	Apply tax rate to the temporary difference	$13.20	$33,000
6	Deferred tax asset or liability? A deferred tax liability arises from a taxable temporary difference. A deferred tax asset arises from a deductible temporary difference.	Liability	Asset

The table above includes a number of new terms such as tax base and temporary difference. The next section considers the HKAS 12 definitions of each of them.

HKAS 12.5

2.2 Definitions

Key terms

Deferred tax liabilities are the amounts of income taxes payable in future periods in respect of taxable temporary differences.

Deferred tax assets are the amounts of income taxes recoverable in future periods in respect of:

- Deductible temporary differences
- The carry forward of unused tax losses
- The carry forward of unused tax credits

Temporary differences are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base. Temporary differences may be either:

- **Taxable temporary differences**, which are temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled; or

- **Deductible temporary differences**, which are temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.

The **tax base** of an asset or liability is the amount attributed to that asset or liability for tax purposes. *(HKAS 12)*

HKAS 12 provides further guidance on some of the definitions seen above, and sections 2.2.1 to 2.2.3 below consider tax base, temporary differences and deferred tax asset/liability in turn.

HKAS 12.7

2.2.1 Tax base

The **tax base of an asset** is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to the entity when it recovers the carrying amount of the asset.

Where those economic benefits are not taxable, the tax base of the asset is the same as its carrying amount.

Make sure that you understand this idea by attempting the following self-test question.

Self-test question 2

State the tax base of each of the following assets:

(a) Interest receivable has a carrying amount of $1,000. The related interest revenue is not taxable.

(b) Dividends receivable from a subsidiary have a carrying amount of $5,000. The dividends are not taxable.

(c) A machine cost $10,000. For tax purposes, depreciation of $3,000 has already been deducted in the current and prior periods and the remaining cost will be deductible in future periods, either as depreciation or through a deduction on disposal. Revenue generated by using the machine is taxable, any gain on disposal of the machine will be taxable and any loss on disposal will be deductible for tax purposes.

(d) Trade receivables have a carrying amount of $10,000. The related revenue has already been included in taxable profit (tax loss).

(e) A loan receivable has a carrying amount of $1 million. There are no tax consequences for repayment of the loan.

(The answer is at the end of the chapter)

HKAS 12.8

The **tax base of a liability** is its carrying amount, less any amount that will be deductible for tax purposes in relation to the liability in future periods.

For revenue received in advance, the tax base of the resulting liability is its carrying amount, less any amount of the revenue that will *not* be taxable in future periods.

Self-test question 3

State the tax base of each of the following liabilities:

(a) Current liabilities include accrued expenses with a carrying amount of $1,000. The related expense will be deducted for tax purposes on an accrual basis.

(b) Current liabilities include revenue received in advance, with a carrying amount of $1,000. The related revenue was taxed on an accrual basis.

(c) Current liabilities include accrued fines and penalties with a carrying amount of $100. Fines and penalties are not deductible for tax purposes.

(d) A loan payable has a carrying amount of $1 million. There are no tax consequences for repayment of the loan.

(The answer is at the end of the chapter)

HKAS 12, Illustrative Examples

HKAS 12 gives the following examples of circumstances in which the carrying amount of an asset or liability will be **equal to its tax base**.

- **Accrued expenses** have already been deducted in determining an entity's current tax liability for the current or earlier periods.
- A **loan payable** is measured at the amount originally received and this amount is the same as the amount repayable on final maturity of the loan.
- **Accrued expenses** will never be deductible for tax purposes.
- **Accrued income** will never be taxable.

2.2.2 Temporary differences

As we have already seen, a temporary difference (which may be taxable or deductible) arises where there is a difference between the carrying amount of item and its tax base:

- Where carrying amount > tax base there is a taxable temporary difference
- Where carrying amount < tax base there is a deductible temporary difference

The approach to calculating temporary differences provided within HKAS 12 is known as a "balance sheet approach". This is because the carrying amount of an item is found in the statement of financial position and the tax base of an item is in effect its carrying amount for tax purposes.

It may be easier to think about the reason for deferred tax from a profit or loss point of view instead (remembering that assets and liabilities are of course related to income and expenses!). Accounting profits and taxable profits are different, as you will know from your tax studies. There are two reasons for the differences:

(a) Permanent differences occur when revenue or expenses included in accounting profits are excluded from the computation of taxable profits (for example, client entertainment expenses may not be allowable for tax purposes).

(b) Temporary differences occur when revenue or expenses are included in both accounting profits and taxable profits, but in different accounting periods. We have already seen two examples of this – where depreciation on an asset is charged faster for tax purposes than for accounting purposes, and where a provision is recognised as an expense when payable but does not benefit from tax relief until paid.

In the long run, there is no difference between total taxable profits and total accounting profits (except for permanent differences) so that temporary differences originate in one period and will be reversed in one or more subsequent periods. Deferred tax is caused by **temporary differences**.

Sections 3 and 4 of this chapter consider taxable and deductible temporary differences in more detail.

2.2.3 Deferred tax assets and liabilities

Temporary differences give rise to deferred tax liabilities and assets:

- A taxable temporary difference results in a deferred tax liability.
- A deductible temporary difference results in a deferred tax asset.

Deferred tax assets also arise from unused tax losses that tax law allows to be carried forward.

HKAS 12.47

2.3 Measurement of deferred tax

A deferred tax asset or liability is measured by applying the tax rate to the temporary difference calculated.

The tax rate applied to the temporary difference should be that which is expected to apply to the period when the asset is realised or the liability is settled, based on tax laws in place by the reporting date.

More detailed measurement rules are provided in section 5 of this chapter.

HKAS 12.58

2.4 Recognition of deferred tax

Deferred tax assets and liabilities relating to all temporary differences should be aggregated and the overall deferred tax liability or asset recorded in the financial statements.

From year to year, only the movement in this amount is recorded. The opposite entry is to the deferred tax charge, which forms part of the overall tax charge in the statement of profit or loss and other comprehensive income.

More detailed recognition rules are provided in section 6 of this chapter.

Example: Deferred tax

The following is relevant to Casares Co. in the year ended 31 December 20X1:

- Non-current assets originally cost $780,000. Accumulated depreciation to date is $210,000 and tax allowances given amount to $320,000 on a cumulative basis
- Interest receivable in Casares' statement of financial position is $160,000. This will not be taxed until it is received in the year ended 31 December 20X2.
- A provision for $98,000 for legal expenses payable is included in the statement of financial position. This will not be allowable for tax purposes until it is paid in the year ended 31 December 20X2.

The tax rate applicable to Casares is 16.5%, and since all tax arises within the same taxation authority deferred tax assets and liabilities may be offset.

At 31 December 20X0 the deferred tax liability reported in Casares' financial statements was $22,430.

Required

Calculate amounts to be recognised in Casares’ financial statements in respect of deferred tax in the year ended 31 December 20X1.

Solution

First, the deferred tax asset or liability must be considered for each of the items separately:

Non-current assets

Carrying amount (780,000 – 210,000)	$570,000
Tax base (780,000 – 320,000)	$460,000
Temporary difference	$110,000
Taxable or deductible?	Taxable since CA > TB
Deferred tax liability (110,000 × 16.5%)	$18,150

Interest receivable

Carrying amount	$160,000
Tax base	$nil *
Temporary difference	$160,000
Taxable or deductible?	Taxable since CA > TB
Deferred tax liability (160,000 × 16.5%)	$26,400

*The tax base of an asset is the amount that will be *deductible* for tax purposes in the future. Here nothing will be deductible – instead an amount will be taxable.

Provision

Carrying amount	($98,000)
Tax base	$nil **
Temporary difference	$98,000
Taxable or deductible?	Deductible since CA < TB
Deferred tax asset (98,000 × 16.5%)	$16,170

** The tax base of a liability is its carrying amount ($98,000) less any amount deductible for tax purposes in the future ($98,000).

In summary therefore:

	$
Deferred tax liability 1	18,150
Deferred tax liability 2	26,400
Deferred tax asset	(16,170)
Net deferred tax liability	28,380

The increase in deferred tax liability since 31 December 20X0 is $5,950 (28,380 – 22,430) and this is accounted for by:

		$	$
DEBIT	Tax charge	5,950	
CREDIT	Deferred tax liability		5,950

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR CASARES FOR THE YEAR ENDED 31 DECEMBER 20X1

	$
Tax charge – deferred tax	5,950

STATEMENT OF FINANCIAL POSITION FOR CASARES AT 31 DECEMBER 20X1

	$
Deferred tax liability	28,380

3 Taxable temporary differences

Topic highlights

Deferred tax liabilities arise from taxable temporary differences.

Remember the basic rule that a taxable temporary difference arises where the carrying amount of an item in the statement of financial position exceeds its tax base, and this taxable temporary difference results in a deferred tax liability.

Try to **understand the reasoning** behind the recognition of deferred tax liabilities on taxable temporary differences.

(a) When an **asset is recognised**, it is expected that its carrying amount will be recovered in the form of economic benefits that flow to the entity in future periods.

(b) If the carrying amount of the asset is **greater than** its tax base, then taxable economic benefits will also be greater than the amount that will be allowed as a deduction for tax purposes.

(c) The difference is therefore a **taxable temporary difference** and the obligation to pay the resulting income taxes in future periods is a **deferred tax liability**.

(d) As the entity recovers the carrying amount of the asset, the taxable temporary difference will **reverse** and the entity will have taxable profit.

(e) It is then probable that economic benefits will flow from the entity in the form of **tax payments**, and so the recognition of all deferred tax liabilities (except those excluded below) is required by HKAS 12.

The following are examples of circumstances that give rise to taxable temporary differences.

HKAS 12, Illustrative Examples

3.1 Examples of taxable temporary differences

HKAS 12 provides a number of examples of situations where taxable temporary differences may arise.

3.1.1 Transactions affecting the statement of profit or loss and other comprehensive income

(a) **Depreciation** of an asset is accelerated for tax purposes. When new assets are purchased, allowances may be available against taxable profits which exceed the amount of depreciation chargeable on the assets in the financial accounts.

(b) **Development costs** which have been capitalised will be amortised in profit or loss, but they were deducted in full from taxable profit in the period in which they were incurred.

Example: Taxable temporary differences (1)

Leeming Bar Co. is engaged in research and development activities. In the year ended 31 August 20X2, the company spent $740,000 on such activities. $310,000 of this meets the requirements of HKAS 38 and has been capitalised. To date no amortisation has been charged. For tax purposes the full $740,000 qualifies for 100% relief in the year of expenditure. The applicable tax rate is 16.5%.

Required

What is the deferred tax impact of this expenditure?

Solution

Carrying amount	$310,000
Tax base	$nil *
Temporary difference	$310,000
Taxable or deductible?	Taxable since CA > TB
Therefore deferred tax liability (310,000 × 16.5%)	$51,150

*The tax base of an asset is the amount that will be deductible for tax purposes in the future. Here nothing will be deductible in the future as tax relief has already been given.

HKAS 12, Illustrative Examples

3.1.2 Transactions that affect the statement of financial position

(a) **Depreciation of an asset** is not deductible for tax purposes. No deduction will be available for tax purposes when the asset is sold/scrapped.

(b) A borrower records a **loan** at proceeds received (amount due at maturity) less transaction costs. The carrying amount of the loan is subsequently increased by amortisation of the transaction costs against accounting profit. The transaction costs were, however, deducted for tax purposes in the period when the loan was first recognised.

(c) A **loan payable** is measured on initial recognition at net proceeds (net of transaction costs). The transaction costs are amortised to accounting profit over the life of the loan. Those transaction costs are not deductible in determining the taxable profit of future, current or prior periods.

(d) The liability component of a **compound financial instrument** (e.g. a convertible bond) is measured at a discount to the amount repayable on maturity, after assigning a portion of the cash proceeds to the equity component (see HKAS 32). The discount is not deductible in determining taxable profit.

(e) **Development costs** may be capitalised and amortised over future periods in determining accounting profit but deducted in determining taxable profit in the period in which they are incurred. Such development costs have a tax base of nil as they have already been deducted from taxable profit. The temporary difference is the difference between the carrying amount of the development costs and their tax base of nil.

Example: Taxable temporary differences (2)

A company purchased a machine for production costing $200,000. At the end of 20X9 the carrying amount is $120,000. The total depreciation allowance for tax purposes is $90,000 and the current tax rate is 16.5%.

Required

Calculate the deferred tax liability for the machinery.

Solution

Carrying amount	$120,000
Tax base (200,000 – 90,000)	$110,000
Temporary difference	$10,000
Taxable or deductible?	Taxable since CA > TB
Therefore deferred tax liability (10,000 × 16.5%)	$1,650

The logic behind this liability is as follows: In order to recover the carrying amount of $120,000, the entity must earn taxable income of $120,000, but it will only be able to deduct $110,000 as a taxable expense. The entity must therefore pay income tax of $10,000 × 16.5% = $1,650 when the carrying amount of the asset is recovered.

HKAS 12.20

3.1.3 Fair value adjustments and revaluations

In the following examples, an asset in the statement of financial position is adjusted to be carried at fair value, however such an adjustment is not made for tax purposes and original cost remains the tax base.

(a) **Current investments** or financial instruments carried at fair value.
(b) **Investment properties** carried at fair value.

In the case of **revalued property, plant and equipment**, there is a taxable temporary difference only where the revaluation does not affect current taxable profits.

If the revaluation affects the taxable profit for the current period, the tax base of the asset changes to become equal to fair value (and so carrying value) and **no temporary difference** arises.

Example: Revaluation

During the year ended 31 December 20X1, Marshall revalues a non-current asset to $8,000,000. The asset cost $6,000,000 three years ago and was being depreciated at 2% straight line. Capital allowances were available at 4% straight line. Marshall's rate of tax is 16.5%.

What deferred tax arises on the revaluation in 20X1, assuming that the revaluation gain is not taxable in 20X1?

Solution

	$'000
Carrying value of non-current asset prior to revaluation ($6,000,000 × 94%)	5,640
Revalued amount	8,000
Taxable temporary difference = revaluation gain	2,360
Therefore deferred tax liability (16.5% × 2.36m)	389.4

HKAS 12.21,22

3.2 Taxable temporary differences which do not result in deferred tax liabilities

There are **two circumstances** given in the standard where a taxable temporary difference does not result in a deferred tax liability:

(a) The deferred tax liability arises from the initial recognition of **goodwill**.

(b) The deferred tax liability arises from the **initial recognition** of an asset or liability in a transaction which:

  (i) is *not* a business combination (see section 8)

  (ii) at the time of the transaction affects neither accounting profit nor taxable profit (tax loss).

HKAS 12.22

3.2.1 Initial recognition of an asset or liability

A temporary difference can arise on initial recognition of an asset or liability, e.g. if part or all of the cost of an asset will not be deductible for tax purposes. The **nature of the transaction** which led to the initial recognition of the asset is important in determining the method of accounting for such temporary differences.

If the transaction affects *either* accounting profit or taxable profit, an entity will **recognise any deferred tax liability** or asset. The resulting deferred tax expense or income will be recognised in profit or loss.

Where a transaction affects **neither accounting profit nor taxable profit** it would be normal for an entity to recognise a deferred tax liability or asset and adjust the carrying amount of the asset or liability by the same amount. However, HKAS 12 does *not* permit this recognition of a deferred tax asset or liability as it would make the financial statements less transparent. This will be the case both on initial recognition and subsequently, nor should any subsequent changes in the unrecognised deferred tax liability or asset as the asset is depreciated be made.

An example of the initial recognition of an asset in a transaction which does not affect either accounting or taxable profit at the time of the transaction is an intangible asset with a finite life which attracts no tax allowances. In this case, taxable profit is never affected, and amortisation is only charged to accounting profit after the transaction.

Example: Initial recognition

As an example of the last paragraph, suppose Perris Co. intends to use an asset which cost $10,000 in 20X7 through its useful life of five years. Its residual value will then be nil. The tax rate is 16.5%. Any capital gain on disposal would not be taxable (and any capital loss not deductible). Depreciation of the asset is not deductible for tax purposes.

Required

State the deferred tax consequences in each of years 20X7 and 20X8.

Solution

As at 20X7, as it recovers the carrying amount of the asset, Perris Co. will earn taxable income of $10,000 and pay tax of $1,650. The resulting deferred tax liability of $1,650 would not be recognised because it results from the initial recognition of the asset.

As at 20X8, the carrying value of the asset is now $8,000. In earning taxable income of $8,000, the entity will pay tax of $1,320. Again, the resulting deferred tax liability of $1,320 is not recognised, because it results from the initial recognition of the asset.

The following question on accelerated depreciation should clarify some of the issues and introduce you to the calculations.

Self-test question 4

Jojo Co. buys equipment for $50,000 on 1 January 20X1 and depreciates it on a straight line basis over its expected useful life of five years. For tax purposes, the equipment is depreciated at 25% per annum on a straight line basis. The tax rate is 15%.

Required

Show the current and deferred tax impact in years 20X1 to 20X5 of the acquisition of the equipment.

(The answer is at the end of the chapter)

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4 Deductible temporary differences

Topic highlights

Deferred tax assets arise from deductible temporary differences.

The **standard states** that deferred tax assets can only be recognised when **sufficient future taxable profits** exist against which they can be utilised.

Remember the basic rule that a deductible temporary difference arises where the carrying amount of an asset or liability is less than its tax base, and this deductible temporary difference normally results in a deferred tax asset.

Try to **understand the reasoning** behind the recognition of deferred tax assets on taxable temporary differences:

(a) When a **liability is recognised**, it is assumed that its carrying amount will be settled in the form of outflows of economic benefits from the entity in future periods.

(b) When these resources flow from the entity, part or all may be deductible in determining taxable profits of a **period later** than that in which the liability is recognised.

(c) A **temporary tax difference** then exists between the carrying amount of the liability and its tax base.

(d) A **deferred tax asset** therefore arises, representing the income taxes that will be recoverable in future periods when that part of the liability is allowed as a deduction from taxable profit.

(e) Similarly, when the carrying amount of an asset is **less than its tax base**, the difference gives rise to a deferred tax asset in respect of the income taxes that will be recoverable in future periods.

The following are common examples of situations that result in a deductible temporary difference.

HKAS 12, Illustrative Examples

4.1 Examples of deductible temporary differences

HKAS 12 provides a number of examples of deductible temporary differences.

4.1.1 Transactions affecting the statement of profit or loss and other comprehensive income

(a) **Retirement benefit costs** (pension costs) are deducted from accounting profit as service is provided by the employee. They are not deducted in determining taxable profit until the entity pays either retirement benefits or contributions to a fund. (This may also apply to similar expenses.)

(b) **Accumulated depreciation** of an asset in the financial statements is greater than the accumulated depreciation allowed for tax purposes up to the end of the reporting period.

(c) The **net realisable value** of inventory, or the **recoverable amount** of an item of property, plant and equipment falls and the carrying value is therefore **reduced**, but that reduction is ignored for tax purposes until the asset is sold.

(d) **Research costs** (or organisation/other start-up costs) are recognised as an expense for accounting purposes but are not deductible against taxable profits until a later period.

(e) Income is **deferred** in the statement of financial position, but has already been included in taxable profit in current/prior periods.

A non-taxable **government grant** related to an asset is deducted in arriving at the carrying amount of the asset but, for tax purpose, is not deducted from the asset's depreciable amount (in other words its tax base); the carrying amount of the asset is less than its tax base and this gives rise to a deductible temporary difference. Government grants may also be set up as deferred income in which case the difference between the deferred income and its tax base of nil is a deductible temporary difference. (**Note**. Whichever method of presentation an entity adopts, a deferred tax asset may *not* be recognised here according to the standard.)

Example: Deductible temporary differences (1)

Teide Co. owns a specialised machine which originally cost $4,000,000. In the year ended 31 October 20X2 as the result of economic recession, Teide undertook an impairment review and found that the recoverable amount of the machine was $2,600,000, this being $800,000 lower than carrying amount. At 31 October 20X2, tax allowances given in respect of the machine amounted to $1,000,000.

Required

What amount of deferred tax is recognised in respect of the machine at 31 October 20X2?

Solution

Carrying amount (recoverable amount)	$2,600,000
Tax base (4,000,000 – 1,000,000)	$3,000,000
Temporary difference	$400,000
Taxable or deductible?	Deductible since CA < TB
Therefore deferred tax asset (400,000 × 16.5%)	$66,000

4.1.2 Fair value adjustments and revaluations

A fair value which is lower than cost may be shown for current investments or financial instruments. However, no equivalent adjustment for tax is to be made.

HKAS 12.27-30

4.2 Recognition of deferred tax assets

Although the circumstances listed above will result in a deductible temporary difference, they will not necessarily result in a deferred tax asset.

This is because the recognition criteria of HKAS 12 state that a deferred tax asset can only be recognised to the extent that it is probable that taxable profit will be available against which it can be utilised.

4.2.1 Sufficient taxable profit

When can we be sure that sufficient taxable profit will be available against which a deductible temporary difference can be utilised? HKAS 12 states that this will be assumed when sufficient **taxable temporary differences** exist which relate to the same taxation authority and the same taxable entity. These should be expected to reverse as follows:

(a) In the same period as the expected reversal of the deductible temporary difference.

(b) In periods into which a tax loss arising from the deferred tax asset can be carried back or forward.

Only in these circumstances is the deferred tax asset **recognised**, in the period in which the deductible temporary differences arise.

4.2.2 Insufficient taxable profit

What happens when there are **insufficient taxable temporary differences** (relating to the same taxation authority and the same taxable entity)? It may still be possible to recognise the deferred tax asset, but only to the following extent.

(a) **Taxable profits** are sufficient in the same period as the reversal of the deductible temporary difference (or in the periods into which a tax loss arising from the deferred tax asset can be carried forward or backward), ignoring taxable amounts arising from deductible temporary differences arising in future periods.

(b) **Tax planning opportunities** exist that will allow the entity to create taxable profit in the appropriate periods.

With reference to (b), **tax planning opportunities** are actions that an entity would take in order to create or increase taxable income in a particular period before the expiry of a tax loss or tax credit carry forward. For example, in some countries it may be possible to increase or create taxable profit by electing to have interest income taxed on either a received or receivable basis, or deferring the claim for certain deductions from taxable profit.

In any case, where tax planning opportunities **advance taxable profit** from a later period to an earlier period, the utilisation of a tax loss or a tax credit carry forward will still depend on the existence of future taxable profit from sources other than future originating temporary differences.

If an entity has a **history of recent losses**, then this is evidence that future taxable profit may not be available.

Example: Deductible temporary differences (2)

Rombauld Co. recognises a liability of $75,000 for accrued product warranty costs on 31 December 20X1. These product warranty costs will not be deductible for tax purposes until the entity pays claims. The tax rate is 16.5%.

Required

State the deferred tax implications of this situation.

Solution

Carrying amount	($75,000)
Tax base	$nil *
Temporary difference	$75,000
Taxable or deductible?	Deductible since CA < TB
Therefore deferred tax asset (75,000 × 16.5%)	$12,375

*The tax base of the liability is nil (carrying amount of $75,000 less the $75,000 that will be deductible for tax purposes when the warranty costs are paid).

The logic behind this is as follows: when the liability is settled for its carrying amount, the entity's future taxable profit will be reduced by $75,000 and so its future tax payments by $75,000 × 16.5% = $12,375.

4.3 Deductible temporary differences which do not result in deferred tax assets

HKAS 12.33

4.3.1 Initial recognition of an asset or liability

There are circumstances where the overall rule for recognition of deferred tax asset is *not* allowed. This applies where the deferred tax asset arises from **initial recognition** of an asset or liability in a transaction which is not a business combination, *and* at the time of the transaction, affects neither accounting nor taxable profit/tax loss.

The example given by the standard is of a non-taxable government grant related to an asset, deducted in arriving at the carrying amount of the asset. For tax purposes, however, it is *not* deducted from the asset's depreciable amount (i.e. its tax base). The carrying amount of the asset is less than its tax base and this gives rise to a deductible temporary difference, however this is not recognised as a deferred tax asset.

HKAS 12.34-36

4.4 Tax losses and credits carried forward

HKAS 12 states that a deferred tax asset may be recognised by an entity which has unused tax losses or credits (i.e. which it can offset against taxable profits) at the end of a period, to the extent that it is probable future taxable profits will be available to set off the unused tax losses/credits.

The recognition criteria for deferred tax assets here is identical to the recognition criteria for deferred tax assets arising from deductible differences. The fact that future taxable profits may not be available is confirmed by the existence of unused tax losses. For an entity with a past record of recent tax losses, a deferred tax asset arising from unused tax losses or credits should be recognised only to the extent that it has adequate taxable temporary differences or where it is certain that taxable profit will be available to set off the unused losses/credits.

The following are important criteria for assessing the probability that taxable profit will be available against which unused tax losses/credits can be utilised:

- Availability of sufficient taxable temporary differences (same tax authority/taxable entity) against which unused tax losses/credits can be utilised before they expire
- The likelihood that the entity will have taxable profits before the expiry of the unused tax losses/credits
- The unlikely recurrence of unused tax losses resulting from identifiable causes
- Availability of tax planning opportunities (see above)

Deferred tax asset is not recognised if it is probable that taxable profit will not be available.

Example: Taxable profit not available

Jerome Co. has made trading profits for a number of years, however due to an economic downturn in the first half of the year, reported a taxable loss of $270,000 in the year ended 31 December 20X1. In accordance with local tax law, Jerome intends to carry $130,000 of this back to 20X0 to set against the taxable profits of that year, and carrying the remaining $140,000 forward indefinitely. By the end of 20X1, management had identified an upturn in orders and felt that Jerome would return to profit in 20X2.

What is the deferred tax impact, if any, of Jerome's losses?

Jerome pays tax at 16.5%.

Solution

- The $130,000 carried back to 20X0 is relevant to current tax rather than deferred tax, and a receivable of $21,450 should be recognised.
- It appears that the $140,000 carried forward will be able to be utilised by Jerome and therefore a deferred tax asset of $23,100 can be recognised (16.5% × $140,000).

HKAS 12.37

4.5 Reassessment of unrecognised deferred tax assets

An entity should carry out a reassessment for all unrecognised deferred tax assets at the end of each reporting period. The availability of future taxable profits and whether part or all of any unrecognised deferred tax assets should now be recognised are the issues to be considered. This may be due to an expected continuation in improvement of trading conditions. Conversely, a previously recognised deferred tax asset may require decreasing or derecognising where future taxable profits are no longer available.

5 Measurement of deferred tax

Topic highlights

A deferred tax asset or liability is measured by applying the tax rate which is expected to apply to the period when the asset is realised or the liability is settled to the temporary difference. The resulting amount is not discounted.

5.1 Full provision method

HKAS 12 adopts the full provision method of providing for deferred tax, in other words deferred tax is provided for on all temporary differences, irrespective of the future plans of an entity.

This method has the **advantage** that it recognises that each temporary difference at the year end has an effect on future tax payments. The **disadvantage** of full provision is that, under certain types of tax system, it gives rise to large liabilities that may fall due only far in the future.

HKAS 12.47

5.2 Applicable tax rate

Where the tax rate fluctuates year to year, consideration must be given to **which tax rate** to apply to temporary differences in calculating a deferred tax asset or liability.

HKAS 12 requires deferred tax assets and liabilities to be measured at the tax rates expected to apply in the period **when the asset is realised or liability settled**, based on tax rates and laws enacted (or substantively enacted) at the end of the reporting period.

This is referred to as the **liability method**.

HKAS 12.49

5.2.1 Different rates of tax

Some countries apply different tax rates to different levels of taxable income. **Average tax rates** should then be used to measure the deferred tax assets and liabilities since these rates are expected to be applied to the taxable profit (loss) of the periods in which the temporary differences are expected to reverse.

HKAS 12.51,51A

5.2.2 Manner of recovery or settlement

In some jurisdictions either the tax rate or the tax base will differ depending on the way in which an entity recovers or settles the carrying amount of an asset or liability.

For example, the tax rate applicable to income from the ongoing use of an asset may differ from the tax rate applicable to a chargeable gain on its sale.

In this instance the entity must consider the expected manner of recovery or settlement. Deferred tax liabilities and assets must be measured accordingly, using **an appropriate tax rate and tax base**.

Example: Manner of recovery/settlement

Clio Co. has an asset with a carrying amount of $100,000 and a tax base of $60,000. If the asset were sold, a tax rate of 18% would apply. A tax rate of 25% would apply to other income.

Required

State the deferred tax consequences if the entity:

(a) sells the asset without further use.
(b) expects to keep the asset and recover its carrying amount through use.

Solution

(a) A deferred tax liability is recognised of $(100,000 – 60,000) × 18% = $7,200.
(b) A deferred tax liability is recognised of $(100,000 – 60,000) × 25% = $10,000.

HKAS 12.51C

In 2010, HKAS 12 was amended to include a rebuttable presumption that deferred tax on investment properties carried at fair value under HKAS 40 should be measured based on recovery through sale rather than use. The amendment was intended to avoid any subjective assessment in trying to decide whether the carrying amount of an investment property will be recovered through use or through sale.

As there is no capital gains tax in Hong Kong, this amendment will generally result in the deferred tax liability on such investment properties being limited to the tax effect of any claw back on sale of any depreciation allowances previously given. No deferred tax arises in respect of the excess of fair value over cost.

Example

A company based in Hong Kong owns an investment property with a fair value carrying amount of $10 million. The property cost $9 million. The tax base of the property is $8 million and the tax rate on income is 16.5%.

Prior to the amendment to HKAS 12, if it were presumed that the carrying value of the property would be recovered through use, the deferred tax liability would have been $330,000 (16.5% × ($10 million – $8 million)).

The amendment, however, means that it is presumed that the carrying value will be recovered through sale. Therefore, the deferred tax liability is restricted to the excess of allowances given i.e. $165,000 (16.5% × ($9million – $8million)).

The presumption is rebutted where the investment property is depreciable and is held with the intention of consuming substantially all the economic benefits of the property through use rather than sale, in other words, where the entity expects the asset's income-generating ability to wear out while the asset is still owned by the entity.

Self-test question 5

Crescent Co. owns a building with an original cost of $10m. In 20X1, the carrying value was $8m and the asset was revalued to $15m. No equivalent adjustment was made for tax purposes. Total depreciation allowance for tax purposes is $3m and the tax rate is 30%. If the asset is sold for more than cost, the total tax depreciation allowance of $3m will be included in taxable income but sale proceeds in excess of cost will not be taxable.

Required

State the deferred tax consequences if the entity:

(a) expects to recover the carrying value through use,
(b) expects to sell the building.

(The answer is at the end of the chapter)

Self-test question 6

The facts are as in Self-test question 5 above, except that if the building is sold for more than cost, the total tax depreciation allowance will be included in taxable income (taxed at 30%) and the sale proceeds will be taxed at 40% after deducting an inflation-adjusted cost of $11m.

Required

State the deferred tax consequences if the entity:

(a) expects to recover the carrying value through use,
(b) expects to sell the building.

(The answer is at the end of the chapter)

If the tax base is not immediately apparent in Self-test question 6 above, it may be helpful to consider the fundamental principle of HKAS 12: that an entity should recognise a deferred tax liability (asset) whenever recovery or settlement of the carrying amount of an asset or liability would make future tax payments larger (smaller) than they would be if such recovery or settlement would have no consequences.

HKAS 12.53,54

5.3 Discounting

The standard does not allow deferred tax assets and liabilities to **be discounted**. This is because the complexities and difficulties involved will affect reliability.

Discounting would require detailed scheduling of the timing of the reversal of each temporary difference, but this is often impracticable. In addition, if discounting were permitted, it would affect comparability.

It is, however the case that some temporary differences are based on discounted amounts e.g. retirement benefit obligations.

6 Recognition of deferred tax

HKAS 12.58,61A

As with current tax, deferred tax is normally recognised as income or an expense and included in the profit or loss for the period. The amount recognised comprises:

(a) deferred tax relating to temporary differences

(b) adjustments arising as a result of changes in the carrying amount of deferred tax assets and liabilities due to changes in the tax rates, reassessment of the recoverability of deferred tax assets or a change in the expected recovery of an asset.

The exceptions to recognition of deferred tax in profit or loss are where the tax arises from the events below.

(a) A transaction or event which is recognised in **other comprehensive income** e.g. a revaluation.

(b) A transaction or event which is recognised (in the same or a different period) **directly in equity** e.g. the correction of an error.

(c) A **business combination** (other than the acquisition by an investment entity of a subsidiary that is required to be measured at fair value through profit or loss) (see section 10.4 of the chapter).

Where transactions or events are recognised in other comprehensive income or directly in equity, the related tax is also recognised in other comprehensive income or directly in equity.

Where it is not possible to determine the amount of tax that relates to items recognised in other comprehensive income or directly in equity, such tax amounts should be based on a reasonable **pro rata allocation** of the entity's tax.

7 Presentation of deferred tax

HKAS 12.74

Deferred tax assets and liabilities can be offset only if:

(a) the entity has a legally enforceable right to set off current tax assets against current tax liabilities, and

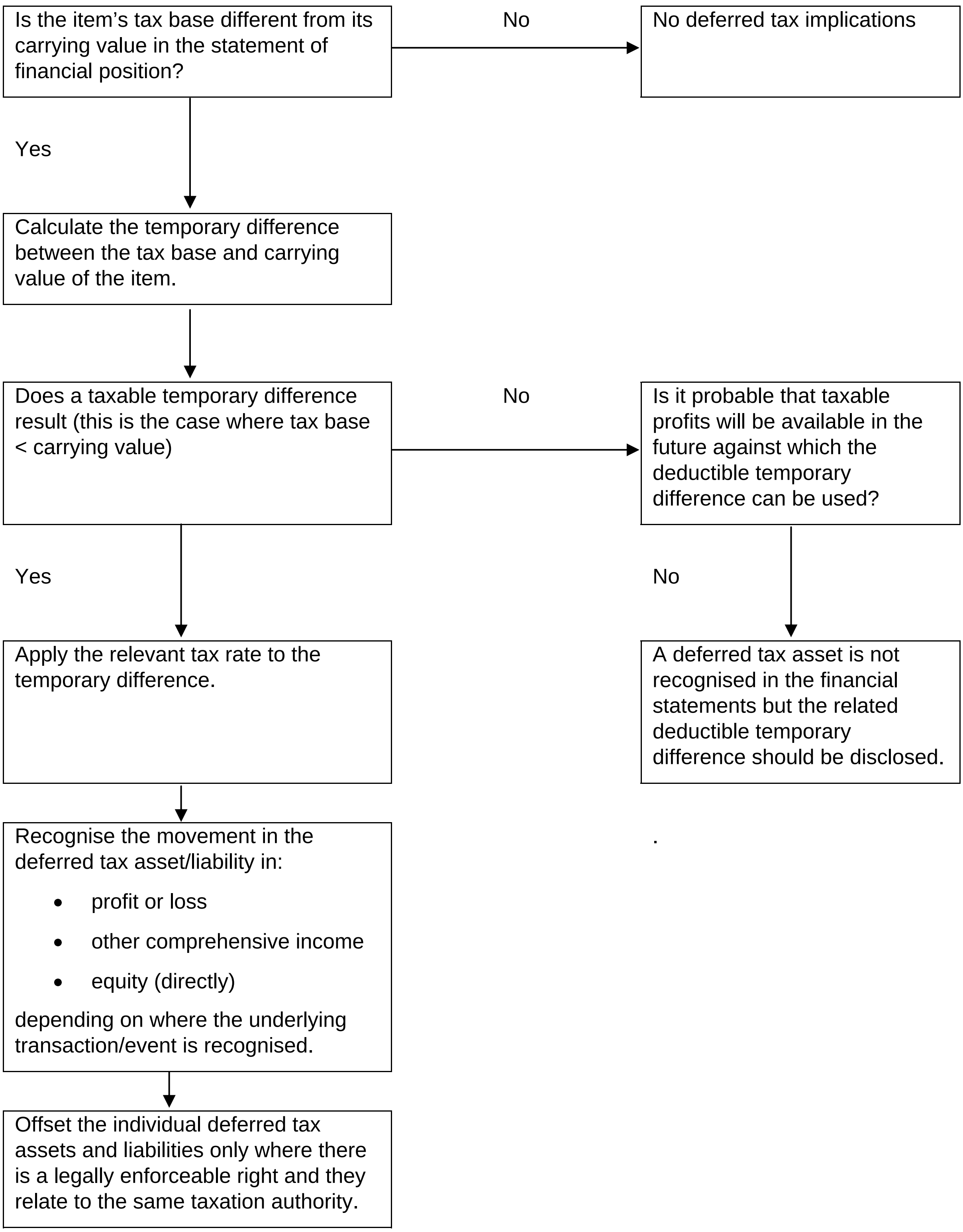
(b) the deferred tax assets and liabilities relate to income taxes levied by the same taxation authority on either:

    (i) the same taxable entity, or

    (ii) different taxable entities which intend either to settle current tax liabilities and assets on a net basis, or to realise the assets and settle the liabilities simultaneously, in each future period in which significant amounts of deferred tax liabilities or assets are expected to be settled or recovered.

8 Summary flowchart

The following flowchart will help to summarise the approach to deferred tax that we have seen throughout sections 2 to 7 of the chapter.



9 Disclosure of income taxes

The following disclosures are required in relation to income taxes:

1 The major components of tax expense in profit or loss, including the following:

(a) Current tax expense

(b) Adjustments recognised in the period for the current tax of previous periods;

(c) The amount of deferred tax expense (income) relating to the origination and reversal of temporary differences;

(d) The amount of deferred tax expense (income) relating to changes in tax rates or the imposition of new taxes;

2 The aggregate deferred tax relating to items that are charged or credited directly to equity.

3 The amount of income tax (including deferred tax) relating to each component of other comprehensive income.

4 An explanation of the relationship between tax expense and accounting profit in either or both of the following forms:

(a) A numerical reconciliation between tax expense and the product of accounting profit multiplied by the applicable tax rate(s), or

(b) A numerical reconciliation between the average effective tax rate and the applicable tax rate.

5 An explanation of changes in the applicable tax rate(s) compared to the previous accounting period.

6 The amount (and expiry date, if any) of deductible temporary differences, unused tax losses and unused tax credits for which no deferred tax asset is recognised in the statement of financial position.

7 In respect of each type of temporary difference:

(a) The amount of deferred tax assets and liabilities recognised in the statement of financial position.

(b) The amount of deferred tax income or expense recognised in profit or loss.

8 The amount of a deferred tax asset and the nature of evidence supporting its recognition when:

(a) the utilisation of the deferred tax asset is dependent on future taxable profits in excess of the profits arising from the reversal of existing taxable temporary differences, and

(b) the entity has suffered a loss in either the current or preceding period in the tax jurisdiction to which the deferred tax asset relates.

9.1 Reconciliation

Disclosure point number (4) listed above refers to a reconciliation between tax expense and accounting profit. Two possible forms are suggested. The following example shows both possible forms:

Example: Reconciliation

Rugby Co. reports a profit before tax for the year ended 31 December 20X3 of $8.775m and a tax expense of $3.977m. The tax rate applicable to the jurisdiction in which Rugby operates is 40% (38% 20X2). Included in Rugby's statement of profit or loss are the following items:

- Charitable donations of $500,000
- Fines for environmental pollution of $700,000
- A gain on disposal of machinery of $125,000

Net taxable temporary differences at 1 January 20X3 were $1,850,000.

Required

Draft the tax reconciliation as required by HKAS 12 in the two forms allowed.

Solution

The first form allowed reconciles between the product of accounting profit multiplied by the applicable tax rate(s) and tax expense:

	$'000	$'000
Profit before tax		8,775
Tax at applicable rate of 40%		3,510
Tax effect of expenses that are not deductible in determining taxable profit:		
Charitable donations (40% × 500,000)	200	
Fines for environmental pollution (40% × 700,000)	280	
		480
Tax effect of income that is not taxable in determining taxable profit:		
Gain on disposal of property, plant and equipment (40% × 125,000)		(50)
Increase in opening deferred tax resulting from an increase in tax rate (1,850,000 × 2%)		37
Tax expense		3,977

The alternative form of the required disclosure reconciles the applicable tax rate to the average effective tax rate:

	%
Applicable tax rate	40.0
Tax effect of expenses that are not deductible for tax purposes:	
Charitable donations (200/8,775 × 100%)	2.3
Fines for environmental pollution (280/8,775 × 100%)	3.2
Tax effect of income that is not taxable in determining taxable profit:	
Gain on disposal of property, plant and equipment (50/8,775 × 100%))	(0.6)
Effect on opening deferred taxes of reduction in tax rate (37/8,775 × 100%)	0.4
Average effective tax rate	45.3

10 Deferred taxation and business combinations

Topic highlights

Temporary differences may arise as a result of **business combinations**.

There are a number of deferred tax implications of a business combination. Everything that HKAS 12 states in relation to deferred tax and business combinations is brought together in this section. Please note that accounting for business combinations is covered in the final section of this book, Part D on group financial statements (chapters 26 to 30).

10.1 Temporary differences arising as a result of business combinations

Earlier in the chapter we considered a number of common situations which result in either a taxable or deductible temporary difference.

When interests are held in subsidiaries, branches, associates or joint ventures, **temporary differences** arise because the carrying amount of the investment (i.e. the parent's share of the net assets including goodwill) becomes different from the tax base (often the cost) of the investment.

Reasons for these differences include the following:

- The existence of **undistributed profits** of subsidiaries, branches, associates and joint ventures
- **Changes in foreign exchange rates** when a parent and its subsidiary are based in different countries
- A **reduction in the carrying amount** of an investment in an associate to its recoverable amount

The **temporary difference in the consolidated financial statements** may be different from the temporary difference associated with that investment in the parent's separate financial statements when the parent carries the investment in its separate financial statements at cost or revalued amount.

HKAS 12 provides examples of both taxable and deductible temporary differences.

HKAS 12, Illustrative Examples

10.1.1 Taxable temporary differences

In a business combination, such as when one company buys all the shares of another company, the cost of the acquisition must be allocated to the fair values of the identifiable assets and liabilities acquired as at the date of the transaction. Temporary differences can arise when the tax bases of the identifiable assets and liabilities acquired are not affected by the business combination. For example, where the carrying amount of an asset is increased to fair value but the tax base of the asset remains at cost to the previous owner, a taxable temporary difference arises which results in a deferred tax liability and this will also affect goodwill.

The following are also provided by the standard as examples of situations which will result in a taxable temporary difference:

(a) **Unrealised losses resulting from intragroup transactions** are eliminated by inclusion in the carrying amount of inventory or property, plant and equipment.

(b) **Retained earnings** of subsidiaries, branches, associates and joint ventures are included in consolidated retained earnings, but income taxes will be payable if the profits are distributed to the reporting parent.

(c) Investments in foreign subsidiaries, branches or associates or interests in foreign joint ventures are affected by **changes in foreign exchange rates**.

(d) An entity accounts in its own currency for the cost of the non-monetary assets of a foreign operation that is **integral to the reporting entity's operations** but the taxable profit or tax loss of the foreign operation is determined in the foreign currency.

Self-test question 7

On 31 December 20X1, Basil Co. acquired a 60% stake in Lemongrass Co.. Among Lemongrass's identifiable assets at that date was inventory with a carrying amount of $8,000 and a fair value of $12,000. The tax base of the inventory was the same as the carrying amount.

The consideration given by Basil Co. resulted in the recognition of goodwill acquired in the business combination.

Income tax is payable by Basil Co. at 25% and by Lemongrass at 20%.

Required

What is the deferred tax impact of this transaction in the Basil group financial statements?

(The answer is at the end of the chapter)

HKAS 12, Illustrative Examples

10.1.2 Deductible temporary differences

In a business combination, when a **liability** is recognised on acquisition but the related costs are not deducted in determining taxable profits until a later period, a deductible temporary difference arises resulting in a deferred tax asset. A deferred tax asset will also arise when the fair value of an identifiable asset acquired is less than its tax base. In both these cases goodwill is affected (see below).

The standard also provides the following examples of situations will result in a deductible temporary difference:

(a) **Unrealised profits resulting from intragroup transactions** are eliminated from the carrying amount of assets, such as inventory or property, plant or equipment, but no equivalent adjustment is made for tax purposes.

(b) Investments in foreign subsidiaries, branches or associates or interests in foreign joint ventures are affected by **changes in foreign exchange rates**.

(c) A foreign operation accounts for its **non-monetary assets** in its own (functional) currency. If its taxable profit or loss is determined in a different currency (under the presentation currency method) changes in the exchange rate result in temporary differences. The resulting deferred tax is charged or credited to profit or loss.

Self-test question 8

Oregano Co. owns 70% of Thyme Co.. During 20X1 Thyme sold goods to Oregano for $120,000 at a mark-up of 20% above cost. Half of these goods are held in Oregano's inventories at the year end. The rate of income tax is 30%.

Required

What is the deferred tax impact of this transaction in the Oregano group financial statements?

(The answer is at the end of the chapter)

10.2 Recognition criteria

HKAS 12 provides recognition criteria for both deferred tax liabilities and assets in a business combination situation.

HKAS 12.39

10.2.1 Deferred tax liability

Entities should **recognise a deferred tax liability** for all taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, *except* to the extent that both of these conditions are satisfied:

(a) The parent/investor/venturer is able to **control the timing of the reversal** of the temporary difference.

(b) It is probable that the temporary difference **will not reverse** in the foreseeable future.

HKAS 12.44

10.2.2 Recognition of deferred tax asset

HKAS 12 requires that a **deferred tax asset** should be recognised for all deductible temporary differences arising from investments in subsidiaries, branches and associates, and interests in joint ventures, to the extent that (and *only* to the extent that) both these are probable that:

(a) the temporary difference will **reverse** in the foreseeable future
(b) **taxable profit** will be available against which the temporary difference can be utilised

The **prudence principle** discussed above for the recognition of deferred tax assets should be considered.

10.3 Application of the recognition criteria

HKAS 12.40

10.3.1 Undistributed profits

Where a parent company controls the dividend policy of its subsidiary, it can control the timing of the reversal of temporary differences. In addition, it would often be **impracticable** to determine the amount of income taxes payable when the temporary differences reverses.

Therefore, when the parent has determined that those profits will not be distributed in the foreseeable future, the parent does not recognise a deferred tax liability. The same applies to investments in branches.

HKAS 12.41

10.3.2 Foreign exchange

Where a foreign operation's taxable profit or tax loss (and therefore the tax base of its non-monetary assets and liabilities) is determined in a **foreign currency**, changes in the exchange rate give rise to temporary differences. These relate to the foreign entity's own assets and liabilities, rather than to the reporting entity's investment in that foreign operation, and so the reporting entity should recognise the resulting deferred tax liability or asset. The resulting deferred tax is charged or credited to profit or loss.

HKAS 12.42

10.3.3 Associates

An investor in an **associate** does not control that entity and so cannot determine its dividend policy. Therefore, unless there is an agreement requiring that the profits of the associate should not be distributed in the foreseeable future, the investor should recognise a deferred tax liability arising from taxable temporary differences associated with its investment in the associate. Where an investor cannot determine the exact amount of tax, but only a minimum amount, then the deferred tax liability should be that amount.

HKAS 12.43

10.3.4 Joint arrangements

In a **joint arrangement**, the agreement between the parties usually deals with profit sharing. When a joint venturer or joint operator can control the sharing of profits and it is probable that the profits will not be distributed in the foreseeable future, a deferred liability is not recognised.

HKFRS 3.24, HKAS 12.15,66-68

10.4 Recognition of deferred tax arising from business combinations

HKFRS 3 *Business Combinations* requires an entity to recognise any deferred tax assets (to the extent that they meet the relevant recognition criteria) or deferred tax liabilities resulting from temporary differences on a business combination as identifiable assets and liabilities at the date of acquisition.

These deferred tax assets and deferred tax liabilities, consequently, will affect the amount of goodwill or the bargain purchase gain the entity recognises.

An entity will not, however, recognise deferred tax liabilities arising from the initial recognition of goodwill.

A business combination may result in a change in the probability of realising a pre-acquisition deferred tax asset of the acquirer. There is a chance that the acquirer will recover its own deferred tax asset that was not recognised before the combination of the businesses, e.g. by setting off unused tax losses against the future taxable profit of the acquiree.

Alternatively, as a result of the business combination it might no longer be probable that future taxable profit will allow the deferred tax asset to be recovered. The acquirer should recognise a change in the deferred tax asset in the period of the business combination, but does not take it into account in calculating the goodwill or bargain purchase gain it recognises in the business combination.

The potential benefit of the acquiree's income tax loss carry forwards or other deferred tax assets might not satisfy the criteria for separate recognition when a business combination is initially accounted for but might be **realised subsequently**. An entity shall recognise acquired deferred tax benefits that it realises after the business combination as follows:

(a) Acquired deferred tax benefits recognised within the measurement period that result from new information about facts and circumstances that existed at the acquisition date shall be applied to reduce the carrying amount of any goodwill related to that acquisition. If the carrying amount of that goodwill is zero, any remaining deferred tax benefits shall be recognised in profit or loss.

(b) All other acquired deferred tax benefits realised shall be recognised in profit or loss (or, if this standard so requires, outside profit or loss).

Self-test question 9

On 1 September 20X1, Orchid acquired 90% of the ordinary share capital of Daffodil for consideration totalling $1.75million. At the date of acquisition, Daffodil's statement of financial position showed net assets of $1.8million, although the fair value of inventory was assessed to be $100,000 above its carrying amount.

Required

Explain the deferred tax implications, assuming a tax rate of 16.5%.

(The answer is at the end of the chapter)

Self-test question 10

Dandelion purchased 75% of the ordinary share capital of Bluebell for $1.1m when the net assets of Bluebell were $1m, giving rise to goodwill of $350,000. At 31 December 20X1 the following is relevant:

1 Goodwill has not been impaired
2 The net assets of Bluebell amount to $1.2m

Required

What temporary difference arises on this investment at 31 December 20X1?

(The answer is at the end of the chapter)

Example: Deferred tax arising from business combinations

In recent years, Lily Co. has made the following acquisitions of other companies:

- On 1 January 20X6, it acquired 90% of the share capital of Blossom, resulting in goodwill of $1.4 million.

- On 1 July 20X6 it acquired the whole of the share capital of Snowdrop for $6 million. At this date the fair value of the net assets of Snowdrop was $4.5 million and their tax base was $4 million.

The following information is relevant to Lily Group's year ended 31 December 20X6:

Blossom

1. Blossom has made a provision amounting to $1.8 million in its accounts in respect of litigation. This is tax allowable only when the cost is actually incurred. The case is expected to be settled within 12 months.
2. Blossom has a number of investments classified as at fair value through profit or loss in accordance with HKFRS 9. The remeasurement gains and losses recognised in profit or loss for accounting purposes are not taxable/tax allowable until such date as the investments are sold. To date the cumulative unrealised gain is $2.5 million.
3. Blossom has sold goods to Lily in the year making a profit of $1 million. A quarter of these goods remain in Lily's inventory at the year end.

Snowdrop

1. At its acquisition date, Snowdrop had unrelieved brought forward tax losses of $0.4 million. It was initially believed that Snowdrop would have sufficient taxable profits to utilise these losses and a deferred tax asset was recognised in Snowdrop's financial statements at acquisition. Subsequent events have proven that the future taxable profits will not be sufficient to utilise the full brought forward loss.
2. At acquisition Snowdrop's retained earnings amounted to $3.5 million. The directors of Lily Group have decided that in each of the next four years to the intended listing date of the group, they will realise earnings through dividend payments from the subsidiary amounting to $600,000 per annum. Snowdrop has not declared a dividend for the current year. Tax is payable on remittance of dividends.
3. $300,000 of the purchase price of Snowdrop has been allocated to intangible assets. The recognition and measurement criteria of HKFRS 3 and HKAS 38 do not appear to have been met, however the directors believe that the amount is allowable for tax and have calculated the tax charge accordingly. It is believed that this may be challenged by the tax authorities.

Required

What are the deferred tax implications of the above issues for the Lily Group?

Solution

Acquisitions

Any fair value adjustments made for consolidation purposes will affect the group deferred tax charge for the year.

A taxable temporary difference will arise where the fair value of an asset exceeds its carrying value, and the resulting deferred tax liability should be recorded against goodwill.

A deductible temporary difference will arise where the fair value of a liability exceeds its carrying value, or an asset is revalued downwards. Again, the resulting deferred tax amount (an asset) should be recognised in goodwill.

In addition, it may be possible to recognise deferred tax assets in a group which could not be recognised by an individual company. This is the case where tax losses brought forward, but not considered to be an asset, due to lack of available taxable profits to set them against, can now be used by another group company.

Goodwill

Goodwill arose on both acquisitions. According to HKAS 12, however, no provision should be made for the temporary difference arising on this.

Blossom

1 A deductible temporary difference arises when the provision is first recognised. This results in a deferred tax asset calculated as $540,000 (30% × $1.8m). The asset may, however, only be recognised where it is probable that there will be future taxable profits against which the future tax allowable expense may be set. There is no indication that this is not the case for Blossom.

2 A taxable temporary difference arises where investments are revalued upwards for accounting purposes but the uplift is not taxable until disposal. In this case the carrying value of the investments has increased by $2.5 million, and this has been recognised in profit or loss. The tax base has not, however changed. Therefore, a deferred tax liability should be recognised on the $2.5 million, and in line with the recognition of the underlying revaluation, this should be recognised in profit or loss.

3 This intra-group transaction results in unrealised profits of $250,000 which will be eliminated on consolidation. The tax on this $250,000 will, however, be included within the group tax charge (which comprises the sum of the individual group companies' tax charges). From the perspective of the group there is a temporary difference. Deferred tax should be provided on this difference using the tax rate of Lily (the recipient company).

Snowdrop

1 Unrelieved tax losses give rise to a deferred tax asset only where the losses are regarded as recoverable. They should be regarded as recoverable only where it is probable that there will be future taxable profits against which they may be used. It is indicated that the future profits of Snowdrop will not be sufficient to realise all of the brought forward loss, and therefore the deferred tax asset is calculated only on that amount expected to be recovered.

2 Deferred tax is recognised on the unremitted earnings of investments, except where:

(a) the parent is able to control the payment of dividends
(b) it is unlikely that the earnings will be paid out in the foreseeable future

Lily controls Snowdrop and is therefore able to control its dividend payments, however it is indicated that $2.4million will be paid as dividends in the next four years. Therefore, a deferred tax liability related to this amount should be recognised.

3 The directors have assumed that the $300,000 relating to intangible assets will be tax allowable, and the tax provision has been calculated based on this assumption. However, this is not certain, and extra tax may have to be paid if this amount is not allowable. Therefore, a liability for the additional tax amount should be recognised.

10.5 Section summary

In relation to deferred tax and business combinations you should be familiar with:

- circumstances that give rise to **taxable temporary differences**
- circumstances that give rise to **deductible temporary differences**
- their **treatment** once an acquisition takes place
- reasons **why deferred tax arises** when investments are held
- **recognition** of deferred tax on business combinations

11 Interpretations relating to deferred tax

11.1 HK(SIC) Int-21 *Income Taxes – Recovery of Revalued Non-depreciable Assets*

HK(SIC) Int-21 deals with cases where a non-depreciable asset (freehold land) is carried at revaluation under HKAS 16.

The Interpretation deems that no part of such an asset's carrying amount will be recovered through use. Therefore the deferred tax asset or liability that arises from revaluation must be measured based on recovery through sale of the asset.

In some jurisdictions, this will result in the use of a capital gains tax rate rather than the rate applicable to corporate earnings.

HK(SIC) Int-12 has been incorporated into HKAS 12 as part of the amendments to HKAS 12 issued in December 2010. It is therefore withdrawn for accounting periods starting on or after 1 January 2012.

11.2 HK(SIC) Int-25 *Income Taxes – Changes in the Tax Status of an Entity or its Shareholders*

A change in the tax status of an entity or its shareholders may have consequences for an entity by increasing or decreasing its tax liabilities or assets.

This may, for example, occur upon:

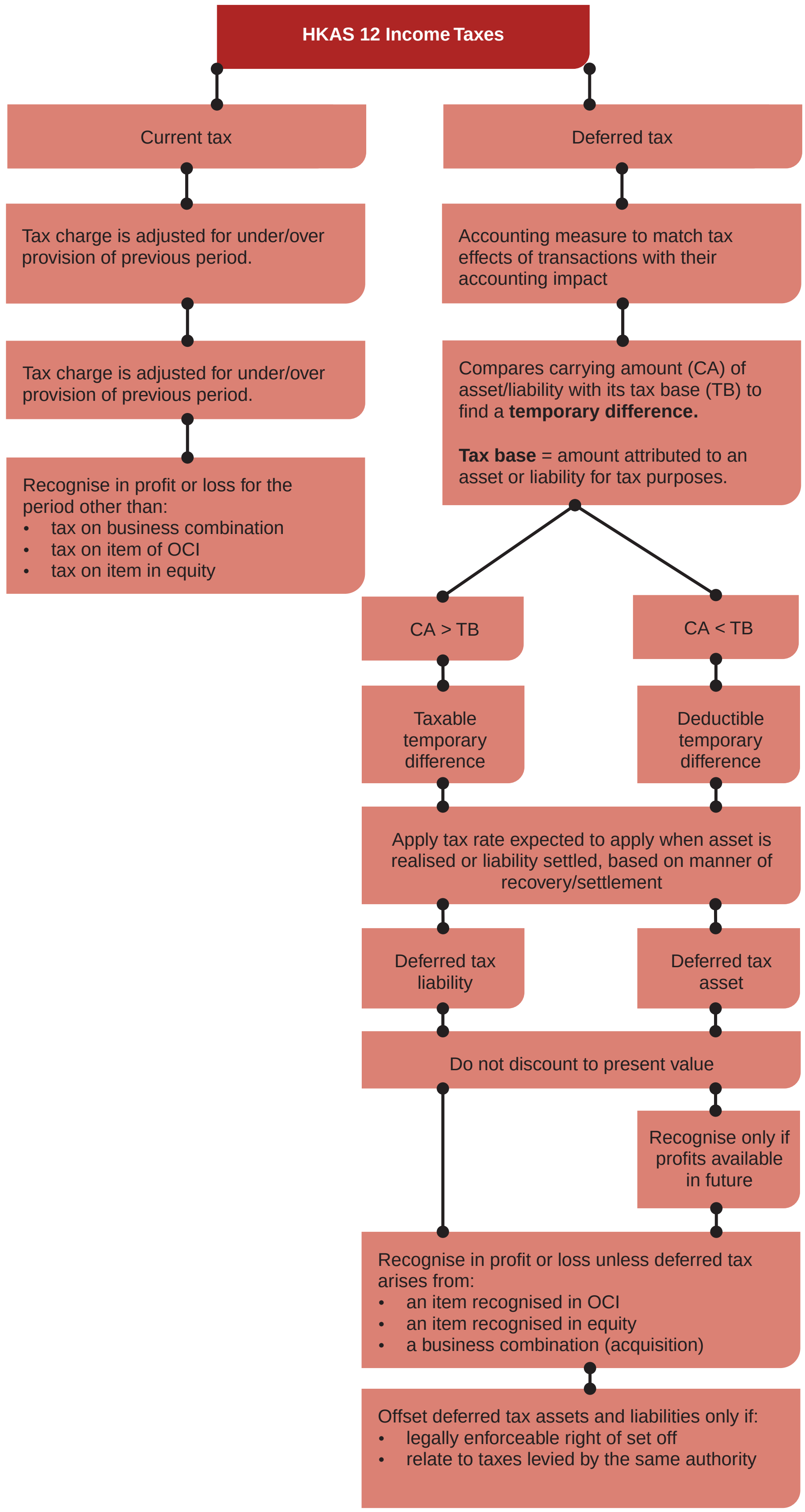
- the public listing of an entity's equity instruments
- the restructuring of an entity's equity
- a controlling shareholder's move to a foreign country.

As a result of such an event, an entity may be taxed differently; it may for example gain or lose tax incentives or become subject to a different rate of tax in the future.

A change in the tax status of an entity or its shareholders may have an immediate effect on the entity's current tax liabilities or assets. The change may also increase or decrease the deferred tax liabilities and assets recognised by the entity, depending on the effect the change in tax status has on the tax consequences that will arise from recovering or settling the carrying amount of the entity's assets and liabilities.

A change in the tax status of an entity or its shareholders does not give rise to increases or decreases in amounts recognised directly in equity. The current and deferred tax consequences of a change in tax status shall be included in net profit or loss for the period, unless those consequences relate to transactions and events that result, in the same or a different period, in a direct credit or charge to the recognised amount of equity. Those tax consequences that relate to changes in the recognised amount of equity, in the same or a different period (not included in net profit or loss), shall be charged or credited directly to equity.

Topic recap


HKAS 12 Income Taxes
Current tax
Tax charge is adjusted for under/over provision of previous period.
Tax charge is adjusted for under/over provision of previous period.
Recognise in profit or loss for the period other than:
• tax on business combination
• tax on item of OCI
• tax on item in equity
Deferred tax
Accounting measure to match tax effects of transactions with their accounting impact
Compares carrying amount (CA) of asset/liability with its tax base (TB) to find a **temporary difference.**
Tax base = amount attributed to an asset or liability for tax purposes.
CA > TB
CA < TB
Taxable temporary difference
Deductible temporary difference
Apply tax rate expected to apply when asset is realised or liability settled, based on manner of recovery/settlement
Deferred tax liability
Deferred tax asset
Do not discount to present value
Recognise only if profits available in future
Recognise in profit or loss unless deferred tax arises from:
• an item recognised in OCI
• an item recognised in equity
• a business combination (acquisition)
Offset deferred tax assets and liabilities only if:
• legally enforceable right of set off
• relate to taxes levied by the same authority

Answers to self-test questions

Answer 1

(a)

	$
Current year tax liability ($760,000 × 16.5%)	125,400
Overprovision in 20X0 ($130,000 – $126,700)	3,300

Therefore

- $125,400 is recognised as a current tax liability in the statement of financial position at 31 December 20X1
- $122,100 ($125,400 – $3,300) is recognised as tax charge in the statement of profit or loss and other comprehensive income for the year ended 31 December 20X1

(b) If the previous year's tax was settled at $131,000, tax was underprovided. Therefore the underprovision of $1,000 is added to the 20X1 tax charge to make it $126,400. The liability in the statement of financial position remains unchanged at $125,400.

Answer 2

(a) The tax base of the interest receivable is $1,000.
(b) The tax base of the dividend is $5,000.
(c) The tax base of the machine is $7,000.
(d) The tax base of the trade receivables is $10,000.
(e) The tax base of the loan is $1 million.

In the case of (b), in substance the entire carrying amount of the asset is deductible against the economic benefits. There is no taxable temporary difference. An alternative analysis is that the accrued dividends receivable have a tax base of nil and a tax rate of nil is applied to the resulting taxable temporary difference ($5,000). Under both analyses, there is no deferred tax liability.

Answer 3

(a) The tax base of the accrued expenses is $1,000.
(b) The tax base of the revenue received in advance is $1,000.
(c) The tax base of the accrued fines and penalties is $100.
(d) The tax base of the loan is $1 million.

Answer 4

The temporary differences associated with the equipment are as follows:

			Year		
	20X1	*20X2*	*20X3*	*20X4*	*20X5*
	$	$	$	$	$
Carrying amount	40,000	30,000	20,000	10,000	–
Tax base	37,500	25,000	12,500	–	–
Taxable temporary difference	2,500	5,000	7,500	10,000	–
Opening deferred tax liability	–	375	750	1,125	1,500
Deferred tax expense (income): bal fig	375	375	375	375	(1,500)
Closing deferred tax liability @ 15%	375	750	1,125	1,500	–

Answer 5

The tax base of the building is \$7m (\$10m – \$3m).

(a) If the entity expects to recover the carrying amount by using the building, it must generate taxable income of \$15m, but will only be able to deduct depreciation of \$7m. On this basis there is a deferred tax liability of \$2.4m ((\$15m – \$7m) × 30%).

(b) If the entity expects to recover the carrying amount by selling the building immediately for proceeds of \$15m the deferred tax liability will be computed as follows:

	Taxable temporary difference	*Tax rate*	*Deferred tax liability*
	\$'000		\$'000
Total tax depreciation allowance	3,000	30%	900
Proceeds in excess of cost	5,000	Nil	–
Total	8,000		900

Note. The additional deferred tax that arises on the revaluation is charged directly to equity: see Answer 6 below.

Answer 6

(a) If the entity expects to recover the carrying amount by using the building, the situation is as in answer 5 (a) in the same circumstances.

(b) If the entity expects to recover the carrying amount by selling the building immediately for proceeds of \$15m, the entity will be able to deduct the indexed costs of \$11m. The net profit of \$4m will be taxed at 40%. In addition, the total tax depreciation allowance of \$3m will be included in taxable income and taxed at 30%. On this basis, the tax base is \$8m (\$11m – \$3m), there is a taxable temporary difference of \$7m and there is a deferred tax liability of \$2.5m (\$4m × 40% plus \$3m × 30%).

Answer 7

The excess of an asset's fair value over its tax base at the time of a business combination results in a deferred tax liability. As it arises in Lemongrass, the tax rate used is 20% and the liability is \$800 ((\$12,000 – \$8,000) × 20%).

The recognition of a deferred tax liability in relation to the initial recognition of goodwill is specifically prohibited by HKAS 12.

Answer 8

There is an unrealised profit relating to inventories still held within the group of ½ × \$20,000 = \$10,000, which must be eliminated on consolidation. But the tax base of the inventories is unchanged, so it is higher than the carrying amount in the consolidated statement of financial position and there is a deductible temporary difference of \$10,000.

Answer 9

- The carrying amount of the inventory in the group accounts is \$100,000 more than its tax base (being carrying amount in Daffodil's own accounts).
- Deferred tax on this temporary difference is 16.5% × \$100,000 = \$16,500.
- A deferred tax liability of \$16,500 is recognised in the group statement of financial position.
- Goodwill is increased by (\$16,500 × 90%) = \$14,850.

Answer 10

- The tax base of the investment in Bluebell is the cost of $1.1m. The carrying value is the share of net assets (75% × $1.2m) + goodwill of $350,000 = $1.25m
- The temporary difference is therefore $1.25m – $1.1m = $150,000.
- This is equal to the group share of post acquisition profits: 75% × $200,000 change in net assets since acquisition.

Exam practice

Healthy Supplement Inc

29 minutes

Healthy Supplement Inc. (HSI) was incorporated on 1 October 20X1 and is engaged in the design and manufacture of nutrition products. Below is the computation of income tax for the first financial year ended 30 September 20X2:

	HK$'000
Profit before tax	54,018
Adjusted for:	
Non-taxable interest income	(1,039)
Release of government grant to P/L	(1,200)
Depreciation charged to P/L	15,933
Non-deductible legal and professional fees	1,358
Provision for product warranty charged to P/L	4,200
Depreciation allowance	(38,500)
Government grant received	9,600
Warranty expenses paid	(1,248)
Assessable profit	43,122
Income tax prepaid on 30 June 20X2	4,600

During the year, HSI acquired plant and equipment of HK$94,334,000 which are depreciated on a straight line basis over useful lives of 3 to 10 years, all of them were still in use by the entity. Included in this amount is HK$4,388,000 related to certain expenditure which is not tax deductible under tax law. The non-tax deductible items were acquired on 1 April 20X2 and depreciated for half a year out of an estimated useful life of 5 years up to the end of the reporting period.

An asset-related government grant is taxable upon receipt while HSI adopted HKAS 20 to recognise the grant to profit or loss over the expected useful lives of the related assets.

Warranty expenses are tax deductible when payment is made.

The standard income tax rate for HSI is 20%. A 2% tax rate deduction is provided for an entity's first year of operation.

Required

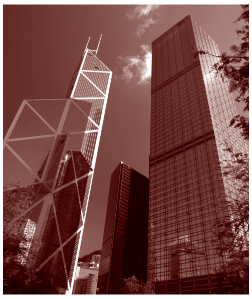
(a) Calculate the current tax expense for the year ended and the current tax payable as at 30 September 20X2. **(2 marks)**

(b) Calculate the deferred tax assets/liabilities as at 30 September 20X2 and the deferred tax credit/charge for the year then ended. **(8 marks)**

(c) Prepare the tax reconciliation for disclosure in the financial statements of HSI for the year ended 30 September 20X2. **(6 marks)**

(Total = 16 marks)

HKICPA December 2012 (amended)


chapter 16

Employee benefits

Topic list

Learning focus

An increasing number of companies and other entities now provide a pension and other employee benefits as part of their employees' remuneration package. In view of this trend, it is important that there is standard best practice for the way in which employee benefit costs are recognised, measured, presented and disclosed in the sponsoring entities' accounts. You must ensure that you understand and can apply the rules of HKAS 19 as amended in 2011.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
Account for transactions in accordance with Hong Kong Financial Reporting Standards		
3.04	**Employee benefits**	2
3.04.01	Identify short-term employee benefits in accordance with HKAS 19 and apply the recognition and measurement principles in respect of short-term employee benefits	
3.04.02	Distinguish between defined contribution plans and defined benefit plans	
3.04.03	Account for defined contribution plans	
3.04.04	Identify termination benefits in accordance with HKAS 19 and apply the recognition and measurement principles in respect of termination benefits	

1 HKAS 19 *Employee Benefits*

Topic highlights

HKAS 19 *Employee Benefits* provides guidance on the accounting treatment to be applied to short-term employment benefits, post-employment benefits (pensions), other long-term employment benefits and termination benefits. Amendments to the standard in 2011 reduced the complexity of accounting for employee benefits.

Before we look at HKAS 19, we should consider the nature of employee benefit costs and why there is an accounting problem which must be addressed by a standard.

HKAS 19.5

1.1 Employee benefits

Companies generally provide their employees with a package of pay and benefits, which may include some or all of the following:

- Short-term benefits including:
  - wages and salaries
  - contributions to Mandatory Provident Fund
  - paid annual leave
  - paid sick leave
  - paid maternity/paternity leave
  - profit shares and bonuses paid within 12 months of the year end
  - paid jury service
  - paid military service
  - non-monetary benefits, e.g. medical care, cars, free goods
- Post-employment benefits, e.g. pensions and post-employment medical care
- Other long-term benefits, e.g. profit shares, bonuses or deferred compensation payable later than 12 months after the year end, sabbatical leave, long-service benefits
- Termination benefits, e.g. early retirement payments and redundancy payments

Benefits may be paid to the employees themselves, to their dependants (spouses, children, etc.) or to third parties.

1.2 The accounting problem

In the case of the **short-term benefits** listed above, the employee will receive the benefit at about the same time as he or she earns it. The accounting is therefore relatively straightforward with the costs of providing the benefit recognised as an expense in the employer's financial statements.

Accounting for the cost of **deferred employee benefits** is less clear cut. This is because of the long time scale, complicated estimates and uncertainties involved in these types of benefit. In addition, the costs could be viewed in a number of ways, for example as deferred salary to the employee or as a deduction from the employee’s true gross salary.

In the past, entities accounted for these benefits simply by making a charge to the profit or loss of the employing entity on the basis of actual payments made. This led to substantial variations in reported profits of these entities and disclosure of information on these costs was usually sparse.

1.2.1 The accounting solution

HKAS 19 addresses the problem described above by prescribing how employee benefits should be recognised and measured.

The standard requires an entity to recognise:

(a) a **liability** when an employee has provided a service in exchange for benefits to be received by the employee at some time in the future.

(b) an **expense** when the entity receives the economic benefits from a service provided by an employee regardless of when the employee received or will receive the benefits for providing the service.

The application of these basic rules to each of the categories of employee benefits described in section 1.1 is provided in HKAS 19 and described throughout the remainder of this chapter. First, however, we must consider a number of important definitions within the standard.

HKAS 19.8

1.3 Definitions

You should refer back to the following definitions as necessary as you work through the rest of this chapter.

Key terms

Definitions of employee benefits

Employee benefits are all forms of consideration given by an entity in exchange for service rendered by employees.

Short-term employee benefits are employee benefits (other than termination benefits) that are expected to be settled wholly before 12 months after the end of the annual reporting period in which the employees render the related service.

Post-employment benefits are employee benefits (other than termination benefits and short-term employee benefits) which are payable after the completion of employment.

Termination benefits are employee benefits provided in exchange for the termination of an employee’s employment as a result of either:

(a) an entity's decision to terminate an employee's employment before the normal retirement date, or

(b) an employee's decision to accept an offer of benefits in exchange for the termination of employment.

Other long-term employee benefits are all employee benefits other than short-term employee benefits, post-employment benefits and termination benefits.

Definitions relating to classification of plans

Post-employment benefit plans are formal or informal arrangements under which an entity provides post-employment benefits for one or more employees.

Defined contribution plans are post-employment benefit plans under which an entity pays fixed contributions into a separate entity (a fund) and will have no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.

Defined benefit plans are post-employment benefit plans other than defined contribution plans.

Key terms (cont'd)

Multi-employer plans are defined contribution plans (other than state plans) or defined benefit plans (other than state plans) that:

(a) pool the assets contributed by various entities that are not under common control; and

(b) use those assets to provide benefits to employees of more than one entity, on the basis that contribution and benefit levels are determined without regard to the identity of the entity that employs the employees concerned.

Definitions relating to the net defined benefit liability (asset)

The **net defined benefit liability (asset)** is the deficit or surplus, adjusted for any effect of limiting a net defined benefit asset to the asset ceiling.

The **deficit or surplus** is:

(a) the present value of the defined benefit obligation less
(b) the fair value of plan assets (if any).

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

The **present value of a defined benefit obligation** is the present value, without deducting any plan assets, of expected future payments required to settle the obligation resulting from employee service in the current and prior periods.

Plan assets comprise:

(a) Assets held by a long-term employee benefit fund
(b) Qualifying insurance policies

Fair value is the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction.

Definitions relating to defined benefit cost

Service cost comprises:

(a) *current service cost* which is the increase in the present value of the defined benefit obligation resulting from employee service in the current period.

(b) *past service cost*, which is the change in the present value of the defined benefit obligation for employee service in prior periods, resulting from a plan amendment (the introduction or withdrawal of, or changes to, a defined benefit plan) or a curtailment (a significant reduction by the entity in the number of employees covered by a plan); and

(c) any gain or loss on settlement.

Net interest on the defined benefit liability (asset) is the change during the period in the net defined benefit liability (asset) that arises from the passage of time.

Remeasurements of the net defined benefit liability (asset) comprise:

(a) actuarial gains and losses

(b) the return on plan assets, excluding amounts included in net interest on the defined benefit liability (asset); and

(c) any change in the effect of the asset ceiling, excluding amounts included in net interest on the net defined benefit liability (asset).

Key terms (cont'd)

Actuarial gains and losses are changes in the present value of the defined benefit obligation resulting from:

(a) experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred), and

(b) the effects of changes in actuarial assumptions.

The **return on plan assets** is interest, dividends and other income derived from the plan assets, together with realised and unrealised gains or losses on the plan assets, less:

(a) any cost of managing plan assets; and

(b) any tax payable by the plan itself, other than tax included in the actuarial assumptions used to measure the present value of the defined benefit obligation.

A **settlement** is a transaction that eliminates all further legal or constructive obligations for part or all of the benefits provided under a defined benefit plan, other than a payment of benefits to, or on behalf of employees that is set out in the terms of the plan and included in the actuarial assumptions.

(HKAS 19)

2 Short-term employee benefits

Topic highlights

Short-term employee benefits are those benefits that are expected to be settled wholly before 12 months after the end of the period in which the employees provide the related services. The cost of the benefits to be paid in exchange for the employee's services should be recognised in the period on an accruals basis.

As mentioned in section 1.1, short-term employee benefits include:

- monetary benefits such as wages and salaries, annual leave, sick leave, maternity leave, and profit shares and bonuses paid within 12 months.
- non-monetary benefits such as medical care, housing and company cars.

HKAS 19.11

2.1 Recognition and measurement

HKAS 19 requires that short-term employee benefits are recognised in the period in which the related service is provided by the employee as:

(a) a liability (after deducting any amount already paid), and

(b) an expense unless another standard (such as HKAS 2 or HKAS 16) requires or permits inclusion in the cost of an asset.

The amount recognised should not be discounted.

Where the amount already paid exceeds the undiscounted amount of the benefits, the resulting asset should be recognised as a prepayment to the extent that it will lead to a reduction in future payments or refund.

The standard explains how these rules are applied in the case of short-term compensated absences and profit-sharing and bonus plans.

HKAS 19.13-18

2.2 Short-term paid absences

Short-term paid absences include paid holiday leave, sick leave, maternity or paternity leave and jury service leave. These are classified by the standard as either:

- accumulating compensated absences, or
- non-accumulating compensated absences.

Accumulating absences are those that can be carried forward and used in future periods if the current period's entitlement is not used in full; non-accumulating absences are those which cannot be carried forward and lapse if the current year entitlement is not used.

2.2.1 Accounting treatment

The cost of accumulating absences should be recognised as an expense when the employee provides the service which results in entitlement to such absences. Where there is an unused entitlement at the reporting date, a liability is recognised, based on an estimated amount.

The cost of non-accumulating absences should be recognised as an expense when the absences occur.

Example: Sick pay

An entity has 10 employees, each of whom is entitled to seven days of paid sick leave per annum. Unused sick leave may be carried forward for one year. Current year leave must be used before carried forward leave. At 31 December 20X8, each employee had, on average, two days of leave unused. Based on past experience the entity expects eight employees to take no more than seven days of sick leave in the coming year. The remaining two employees are expected to take nine days each.

Assuming that each sick day costs the entity $60, what liability for sick leave must be accrued in the statement of financial position as at 31 December 20X8?

Solution

A liability must be recognised in the statement of financial position to the extent that the entity expects to have to pay sick leave next year as a result of the entitlement that has accumulated at 31 December 20X8:

2 employees × 2 days × $60 = $240

		$	$
DEBIT	Employee expense	240	
CREDIT	Liability		240

Being sick leave entitlement at 31 December 20X8 expected to be paid next year

HKAS 19.19-24

2.3 Profit-sharing schemes and bonus plans

HKAS 19 requires that an entity recognises the expected cost of profit-sharing and bonus payments only when:

- the entity has a present legal or constructive obligation to make such payments as a result of past events, and
- a reliable estimate of the obligation can be made.

In this case an expense and liability should be recognised.

Often conditions are attached to bonus payments, for example an employee must still be in the entity's employment when the bonus becomes payable.

Therefore, an estimate should be made based on the expectation of the level of bonuses that will ultimately be paid. A reliable estimate can only be made when:

- the formal terms of the plan include a formula to determine the amount of the benefit;
- the entity determines the amount payable before the financial statements are authorised for issue; or
- past practice provides clear evidence of the amount of a constructive obligation.

Example: Bonus plan

Lowdown Co. has a contractual agreement to pay a total of 5% of its net profit each year as a bonus. The bonus is divided between the employees who are with the entity at its year end. The following data is relevant:

Net profit	$2,000,000
Average employees	50
Employees at start of year	60
Employees at end of year	40

Required

How should the expense be recognised?

Solution

An expense should be recognised for the year in which the profits were made and therefore the employees' services were provided, for:

$2m $\times$ 5% = $100,000

Each of the 40 employees remaining with the entity at the year end is entitled to $2,500. A liability of $100,000 should be recognised if the bonuses remain unpaid at the year end.

3 Post-employment benefits

Topic highlights

There are two types of retirement benefit plan:

- Defined contribution plans
- Defined benefit plans

HKAS 19.26-30

3.1 Types of post-employment benefits

Post-employment benefits are those benefits provided to employees after they have stopped working. They may include:

- retirement benefits (pensions), and
- other benefits such as post-employment life insurance or medical care.

Post-employment benefit schemes are often referred to as "**plans**". Employers (and sometimes employees) make regular contributions to the plan and this money is invested in long-term assets such as stocks and shares.

The return on the plan assets, and sometimes the proceeds of the sale of plan assets, is used to pay for the post-employment benefits.

There are two types of post-employment benefit plans:

- defined contribution, and
- defined benefit.

3.1.1 Defined contribution plans

These plans involve fixed amounts (normally a percentage of an employee's salary) being paid into the plan each year. These amounts, or contributions, may be made by the employer and current employees.

The level of benefits paid out to former employees is resultant on how the plan's investments have performed. In other words there is no guarantee of a fixed amount of benefit.

3.1.2 Defined benefit plans

These plans involve fixed amounts being paid out of the plan to former employees as benefits. The fixed amount is normally calculated as a percentage (based on the number of years' service) of final salary.

As before, contributions are made by the employer (and possibly current employees) and these are invested. The level of contributions is not, however, fixed. Instead it is set at an amount that is expected to result in sufficient investment returns to meet the obligation to pay the defined post-retirement benefits.

Where it appears that there are insufficient assets in the fund, the employer will be required to make increased contributions; where it appears that there are surplus assets in the fund, the employer may stop paying contributions for a period (known as a contributions holiday).

HKAS 19.32-39

3.2 Multi-employer plans

Multi-employer plans were defined above in section 1.3. They are retirement benefit plans in which various entities contribute assets to a pool. These pooled assets are then used to provide benefits to employees of the various contributing entities.

HKAS 19 requires that an entity should **classify** such a plan as a defined contribution plan or a defined benefit plan, under the terms of the plan (including any constructive obligation that exceeds the formal terms of the plan).

If the multi-employer plan is a defined contribution plan, it is accounted for as normal, by recognising the contributions made to the plan as an expense.

If, on the other hand, the multi-employer plan is a **defined benefit plan**, then HKAS 19 requires the entity to account for it as a defined benefit plan. However, it should do so only on a proportional basis. In other words it recognises its proportionate share of the obligation, assets and cost associated with the plan. It should also make all of the normal disclosures for defined benefit plans.

However, determining the extent to which an entity participates in a defined benefit multi-employer plan may be problematic. Therefore, it may be difficult to determine reliably the appropriate proportionate share of the relevant data. In this case, where there is **insufficient information** to determine the relevant amounts to use defined benefit accounting, then the entity should recognise the plan as a defined contribution plan. However, it should also make as many additional disclosures as possible to enable users to understand the nature of the plan. For example, an entity should disclose that the plan is, in fact, a defined benefit plan and information about any known surplus or deficit.

4 Defined contribution plans

Topic highlights

Contributions to a defined contribution plan are recognised as an expense in the period in which they are payable.

HKAS 19.51-52

4.1 Recognition and measurement

Accounting for defined contribution plans is relatively straightforward:

1 **Contributions** to a defined contribution plan should be recognised as an **expense** in the period they are payable (except to the extent that labour costs may be included within the cost of assets).

2 Any liability for **unpaid contributions** that are due as at the end of the period should be recognised as a **liability** (accrued expense).

3 Any **excess contributions** paid should be recognised as an asset (prepaid expense), but only to the extent that the prepayment will lead to, for example, a reduction in future payments or a cash refund.

Where contributions are not payable during the period (or within 12 months of the end of the period) in which the employee provides the services to which they relate, the amount recognised should be discounted, to reflect the time value of money.

Example: Defined contribution plan

Highlife Co. agrees to contribute 4% of employees' total remuneration into a post-employment plan each period.

In the year ended 31 December 20X1, the company paid total salaries of $16 million. A bonus of $4 million based on the income for the period was paid to the employees in March 20X2.

The company had paid $760,000 into the plan by 31 December 20X1.

Required

Calculate the total expense for post-employment benefits for the year and the accrual which will appear in the statement of financial position at 31 December 20X1.

Solution

	$	
Salaries	16,000,000	
Bonus	4,000,000	
	20,000,000	× 4% = $800,000

		$	$
DEBIT	Staff costs expense	800,000	
CREDIT	Cash		760,000
	Accrual		40,000

HKAS 19.53

4.2 Disclosure

HKAS 19 requires that the following is disclosed in respect of defined contribution schemes:

(a) A **description** of the plan
(b) The amount recognised as an **expense** in the period

5 Defined benefit plans

Topic highlights

Defined benefit plans are recognised in the statement of financial position. Changes in the plan are broken down into their constituent parts and recognised in profit or loss or other comprehensive income immediately.

5.1 Introduction to accounting treatment

As we have already discussed, contributions made to defined benefit plans may vary considerably from year to year. The accounting treatment applied to defined contribution plans is therefore not appropriate here, as expensing contributions would result in volatile profits.

Instead, HKAS 19 requires a net defined benefit liability (asset) to be shown in the statement of financial position. This is defined as the deficit or surplus in a defined benefit plan and is calculated as:

(a) the present value of the defined benefit obligation (i.e. the obligation to pay future benefits to employees) less

(b) the fair value of any plan assets

Where the present value of the defined benefit obligation exceeds the fair value of plan assets, a plan is in deficit and an overall net defined benefit liability is recognised; where the fair value of plan assets exceeds the present value of the defined benefit obligation, a plan is in surplus and an overall net defined benefit asset is recognised.

Both the present value of the obligation and the fair value of the plan assets are normally calculated and advised by an actuary. HKAS 19 provides guidance on this. The role of the accountant is therefore to recognise the changes in these amounts from year to year in accordance with HKAS 19.

HKAS 19.61

5.1.1 Constructive obligation

In determining the extent of the obligation to provide retirement benefits, an entity must assess not only its legal obligation under the formal terms of a defined benefit plan, but also any constructive obligation that arises from the entity's informal practices.

Informal practices give rise to a constructive obligation where the entity has no realistic alternative but to pay employee benefits, for example, where a change in an entity's informal practices would cause unacceptable damage to its relationship with employees.

HKAS 19.57

5.2 Accounting steps

HKAS 19 provides a four-step approach to accounting for defined benefit plans:

1	Determine the deficit or surplus	(i) Use an actuarial technique in order to make a reliable estimate of the cost to the entity of providing the post-employment benefit that employees have earned in current and past periods (ii) discount that benefit to determine the present value of the defined benefit obligation (iii) deduct the fair value of plan assets from the present value of the defined benefit obligation
2	Determine the amount of the net defined benefit liability (asset)	The amount of deficit or surplus calculated in step 1 may require adjustment for the effect of limiting a net defined benefit asset to the asset ceiling.
3	Determine amounts to be recognised in profit or loss	These may include: (i) current service cost (ii) past service cost and gain or loss on settlement (iii) net interest on the defined benefit liability (asset)
4	Determine remeasurements to be recognised in other comprehensive income	These may include: (i) actuarial gains and losses (ii) return on plan assets excluding amounts included in net interest on the defined benefit liability (asset)

(iii) any change in the effect of the asset ceiling excluding amounts included in net interest on the defined benefit liability (asset).

Each of these steps is considered in more detail in the following sections of the chapter.

HKAS 19.58-59

5.3 Step 1 – Determine the deficit or surplus

Measurement of the deficit or surplus is not required at every period end. However, it must be made sufficiently regularly such that reported amounts are not materially different from the actual value at the reporting date.

HKAS 19 encourages, but does not require, the use of a qualified actuary.

The cost of providing future benefits in respect of current and past services should be estimated using an actuarial technique, the **projected unit credit method**.

HKAS 19.67-68,75-80

5.3.1 Estimation of future cost using the projected unit credit method

The projected unit credit method assumes that each period of an employee's service gives rise to an additional "unit" of future benefit. Each of these units is measured separately and they are added together to calculate the total obligation.

In measuring the obligation, the actuary must make a number of **actuarial assumptions**, both demographic and financial, for example:

- What the defined benefits will be (this depends upon factors such as length of service and final salary)
- When benefits will be paid (this depends upon retirement age)
- How many employees will draw a pension (this depends upon factors such as mortality rate)

The standard requires actuarial assumptions to be unbiased and mutually compatible. They should also be based on "**market expectations**" at the year end, over the period during which the obligations will be settled.

HKAS 19.83-86

5.3.2 Discount the future benefit to present value

After the future cost of the defined benefit obligation has been measured, it must be discounted to present value using an appropriate discount rate.

The standard requires that this is determined **by reference to market yields at the end of the reporting period on high quality corporate bonds**.

In the absence of a "deep" market in such bonds, the yields on comparable government bonds should be used as reference instead.

The corporate bonds that are used to determine a discount rate should have a term to maturity that is consistent with the expected maturity of the post-employment benefit obligations, although a single weighted average discount rate is sufficient.

HKAS 19.8,113-115

5.3.3 Fair value of plan assets

In order to determine the deficit or surplus, the fair value of plan assets must be deducted from the present value of the defined benefit obligation.

Plan assets are:

(a) assets such as stocks and shares, held by a fund that is legally separate from the reporting entity, which exists solely to pay employee benefits.

(b) insurance policies, issued by an insurer that is not a related party, the proceeds of which can only be used to pay employee benefits.

Investments which may be used for purposes other than to pay employee benefits are not plan assets.

The standard requires that the plan assets are measured at fair value, defined as the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction. HKAS 19 includes the following specific requirements:

(a) The plan assets should exclude any contributions due from the employer but not yet paid.

(b) Plan assets are reduced by any liabilities of the fund that do not relate to employee benefits, such as trade and other payables.

HKAS 19.63-64

5.4 Step 2 – Determine the amount of the net defined benefit liability (asset)

In the statement of financial position, the amount recognised as a **defined benefit liability (or asset)** should be the following.

(a) The **present value of the defined obligation** at the year end, **minus**

(b) The **fair value of the assets of the plan** as at the year end (if there are any) out of which the future obligations to current and past employees will be directly settled.

Where there is a net defined benefit asset, the amount of this may be limited by the "asset ceiling". We shall discuss this in more detail later in the chapter.

HKAS 19.120

5.5 Step 3 – Determine amounts to be recognised in profit or loss

The change in the net defined benefit liability (asset) as measured by an actuary at the start and the end of a financial period can be attributed to contributions made into the plan, payments made out of the plan and three further components:

(a) service costs
(b) net interest on the net defined benefit liability (asset), and
(c) remeasurements.

The first two of these components are recognised in profit or loss. The third is recognised in other comprehensive income and is dealt with in section 5.6.

5.5.1 Service costs

Service costs include:

- current service cost, being the increase in the present value of the defined benefit obligation resulting from employee services during the current period
- past service cost, being the change in the obligation relating to employee services in prior periods arising from amendments or curtailments to the pension plan
- gains or losses on settlement of a defined benefit plan.

Current service costs normally arise in each financial year; past service costs and gains or losses on settlement arise only where a pension plan is amended, curtailed or settled in a period. We shall therefore concentrate on current service costs here and consider past service costs and gains or losses on settlement in more detail in section 5.7.

The current service cost is the increase in the present value of the defined benefit obligation resulting from employee service in the current period. This increase arises from the fact that most defined benefit pensions provide an incremental benefit for each year of service. The current service cost is calculated using the **projected unit credit method** which we mentioned earlier.

Consider a situation where a defined benefit plan provides for a benefit of 2.5% of the employee's salary in his/her final year, for each full year of service. The pension is payable from the age of 65. If an employee is expected to earn $10,000 in his final year of employment, then each year of service will result in an extra $250 for each year of retirement (assuming a 40-year working life). If the employee is expected to live for 15 years after retirement, the benefit payable is the discounted value at retirement date of $250 per annum for 15 years. The current service cost is the present value of this discounted amount.

The current service cost increases the plan obligation and is charged to operating expenses in profit or loss.

HKAS 19.83, 123

5.5.2 Net interest on the net defined benefit liability (asset)

Annual interest arises in respect of both the defined benefit obligation and the plan assets:

(i) An interest charge arises on the unwinding of the discount on the defined benefit obligation as time passes, and

(ii) Interest income is recognised on the plan assets.

HKAS 19 requires that these two interest elements are calculated on a net basis as:

Net defined benefit liability (asset) × discount rate

- The net defined benefit liability (asset) should be determined as at the **start** of the accounting period, taking account of changes during the period as a result of contributions paid into the scheme and benefits paid out.
- The **discount rate** is that determined by reference to **market yields** (at the year end) on high quality fixed-rate corporate bonds.

The net interest cost is charged to finance costs in profit or loss.

HKAS 19.122, 127

5.6 Step 4 – Determine amounts to be recognised in other comprehensive income

The third component of changes in a net defined benefit liability (asset) is remeasurements. These are recognised in other comprehensive income and are never reclassified to profit or loss.

Remeasurements may include:

(a) actuarial gains and losses;

(b) the return on plan assets (excluding amounts included in net interest on the net defined benefit liability (asset)); and

(c) any change in the effect of the asset ceiling (excluding amounts included in net interest on the net defined benefit liability (asset)).

The asset ceiling is a complication that is not relevant in every case, so it is dealt with separately, later in the chapter.

HKAS 19.128

5.6.1 Actuarial gains and losses

We have already seen, in section 5.3.1, that in measuring the defined benefit obligation, the actuary must make a number of **actuarial assumptions** regarding issues such as mortality and salary increases**.**

Actuarial gains and losses arise from changes to the defined benefit obligation because of changes in actuarial assumptions and experience adjustments:

(a) **Actual events:** The calculation of the plan obligation and the current service cost is based on estimates of numbers of employees remaining in the plan during the current year as well as estimates about salary changes during the current year. Where staff leave or salaries are increased by amounts different from those expected, the year end obligation will be different from that previously expected.

(b) **Actuarial assumptions are revised:** The valuation of the plan obligation depends upon a number of what are called actuarial assumptions. These include the discount rate, estimates of staff remaining in the plan until retirement, projected salaries on retirement, mortality rates and the length of time over which benefits need to be paid. These estimates can be changed as the entity, or its actuaries, reassess the future.

(c) **Actual returns on plan assets:** The valuation of the plan assets includes an estimated rate of return for the current year. At the year end the plan assets may have grown by an amount different from that expected.

Such actuarial gains and losses are recognised in other comprehensive income.

5.6.2 Return on plan assets

A new valuation of the plan assets is carried out at each period end, using current fair values. Any difference between the new value, and what has been recognised up to that date (normally the opening balance, interest, and any cash payments into or out of the plan) is treated as a "remeasurement" and recognised in other comprehensive income.

Example: Defined benefit plan

The following information relates to a defined benefit pension plan operated by Snow Co.:

	$m
Present value of defined benefit obligation at 1 January 20X1	100
Present value of defined benefit obligation at 31 December 20X1	120
Fair value of plan assets at 1 January 20X1	60
Fair value of plan assets at 31 December 20X1	55
Current service cost	18
Contributions made into the scheme	12
Payments made to members of the scheme	15

The yield on a high quality corporate bond is 5%.

Calculate amounts to be recognised in profit or loss and other comprehensive income in the year ended 31 December 20X1 and the value of the net defined benefit liability in the statement of financial position at that date.

Solution

	Obligation $m	*Assets* $m	*Net defined benefit liability* $m
At 1 January 20X1	100	60	40
Current service cost	18		
Contributions		12	
Payments	(15)	(15)	
Interest (5% × 100m)/(5% × 60m)	5	3	
	108	60	
Remeasurements (β)	12	(5)	
At 31 December 20X1	120	55	65

In the **statement of profit or loss and other comprehensive income**, the following amounts will be recognised:

	$m
In profit or loss	
Current service cost	18
Net interest on net defined benefit liability (5 – 3)	2
In other comprehensive income	
Remeasurement losses on defined benefit liability (12 + 5)	17

[Note that the remeasurement in relation to both the asset and liability is a loss as it decreases the asset and increases the liability.]

In the **statement of financial position**, the net defined benefit liability of $65m (120 – 55) will be recognised.

Self-test question 1

JSX, a listed entity, has a defined benefits pension scheme. The following information relates to the pension scheme for the year ended 31 October 20X8:

	$
Current service cost	362,600
Contributions to scheme	550,700
Benefits paid	662,400
Fair value of scheme assets at 1 November 20X7	10,660,000
Fair value of scheme assets at 31 October 20X8	11,204,000
Present value of defined benefit obligation at 1 November 20X7	13,290,000
Present value of defined benefit obligation at 31 October 20X8	14,210,000

The yield on a high quality corporate bond was 4%.

Calculate the amount to be recognised in other comprehensive income in respect of the pension scheme for the year ended 31 October 20X8.

(The answer is at the end of the chapter)

5.7 Further issues – past service costs and settlements

Topic highlights

Past service costs arise when a pension plan is amended or curtailed; they are recognised immediately in profit or loss.

Settlements occur when plan benefits are reduced. Gains or losses on settlement are recognised in profit or loss immediately.

Although we have now met the most common items which reconcile the plan surplus or deficit at the start and end of a period, there are two further complications which you must be able to deal with:

- Past service cost
- Settlements

HKAS 19.102-106

5.7.1 Past service cost

Past service costs arise as a result of the amendment or curtailment of a defined benefits plan.

A plan **amendment** arises when an entity introduces a new defined benefits plan, withdraws an existing plan, or changes the benefits payable under an existing plan.

A **curtailment** occurs when an entity significantly reduces the number of employees covered by a plan.

In either case, the past service cost is the resulting change in the present value of the defined benefit plan. The past service cost may be positive where new benefits are introduced or negative where existing benefits are withdrawn. The amount is advised by an actuary.

Past service costs are recognised as an expense in profit or loss at the earlier of the following dates:

(a) when the plan amendment or curtailment occurs

(b) when the entity recognises related restructuring costs in accordance with HKAS 37 or termination benefits in accordance with HKAS 19 (see section 6).

HKAS 19.109,111

5.7.2 Settlements

A **settlement** occurs when an employer enters into a transaction to eliminate all or part of its post-employment benefit obligations, for example, a one-off transfer of obligations under a plan to an insurance company through the purchase of an insurance policy.

The gain or loss on a settlement is the difference between:

(a) the **present value of the defined benefit obligation** being settled, as valued on the date of the settlement; and

(b) the **settlement price**, including any plan assets transferred and any payments made by the entity directly in connection with the settlement.

Any gains or losses on settlement are recognised immediately in profit or loss when the settlement occurs.

Self-test question 2

A defined benefit plan provides for retirement benefits at the rate of 1% of salary per annum for all employees from the commencement of their employment. On 31 December 20X1, the defined benefit obligation is measured at $18 million and the plan assets have a fair value of $15.5 million. Corresponding amounts at 31 December 20X2 are $22.5 million and $16 million.

On 1 January 20X2, the rules of the plan are changed to provide for benefit at the rate of 2% of salary for employees with 15 or more years' service and the defined benefit obligation on the new basis is $20 million. Other relevant information is as follows:

- Current service cost is $3 million for the year ended 31 December 20X2
- Market yields on high quality corporate bonds were 4% at 1 January 20X2 and 4.5% at 31 December 20X2
- An overall remeasurement loss of $1.2 million was identified.

Required

What amount is recognised in profit or loss in respect of the defined benefit plan in the year ended 31 December 20X2?

(The answer is at the end of the chapter)

HKAS 19.64-65, 83

5.8 Further issues – the asset ceiling

In section 5.4 we said that a net defined benefit asset is limited by the "asset ceiling". This term relates to a threshold established by HKAS 19 to ensure that any pension surplus is carried at no more than its recoverable amount. In other words, the net defined benefit asset is restricted to the amount of cash savings available to the entity in the future.

HKAS 19 defines the asset ceiling 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".

The standard further requires that the discount rate used to calculate the present value of future economic benefits is the same as that used to calculate the net interest on the net defined benefit liability (asset) i.e. a rate determined by reference to market yields at the end of the reporting period on high quality corporate bonds.

Where the net defined benefit asset is reduced to the asset ceiling threshold, the related write down is treated as a **remeasurement** and recognised in **other comprehensive income**.

Example: The asset ceiling

Rowan Co. operates a defined benefit pension scheme for its employees. At 1 January 20X1 the present value of the defined benefit obligation was $5 million and the fair value of the plan assets was $5.7 million. Equivalent values at 31 December 20X1 were $5.94 million and $7.1 million.

For the year ended 31 December 20X1:

- Current service cost was $1.5 million
- The interest rate applicable to the net defined benefit asset was 3%
- Contributions of $2 million were made to the plan
- $800,000 was paid out to former employees of Rowan

The present value of future economic benefits in relation to the plan is $1.1 million.

What amount of remeasurement is recognised in other comprehensive income in the year ended 31 December 20X1?

Solution

	Obligation $'000	*Assets* $'000	*Net defined benefit asset* $'000
At 1 January 20X1	5,000	5,700	700
Current service cost	1,500		
Contributions		2,000	
Payments	(800)	(800)	
Interest (3% × 5m)/(3% × 5.7m)	150	171	
	5,850	7,071	
Remeasurements (β)	90	29	
At 31 December 20X1	5,940	7,100	1,160
Remeasurement due to asset ceiling			(60)
Asset ceiling			1,100

Therefore, the total remeasurement amount recognised in other comprehensive income is:

	$'000
Remeasurement loss on obligation	90
Remeasurement gain on assets	(29)
Remeasurement loss due to asset ceiling	60
Net remeasurement loss	121

5.9 Summary of accounting treatment

This section summarises the accounting treatment that we have met so far.

Opening figures	Net defined benefit liability (asset): • Present value of obligation, less • Fair value of plan assets As advised by actuary	
Contributions	As advised by the actuary	DEBIT Plan assets CREDIT Cash / other assets
Benefits paid	Pension payments made to retired former employees	DEBIT Plan obligation CREDIT Plan assets

Current service cost	Increase in plan obligation as a result of one extra year's service. As advised by actuary	DEBIT Operating expense (profit or loss) CREDIT Plan obligation
Past service cost	Change in plan obligation as a result of improvement or withdrawal of benefits.	Improvement of benefits: DEBIT Operating expense (profit or loss) CREDIT Plan obligation Withdrawal of benefits: DEBIT Plan obligation CREDIT Operating expense (profit or loss)
Gains or losses on settlement	Difference between the present value of the obligation on settlement date and the settlement amount.	Loss on settlement: DEBIT Operating expense (profit or loss) CREDIT Plan obligation Gain on settlement: DEBIT Plan obligation CREDIT Operating expense (profit or loss)
Net interest on net defined benefit liability (asset)	Based on high quality corporate bond yield at end of period and net defined benefit liability (asset) at start of period. Discount rate % × net defined benefit liability (asset) b/f	DEBIT Finance cost (profit or loss) CREDIT Plan obligation And DEBIT Plan assets CREDIT Finance cost (profit or loss)
Remeasurements	Due to actuarial differences, the actual return on plan assets differing from the return calculated within net interest and change in the effect of the asset ceiling. Calculated as a balancing figure	DEBIT Other comprehensive income CREDIT Plan obligation / assets Or DEBIT Plan obligation / assets CREDIT Other comprehensive income
Closing figures	Net defined benefit liability (asset): • Present value of obligation, less • Fair value of plan assets As advised by actuary	

HKAS 19.63-64

5.10 Disclosure of defined benefit plans

5.10.1 The statement of financial position

In the statement of financial position, the amount recognised as a **net defined benefit liability** should be calculated as:

	$
Present value of defined benefit obligation at year end	X
Fair value of plan assets at year end	(X)
Net defined benefit liability	X/(X)

If this total is a **negative amount**, there is a net defined benefit asset and this should be shown in the statement of financial position as the **lower** of (a) and (b) below.

(a) The net defined benefit asset as calculated above
(b) The asset ceiling (see section 5.8)

HKAS 19.120

5.10.2 The statement of profit or loss and other comprehensive income

The following amounts should be recognised in profit or loss:

- Current service cost
- Past service cost
- Gain or loss on settlement
- Net interest on the net defined benefit liability (asset)

Remeasurements should be recognised in other comprehensive income.

Self-test question 3

Lewis, a public limited company, has a defined benefit plan for its employees. The present value of the future benefit obligations at 1 January 20X7 was $890m and fair value of the plan assets was $1,000 million. Further data concerning the year ended 31 December 20X7 is as follows:

	$m	
Current service cost	127	
Benefits paid to former employees	150	
Contributions paid to plan	104	
Present value of benefit obligations at 31 December	1,100	As valued by professional actuaries
Fair value of plan assets at 31 December	1,230	
Interest cost (gross yield on "blue chip" corporate bonds)	10%	

On 1 January 20X7 the plan was amended to provide additional benefits with effect from that date subject to a minimum employment period of eight years. The present value of the additional benefits was calculated by actuaries at $30 million.

The present value of future economic benefits available to Lewis in respect of the plan was $120 million at 31 December 20X7.

Required

Prepare the required notes to the statement of profit or loss and other comprehensive income and statement of financial position for the year ended 31 December 20X7.

Assume the contributions and benefits were paid on 31 December 20X7.

(The answer is at the end of the chapter)

6 Termination benefits

Topic highlights

Termination benefits are recognised as a liability and expense when an entity is demonstrably committed to them.

Termination benefits are those employee benefits provided in exchange for the termination of an employee's employment as a result of either:

- an entity's decision to terminate an employee's employment before the normal retirement date; or
- an employee's decision to accept an offer of benefits in exchange for the termination of employment.

These benefits are dealt with separately in HKAS 19 as unlike other benefits, the event which gives rise to an obligation is the termination rather than the service of the employee.

HKAS 19.165

6.1 Recognition

HKAS 19 states that termination benefits should be recognised in full as a liability and an expense at the earlier of:

(i) when the entity can no longer withdraw the offer of termination benefits; and

(ii) when the entity recognises costs for a restructuring that is within the scope of HKAS 37 and involves the payment of termination benefits.

HKAS 19.169

6.2 Measurement

Termination benefits are measured in accordance with the nature of the employee benefit:

- If the termination benefits are an enhancement of post-employment benefits, they are accounted for as such.
- Otherwise:
  - if the termination benefits are expected to be settled wholly before 12 months after the end of the annual reporting period in which the termination benefit is recognised, then they are accounted for as short-term employee benefits.
  - if the termination benefits are not expected to be settled wholly before 12 months after the end of the annual reporting period, then they are accounted for as other long-term employee benefits.

7 Current developments

The IASB issued an exposure draft in March 2013 which proposes to amend IAS 19 (and so HKAS 19 which is aligned with IAS 19). The proposed amendments specify that contributions from employees or third parties set out in the terms of a defined benefit plan are recognised as a reduction in the service cost in the same period in which they are paid, provided that the contributions are linked solely to the employees' service rendered in that period. This is the case where, for example, the contributions are a fixed percentage of salary and the percentage does not change from year to year.

Topic recap

HKAS 19 Employee Benefits

Short-term employee benefits

e.g.
- Annual leave
- Sick pay
- Medical care

Recognise in the period the related service is provided by the employee as a:
- liability
- expense

Post-employment benefits

e.g.
- Pensions
- Post-employment medical care

Termination benefits

Benefits provided in exchange for termination of an employee's employment

Recognise as a liability and expense at the earlier of:
- when the entity can no longer withdraw the offer of termination benefits.
- when the entity recognises a cost for restructuring involving the payment of termination benefits.

Defined contribution

Recognise contributions as an expense in the period in which they are payable.
Accruals/prepayments may arise.

Defined benefit

Recognise the net defined benefit liability/asset in the statement of financial position:

Present value of obligation	X
Less Fair value of plan assets	(X)
Net defined benefit liability/(asset)	X/(X)

An asset is limited by the asset ceiling to the present value of future economic benefits in relation to the plan.

Each element of the change in the present value of the obligation and fair value of plan assets is recognised individually:

	Obligation	*Assets*	*Recognised in:*
b/f	X	X	
Contributions		X	
Benefits paid out	(X)	(X)	
Current service cost	X		Profit or loss
Past service cost	X/(X)		Profit or loss
Loss on settlement	X		Profit or loss
Gain on settlement	(X)		Profit or loss
Net interest on defined benefit liability / asset	X	X	Profit or loss
Remeasurements	X/(X)	X/(X)	Other comprehensive income
c/f	X	X	

Answers to self-test questions

Answer 1

	Assets	*Obligation*
	$	$
At 1 November 20X7	10,660,000	13,290,000
Current service cost		362,600
Contributions	550,700	
Benefits paid	(662,400)	(662,400)
Net interest (4% × b/f assets/obligation)	426,400	531,600
Remeasurement loss on plan obligation (β)		688,200
Remeasurement gain on plan assets (β)	229,300	
At 31 October 20X8	11,204,000	14,210,000

The remeasurement loss recognised in other comprehensive income is $458,900 (688,200 – 229,300)

Answer 2

The past service cost measured as the increase in the defined benefit obligation is $20m – $18m = $2 million.

Net interest is calculated using the **year-end** market rate on a high quality corporate bond. This rate is applied to the net defined benefit liability at the **start of the year**.

Therefore the total charge to profit or loss is:

	$
Current service cost	3,000,000
Past service cost	2,000,000
Net interest 4.5% × (18m – 15.5m)	112,500
	5,112,500

Answer 3

STATEMENT OF FINANCIAL POSITION

	$m
Net defined benefit asset	120

NOTE TO THE STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

Defined benefit expense recognised in profit or loss

	$m
Current service cost	127
Past service cost	30
Interest cost 10% × (1,000 – 890)	(11)
Defined benefit costs recognised in other comprehensive income	
Remeasurement gain on defined benefit pension plan (176 – 114 – 10) (W)	52

WORKINGS

Changes in the present value of the defined benefit obligation

	$m
Opening defined benefit obligation	890
Current service cost	127
Past service cost	30
Interest cost 10% × 890m	89
Benefits paid	(150)
Remeasurement loss (β)	114
Closing defined benefit obligation	1,100

Changes in the fair value of plan assets

	$m
Opening fair value of plan assets	1,000
Interest 10% × 1,000	100
Contributions	104
Benefits paid	(150)
Remeasurement gain (β)	176
Closing fair value of plan assets	1,230

Asset ceiling test

	$m
Closing fair value of plan assets	1,230
Closing defined benefit obligation	(1,100)
Closing net defined benefit asset	130
Asset ceiling	(120)
Remeasurement loss	10

Exam practice

Employee benefits — 29 minutes

(a) HKAS 19 as amended in July 2011 requires that all actuarial gains and losses (or remeasurements) are recognised immediately in other comprehensive income. Prior to these amendments, entities were permitted to defer actuarial gains and losses in excess of 10% of the value of the plan assets or obligation and recognise them over an extended period, either in profit or loss or in other comprehensive income.

Required

What will be the effect of the new requirements on the financial statements of entities which previously chose to defer actuarial gains and losses? **(4 marks)**

(b) The following information relates to the defined benefit employee compensation scheme of Rhodes Co.:

Present value of obligation at start of 20X8 ($'000)	20,000
Market value of plan assets at start of 20X8 ($'000)	20,000

	20X8	*20X9*
	$'000	$'000
Current service cost	1,250	1,430
Benefits paid out	987	1,100
Contributions paid by entity	1,000	1,100
Present value of obligation at end of the year	23,000	20,400
Market value of plan assets at end of the year	21,500	17,840
Yield on corporate bonds at end of year	8%	9%

During 20X8, the benefits available under the plan were improved. The resulting increase in the present value of the defined benefit obligation was $1 million.

On the final day of 20X9, Rhodes Co. divested of part of its business, and as part of the sale agreement, transferred the relevant part of its pension fund to the buyer. The present value of the defined benefit obligation transferred was $5.7 million and the fair value of plan assets transferred was $5.4 million. Rhodes also made a cash payment of $200,000 to the buyer in respect of the plan.

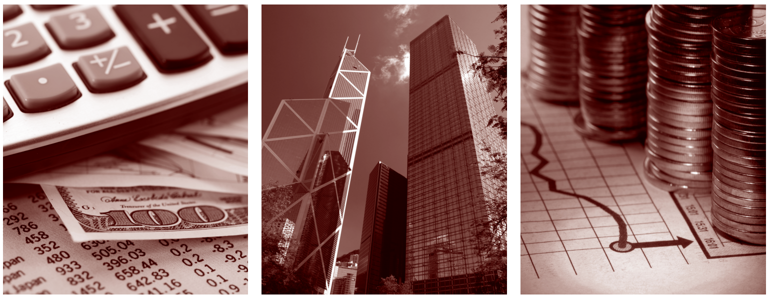
Assume that all transactions occur at the end of the year.

Required

(i) Calculate the net defined benefit liability as at the start and end of 20X8 and 20X9 showing clearly any remeasurement gain or loss on the plan each year. **(6 marks)**

(ii) Show amounts to be recognised in the financial statements in each of the years 20X8 and 20X9 in respect of the plan. **(6 marks)**

(Total = 16 marks)



chapter 17

Borrowing costs

Topic list

Learning focus

Borrowing costs may be considered in the context of non-current assets or may be considered in isolation. HKAS 23 concentrates particularly on the situation where the related borrowings are applied to the construction of certain assets.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
Account for transactions in accordance with Hong Kong Financial Reporting Standards		
3.12	**Borrowing costs**	3
3.12.01	Identify the expenses which constitute borrowing costs in accordance with HKAS 23	
3.12.02	Identify the assets which are qualifying assets	
3.12.03	Determine when the capitalisation of borrowing costs shall commence, be suspended and cease	
3.12.04	Calculate the amount of borrowing costs to be capitalised from specific borrowing and general borrowing	
3.12.05	Prepare journal entries for borrowing costs, including expensed and capitalised borrowing costs	
3.12.06	Disclose relevant information with regard to borrowing costs	

1 HKAS 23 *Borrowing Costs*

Topic highlights

HKAS 23 looks at the treatment of **borrowing costs**, particularly where the related borrowings are applied to the construction of certain assets. These are what are usually called "self-constructed assets", where an entity builds its own inventory or non-current assets over a substantial period of time.

HKAS 23.5

1.1 Definitions

Only two definitions are given by the standard.

Key terms

Borrowing costs. Interest and other costs incurred by an entity in connection with the borrowing of funds.

Qualifying asset. An asset that necessarily takes a substantial period of time to get ready for its intended use or sale. *(HKAS 23)*

HKAS 23.6

1.1.1 Borrowing costs

The standard lists what may be **included in borrowing costs**:

(a) Interest expense calculated using the effective interest method as described in HKFRS 9 *Financial Instruments*

(b) Finance charges in respect of finance leases recognised in accordance with HKAS 17 *Leases* (See Chapter 9)

(c) Exchange differences arising from foreign currency borrowings to the extent they are regarded as an adjustment to interest costs

HKAS 23.7

1.1.2 Qualifying assets

The standard says that any of the following may be qualifying assets:

- Inventories
- Manufacturing plants
- Power generation facilities
- Intangible assets
- Investment properties

Financial assets and inventories manufactured or produced over short periods are **not qualifying assets**, nor are assets ready for sale or their intended use when purchased.

HKAS 23.8,9

1.2 Recognition

All eligible borrowing costs must be **capitalised**.

Only borrowing costs that are **directly attributable** to the acquisition, construction or production of a qualifying asset can be capitalised as part of the cost of that asset. The standard lays out the criteria for determining which borrowing costs are eligible for capitalisation.

All other borrowing costs are expensed to profit or loss.

The journal entry to record borrowing costs is therefore:

DEBIT	Qualifying asset cost	Eligible borrowing costs	
	Finance cost	Ineligible borrowing costs	
CREDIT	Cash/Accrual		Total borrowing costs

HKAS 23.10-15

1.2.1 Borrowing costs eligible for capitalisation

It is necessary to identify those borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset. These borrowing costs **would have been avoided** had the expenditure on the qualifying asset not been made. This is straightforward where funds have been borrowed for the financing of one particular asset.

Where an entity uses **a number of debt instruments** to finance a variety of assets, difficulties arise since there is no direct link between particular borrowings and a specific asset. For example, central borrowings are lent to different parts of the group or entity. Judgment is therefore necessary, particularly where more complex situations can arise (e.g. foreign currency loans).

Once the relevant borrowings are identified with a specific asset, the **amount of borrowing costs to be capitalised** during a period will be the actual borrowing costs incurred on those borrowings, *less* any investment income on the temporary investment of those borrowings. It is not unusual to invest some or all of the funds before they are actually used to finance the qualifying asset.

Self-test question 1

On 1 January 20X9 Vitality Co. borrowed $1.5 million to finance the production of two assets, both of which were expected to take a year to build. Work started at the beginning of 20X9. Expenditure was as follows, with the remaining funds invested temporarily.

	Asset A	*Asset B*
	$'000	$'000
1 January 20X9	250	500
1 July 20X9	250	500

The loan rate was 8% and Vitality Co. can invest surplus funds at 5%.

Required

Ignoring compound interest, calculate the borrowing costs which may be capitalised for each of the assets and consequently the cost of each asset as at 31 December 20X9. Show the relevant journal entries with regard to borrowing costs.

(The answer is at the end of the chapter)

In a situation where **general borrowings are acquired** and applied in part to finance a qualifying asset, then the amount of borrowing costs eligible for capitalisation is arrived at by applying the "capitalisation rate" to the capital expenditure on the asset.

The **capitalisation rate** is computed as the weighted average of the borrowing costs applicable to the entity's outstanding borrowings during the period, *excluding* specific borrowings made to obtain a qualifying asset. However, the amount of these borrowing costs must not exceed actual borrowing costs incurred.

It may be more appropriate to compute a weighted average for borrowing costs for **individual parts of the group or entity**, though an overall weighted average can be used for a group or entity sometimes.

Example: Capitalising interest

On 1 March 20X5 Dunedin Co. drew down $500,000 from existing general borrowings in order to finance the construction of a new asset. Existing borrowings were as follows:

Bank loan	$2,000,000	5% annual interest
Loan notes	$6,000,000	8% annual interest

Construction of the asset commenced on 1 April 20X8 and was completed on 31 March 20X9.

What amount of interest must be capitalised in accordance with HKAS 23?

Solution

The weighted average cost of borrowing is:

$5\% \times 2m/(2m + 6m) + 8\% \times 6m/(2m + 6m) = 7.25\%$

Therefore, interest to be capitalised is calculated as:

$7.25\% \times \$500,000 \times 12/12 = \$36,250$

Self-test question 2

Tumble Co. had the following loans in place at the beginning and end of 20X8.

	1 January 20X8	*31 December 20X8*
	$m	$m
9% Bank loan repayable 20Y0	150	150
8% Bank loan repayable 20Y1	90	90
7.5% debenture repayable 20Y2	–	200

The 7.5% debenture was issued to fund the construction of a qualifying asset (a piece of mining equipment), construction of which began on 1 July 20X8.

On 1 January 20X8, Tumble Co. began construction of a qualifying asset, a piece of machinery for a hydro-electric plant, using existing borrowings. Expenditure drawn down for the construction was: $25 million on 1 January 20X8, $30 million on 1 October 20X8.

Required

Calculate the borrowing costs that can be capitalised for the hydro-electric plant machine.

(The answer is at the end of the chapter)

HKAS 23.16

1.2.2 Carrying amount exceeds recoverable amount

As required by other HKFRS, the carrying amount of a qualifying asset must be **written down or written off** in situations where the carrying amount (or expected ultimate cost) of the asset exceeds its recoverable amount or net realisable value. These written down amounts may be written back in future periods under certain circumstances (again as allowed by other HKFRS).

HKAS 23.17-19

1.2.3 Commencement of capitalisation

Three events or transactions must be taking place for capitalisation of borrowing costs to be started:

(a) Expenditure on the asset is being incurred
(b) Borrowing costs are being incurred
(c) Activities are in progress that are necessary to prepare the asset for its intended use or sale

Expenditure must result in cash payments, transfer of other assets or assumption of interest-bearing liabilities. Any progress payments or grants received in connection with the asset will be treated as **deductions from expenditure**. It is allowed by HKAS 23 to use the **average carrying amount** of the asset during a period (including capitalised borrowing costs) as a reasonable approximation of the expenditure to which the capitalisation rate is applied in the period. Presumably more exact calculations can be used.

Activities necessary to prepare the asset for its intended sale or use encompass not only physical construction work, but also technical and administrative work prior to construction, e.g. obtaining permits. However, holding an asset when no production or development that changes the asset's condition is taking place, e.g. where land is held without any associated development activity, is to be excluded.

HKAS 23.20-21

1.2.4 Suspension of capitalisation

Capitalisation of borrowing costs should be suspended for any extended periods where active development is interrupted.

Any borrowing costs incurred during such periods should be expensed through profit or loss.

Capitalisation of borrowing costs is not normally suspended during:

- a period when substantial technical and administrative work is being carried out
- a temporary delay occurs which is a necessary part of getting an asset ready for intended use, e.g. while inventories are maturing

HKAS 23.22-25

1.2.5 Cessation of capitalisation

Once all the activities necessary to prepare the qualifying asset for its intended use or sale are substantially complete, the capitalisation of borrowing costs should come to an end. This will normally be the case when the **physical construction of the asset is completed**, though routine administrative work and minor modifications may still be outstanding.

An asset may be completed in **parts or stages** and each part can be used while construction is still in progress on the other parts. Capitalisation of borrowing costs should be terminated for each part as it is completed. The example quoted in the standard is a business park consisting of several buildings.

Example: Commencement, suspension and cessation of capitalisation

Lam Co. borrowed $10 million on 1 January 20X8 in anticipation of commencing work to build a new head office later in the year. The interest rate provided by Lam Co.'s bank was 8% per annum, and the loan had a term of five years. Construction began on 15 February and the property was occupied for use on 20 December 20X8.

The following information is relevant:

1 February	Expenditure on building materials began to be incurred
15 February	Building work began
6 May	Building work was suspended due to tropical storms, common to the region through May and June
16 May	Building work recommenced
30 November	Building work is completed and approved by the regulatory authorities
1 December	Decoration and finishing of the property to Lam Co.'s specification commences
15 December	Decoration and finishing work is completed.

What journal entries are required to record the borrowing costs in the year ended 31 December 20X8?

Solution

- Total borrowing costs incurred in the year are $10 million × 8% = $800,000
- Capitalisation of borrowing costs commences on 15 February when building work commences and both expenditure and borrowing costs are being incurred.
- Capitalisation ceases on 30 November when the physical construction of the property is complete. Decoration and finishing qualify as minor modifications not construction.
- Capitalisation does not cease during the temporary suspension of work for inclement weather in May.

- Therefore, capitalised costs are:

  $10 million × 8% × 288/365 days = $631,233

		$	$
DEBIT	Property under construction	631,233	
	Finance costs (800,000 – 631,233)	168,767	
CREDIT	Cash / interest accrual		800,000

HKAS 23.26

1.2.6 Disclosure

The following should be disclosed in the financial statements in relation to borrowing costs:

(a) Amount of borrowing costs **capitalised during the period**.

(b) **Capitalisation rate** used to determine the amount of borrowing costs eligible for capitalisation.

Self-test question 3

On 1 January 20X8 Allan Lee Co. borrowed $20 million to finance the production of two assets, both of which were expected to take a year to build. Production started at the beginning of 20X8. The loan facility was drawn down on 1 January 20X8, and was utilised as follows, with the remaining funds invested temporarily:

	Asset X	*Asset Y*
	$m	$m
1 January 20X8	4.0	6.0
1 July 20X8	7.0	3.0

The loan rate was 10% and Allan Lee can invest surplus funds at 8%.

Required

Ignoring compound interest, calculate the borrowing costs which may be capitalised for each of the assets and consequently the cost of each asset as at 31 December 20X8.

(The answer is at the end of the chapter)

Self-test question 4

Autofact, a car manufacturer, prepares its accounts to 30 June each year. On 1 July 20X8, it purchased for $20million a leasehold interest in a site on which it began to construct a factory with an estimated useful life of 30 years. The building cost $7million to construct and the plant and equipment cost $5million. The construction of the factory was complete on 31 March 20X9 and it was brought into use on 1 July 20X9.

To finance this project, Autofact borrowed $32million on 1 July 20X8. The rate of interest on the loan was 5% per annum and it was repaid on 31 December 20X9.

Required

Calculate the total amount to be included at cost in property, plant and equipment in respect of this project at 30 June 20X9.

Topic recap

HKAS 23 Borrowing Costs

Eligible borrowing costs on qualifying assets MUST be capitalised.

Eligible borrowing costs

Borrowing costs

Interest and other costs incurred by an entity in connection with the borrowing of funds.

Includes:
- Interest expense calculated using the effective interest method
- Finance charges in respect of finance leases
- Exchange differences on foreign currency borrowings to the extent they are regarded as an adjustment to interest costs.

Eligible

Directly attributable to the acquisition, construction or production of a qualifying asset.

Where general borrowings are acquired calculate the eligible borrowing cost as: weighted average interest rate of general borrowings ("capitalisation rate") × capital expenditure on the qualifying asset

Qualifying assets

An asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Includes:
- Inventories
- Manufacturing plants
- Power generation facilities
- Intangible assets
- Investment properties

Excludes:
- Financial assets
- Inventories manufactured over short periods
- Assets ready for sale/intended use when purchased

Commence capitalisation when:

1 expenditure on the asset is being incurred
2 borrowing costs are being incurred
3 activities are in progress to prepare the asset for use or sale

Suspend capitalisation when active development is interrupted for extended periods.

Cease capitalisation when the activities to prepare the asset for use or sale are substantially complete.

Disclose:
- Amount of borrowing costs capitalised in period
- Capitalisation rate used to determine the borrowing costs eligible for capitalisation.

Answers to self-test questions

Answer 1

		Asset A	Asset B
		$	$
Borrowing costs			
To 31 December 20X9	($0.5m, $1m) × 8%	40,000	80,000
Less: investment income			
To 30 June 20X9	($0.25m, $0.5m) × 5% × 6/12	(6,250)	(12,500)
		33,750	67,500
Cost of assets			
Expenditure incurred		500,000	1,000,000
Borrowing costs		33,750	67,500
		533,750	1,067,500

Capitalisation of borrowing costs

		$	$
DEBIT	Asset A	40,000	
DEBIT	Asset B	80,000	
CREDIT	Accrued interest		120,000

Receipt of investment income by investing surplus funds

		$	$
DEBIT	Cash	18,750	
CREDIT	Asset A		6,250
CREDIT	Asset B		12,500

Answer 2

Capitalisation rate = weighted average rate = $\left(9\% \times \frac{150}{150 + 90}\right) + \left(8\% \times \frac{90}{150 + 90}\right) = 8.625\%$

Borrowing costs = ($25m × 8.625%) + ($30m × 8.625% × $^3/_{12}$)
= $2.803m

Answer 3

		Asset X	Asset Y
		$'000	$'000
Borrowing costs			
To 30 June 20X8	$4.0m/$6.0m × 10% × $^6/_{12}$	200	300
To 31 December 20X8	$11.0m/$9.0m × 10% × $^6/_{12}$	550	450
		750	750
Less: investment income			
To 30 June 20X8	$7.0m/$3.0m × 8% × $^6/_{12}$	(280)	(120)
		470	630
Cost of assets			
Expenditure incurred		11,000	9,000
Borrowing costs		470	630
		11,470	9,630

Answer 4

The total amount to be included in property, plant and equipment at 30 June 20X9 is as follows:

	$'000
Lease	20,000
Building	7,000
Plant and equipment	5,000
Interest capitalised ($32,000 × 5% × 9/12)	1,200
	33,200

HKAS 23 states that capitalisation of borrowing costs must cease when substantially all the activities necessary to prepare the asset for its intended use or sale are complete. Accordingly, only nine months' interest (1 July 20X8 to 31 March 20X9) can be capitalised.

Exam practice

Rondo Hospitality Enterprise 27 minutes

Rondo Hospitality Enterprise (RHE) is a hotel operator. The management is considering investing in a new hotel project with 150 rooms. The construction of the hotel building and installation of equipment, furniture and fixtures is scheduled to commence on 1 March 20X3 and be completed by the end of June 20X4. The hotel would be available for use at the same time. The total cost of HK$200 million will be payable in five equal instalments beginning 1 March 20X3 and then payable every 4 months.

Without any delay in the completion of the construction and other unforeseen events, RHE plans to have the pre-opening activities for three months and then commence the operation of the new hotel by 1 October 20X4.

RHE co-ordinates its financing activities through a centralised treasury function, with borrowings being raised from various sources such as bond issues and bank loans, to finance general requirements, including the acquisition and development of qualifying assets. It is expected that the borrowing requirements of RHE will be much greater than the amounts to be incurred for the hotel project.

The expected useful life of the hotel property is 30 years. It is expected that RHE needs to replace certain equipment and furniture in the hotel rooms every five years in addition to carrying out regular repair and maintenance works. Around HK$40 million of the budgeted expenditure is attributable to these capitalised items. The structure of the building can be used until the end of the hotel's useful life.

Required

(a) Calculate the borrowing costs to be capitalised for qualifying assets for the year ending 31 December 20X3 and 20X4. Assume the capitalisation rate to be applied to the expenditure on the qualifying asset is 6.5%. **(3 marks)**

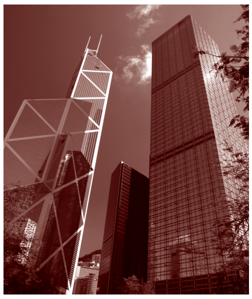
(b) Discuss the factors the management of RHE should consider in relation to the depreciation of the hotel property. **(6 marks)**

(c) Calculate the depreciation to be charged for the year ending 31 December 20X4 with the explanation, assuming a straight line basis is adopted by RHE for depreciation.

(6 marks)

(Total = 15 marks)

HKICPA December 2012



chapter 18

Financial instruments

Topic list

Learning focus

This is a highly controversial and very complex topic. You should concentrate on the essential points. It is also the subject of ongoing change, as over a period of time HKAS 39 is being replaced by HKFRS 9.

You need plenty of practice on the topics in this chapter in order to familiarise yourself with this difficult area.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
Account for transactions in accordance with Hong Kong Financial Reporting Standards		
3.11	**Financial assets, financial liabilities and equity instruments**	2
3.11.01	Discuss and apply the criteria for the recognition and de-recognition of a financial asset or financial liability	
3.11.02	Discuss and apply the rules for the classification of a financial asset, financial liability and equity, and their measurement (including compound instrument)	
3.11.03	Discuss and apply the treatment of gains and losses arising on financial assets or financial liabilities	
3.11.04	Discuss the circumstances that give rise to and apply the appropriate treatment for the impairment of financial assets	
3.11.05	Account for derivative financial instruments and simple embedded derivatives, including the application of own-use exemption	
3.11.06	Disclose relevant information with regard to financial assets, financial liabilities and equity instruments	
3.17	**Hedge accounting**	2
3.17.01	Identify fair value hedges, cash flow hedges and hedges for net investment in accordance with HKAS 39	
3.17.02	Account for fair value hedges, cash flow hedges and hedges for net investment	

1 Financial instruments

Topic highlights

Accounting guidance on financial instruments is provided in four standards:

- HKAS 32 *Financial Instruments: Presentation*
- HKAS 39 *Financial Instruments: Recognition and Measurement*
- HKFRS 7 *Financial Instruments: Disclosures*
- HKFRS 9 *Financial Instruments*

1.1 Background

Financial instruments have, in recent years, become increasingly complex. They vary from straightforward, traditional instruments, such as loan stock or shares through to complex "derivative instruments".

The emergence of more complex instruments towards the end of the 20th century created a problem in that existing accounting guidance was insufficient. Accounting standards boards worldwide were forced to address this through the development of lengthy and detailed standards. In Hong Kong the relevant standards were:

- **HKAS 32** *Financial Instruments: Presentation*, issued in 2004, which originally dealt with:
  - the classification of financial instruments between liabilities and equity
  - presentation of certain compound instruments
  - disclosure of financial instruments
- **HKAS 39** *Financial Instruments: Recognition and Measurement*, issued in 2006, which dealt with:
  - recognition and derecognition of financial instruments
  - the measurement of financial instruments
  - hedge accounting

Both of these standards have, subsequent to their original issue, been amended numerous times as the topic to which they relate continually evolves. In addition, two new standards have been issued:

- **HKFRS 7** *Financial Instruments: Disclosures*, issued in 2005 replaced the part of HKAS 32 dealing with disclosure. In doing so, it revised, simplified and added to financial instrument disclosure requirements.
- **HKFRS 9** *Financial Instruments*, originally issued in 2009 replaced certain parts of HKAS 39, in particular with respect to the classification of financial assets. HKFRS 9 was expanded in 2010 to include guidance on the classification and measurement of financial liabilities and the derecognition of financial assets and liabilities. This standard continues to be a work in progress and in due course will be developed further to replace HKAS 39 in its entirety.

This chapter is based on those parts of all four standards in issue at 31 May 2013. The HKICPA operates a six-month rule, meaning that new or revised standards which have been issued by the cut-off date (31 May 2013 for December 2013 exams and 30 November 2013 for June 2014 exams) are only examined where they have been effective or will become effective within 13 months from the first day of the month in which the examination takes place. In the case of HKFRS 9, the effective date is January 2015 so it is examinable. Any subsequent amendments made to HKFRS 9 will be examined according to the six-month rule as stated above.

HKAS 32.11, HKFRS 9, Appendix A

1.2 Definitions

A number of definitions are common to all four standards.

Key terms

Financial instrument. Any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity.

Financial asset. Any asset that is:

(a) cash;

(b) an equity instrument of another entity;

(c) a contractual right to receive cash or another financial asset from another entity; or to exchange financial instruments with another entity under conditions that are potentially favourable to the entity; or

(d) a contract that will or may be settled in the entity's own equity instruments and is a:

  (i) non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments

  (ii) derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments

Financial liability. Any liability that is a:

(a) contractual obligation to:

  (i) deliver cash or another financial asset to another entity

  (ii) exchange financial instruments with another entity under conditions that are potentially unfavourable

(b) contract that will or may be settled in the entity's own equity instruments and is a:

  (i) non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments

  (ii) derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments

Equity instrument. Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Derivative. A financial instrument or other contract with all three of the following characteristics:

(a) Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable (sometimes called the "underlying")

(b) It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors

(c) It is settled at a future date *(HKAS 32 and HKFRS 9)*

HKAS 32.13-14

Some of the terms used within the definitions themselves need defining:

(a) A "**contract**" need not be in writing, but it must comprise an agreement that has "clear economic consequences" and which the parties to it cannot avoid, usually because the agreement is enforceable in law.

(b) An "**entity**" here could be an individual, partnership, incorporated body or government agency.

HKAS 32.AG4, AG8, AG11-12, AG20-21

1.2.1 Financial assets and liabilities

The definitions of **financial assets and financial liabilities** may seem complicated, but the essential point is that while there may be a chain of contractual rights and obligations, it will lead ultimately to the receipt or payment of cash *or* the acquisition or issue of an equity instrument.

Examples of financial assets and liabilities may include:

Financial assets	Financial liabilities
Trade receivables	Trade payables
An investment in shares	Loans payable
A loan made to another party	Redeemable preference shares

HKAS 32 makes it clear that the following items are *not* financial assets or liabilities:

- **Physical assets**, e.g. inventories, property, plant and equipment, leased assets and intangible assets (patents, trademarks etc.)
- **Prepaid expenses**, deferred revenue and most warranty obligations
- Liabilities or assets that are **not contractual** in nature
- Contractual rights/obligations that **do not involve transfer of a financial asset**, e.g. commodity futures contracts, operating leases

Self-test question 1

Why do you think that physical assets and prepaid expenses do not qualify as financial instruments?

(The answer is at the end of the chapter)

Contingent rights and obligations meet the definition of financial assets and financial liabilities respectively, even though many do not qualify for recognition in financial statements. This is because the contractual rights or obligations exist because of a past transaction or event (e.g. assumption of a guarantee).

HKAS 32.AG15

1.2.2 Primary and derivative instruments

The examples of financial assets and liabilities given in the previous section may be referred to as "primary instruments". You should also be aware of derivative financial instruments.

A **derivative** is a financial instrument that **derives** its value from the price or rate of an underlying item. Common **examples** of derivatives include the following:

- **Forward contracts** which are agreements to buy or sell an asset at a fixed price at a fixed future date.
- **Futures contracts**, which are similar to forward contracts except that contracts are standardised and traded on an exchange.
- **Options**, which are rights (but not obligations) for the option holder to exercise at a pre-determined price; the option writer loses out if the option is exercised.
- **Swaps**, which are agreements to swap one set of cash flows for another (normally interest rate or currency swaps).

A simple example of a forward contract may help you to understand how it derives its value from an underlying item. Say a forward contract exists to sell an asset for $8 on a given date. At today's date the market price of the asset is $5 and therefore it would be fair to say that the contract is worth $3. This value cannot, however, be established without reference to the price of the underlying item, being the market price of the asset. If the underlying item is volatile, then the settlement of the derivative can lead to a very different result from the one originally envisaged.

Derivatives usually have no, or very little, initial cost. Therefore, before the development of HKAS 32 and HKAS 39, they may not have been recognised in the financial statements at all, or recognised at a value bearing no relation to the current value. This is obviously misleading and leaves users of the accounts unaware of the uncertainty and risk to which a company holding derivatives is exposed.

Part of the reason why HKAS 32 and HKAS 39 were developed was in order to correct this situation.

2 HKAS 32: Presentation of financial instruments

HKAS 32.2

2.1 Objective

The objective of **HKAS 32** is:

To establish principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and financial liabilities. It applies to the classification of financial instruments, from the perspective of the issuer, into financial assets, financial liabilities and equity instruments; the classification of related interest, dividends, losses and gains; and the circumstances in which financial assets and financial liabilities should be offset.

(*HKAS 32*)

HKAS 32.4

2.2 Scope

HKAS 32 should be applied in the presentation of **all types of financial instruments**, whether recognised or unrecognised.

Certain items are **excluded**:

(a) Interests in subsidiaries, associates and joint ventures, unless these are accounted for using HKFRS 9 as allowed by HKAS 27, HKAS 28 and HKAS 31

(b) Employers' rights and obligations under employee benefit plans (**HKAS 19**: Chapter 16)

(c) Insurance contracts

(d) Financial instruments, contracts and obligations under share-based payment transactions (**HKFRS 2**: Chapter 13)

2.3 Classification of financial instruments as financial assets, financial liabilities and equity

Topic highlights

Financial instruments are classified as financial assets, financial liabilities or equity. Financial instruments issued to raise capital must be classified as **liabilities** or **equity**.

The **critical feature of a financial liability** is the contractual obligation to deliver cash or another financial instrument.

HKAS 32 requires that the issuer of a financial instrument classifies it, or its component parts, as a financial asset, financial liability or equity based on:

- the substance of the contractual arrangement on initial recognition
- the definitions in the Key terms provided in section 1.2 above

The classification of the financial instrument is made when it is **first recognised** and this classification will continue until the financial instrument is removed from the entity's statement of financial position.

HKAS 32.16

2.3.1 Distinguishing financial liabilities and equity

Distinguishing a financial liability from equity may not be straightforward and therefore HKAS 32 provides additional guidance. The underlying principle is that of substance over form. Although substance and legal form are often **consistent with each other**, this is not always the case.

An instrument is an equity instrument only if there is **no contractual obligation to deliver cash or another financial asset** to another entity or to exchange another financial instrument with the holder under potentially unfavourable conditions to the issuer.

Therefore, for example, a redeemable preference share is classified as a liability, rather than equity, as there is an obligation to deliver cash at the redemption date. On the other hand, ordinary shares are classified as equity as, although the holder of an equity instrument may be entitled to a *pro rata* share of any distributions out of equity, the issuer does *not* have a contractual obligation to make such a distribution.

A financial liability exists **regardless of the way in which the contractual obligation to deliver cash or a financial asset will be settled**. The issuer's ability to satisfy an obligation may be restricted, e.g. by lack of access to foreign currency, but this is irrelevant as it does not remove the issuer's obligation or the holder's right under the instrument.

Self-test question 2

During the financial year ended 31 December 20X5, Kim issued the financial instrument described below. Identify whether it should be classified as liability or equity, **explaining in not more than 40 words** the reason for your choice. You should refer to the relevant Hong Kong Accounting Standards.

Redeemable preference shares with a coupon rate 5%. The shares are redeemable on 31 December 20X9 at premium of 20%.

(The answer is at the end of the chapter)

2.4 Specific classification rules

As well as providing the general classification rules explained in the section above, HKAS 32 also provides guidance on the classification of specific instruments and instruments with specific characteristics. They are:

- puttable financial instruments and obligations arising on liquidation
- financial instruments with contingent settlement provisions
- financial instruments with settlement options
- compound instruments
- rights issues

The remainder of this section deals with each in turn.

HKAS 32.16A-B,E

2.4.1 Puttable financial instruments and obligations arising on liquidation

HKAS 32 was amended in 2008 to introduce criteria for certain puttable instruments and obligations arising on liquidation to be classified as equity. Prior to these amendments, these instruments would have been classified as financial liabilities.

Puttable financial instruments

A puttable financial instrument is an instrument where the holder can "put" the instrument i.e. require the issuer to redeem it in cash. For example, some ordinary shares are puttable, and prior to the revision to HKAS 32, these were classified as liabilities. They are now classified as equity, but only if:

(a) the holder is entitled to a pro-rata share of the entity's net assets on liquidation.

(b) the instrument is in the class of instruments that is the most subordinate and all instruments in that class have identical features.

(c) the instrument has no other characteristics that would meet the definition of a financial liability.

(d) the total expected cash flows attributable to the instrument over its life are based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the entity (excluding any effects of the instrument itself). Profit or loss or change in recognised net assets for this purpose is as measured in accordance with relevant HKFRS.

In addition to the criteria set out above, the entity must have no other instrument that has terms equivalent to (d) above and that has the effect of substantially restricting or fixing the residual return to the holders of the puttable financial instruments.

Where the specified criteria are no longer met, or when they are subsequently met, the instrument should be reclassified. If the instrument presented as equity is reclassified as a financial liability, it will be measured at fair value at the date of reclassification with any difference between the fair value and the carrying amount to be recognised in equity. When the inverse applies, the financial liability will be reclassified to equity at its carrying amount at the date of reclassification.

HKAS 32.16C

Obligations arising on liquidation

As a result of the amendment mentioned above, instruments imposing an obligation on an entity to deliver to another party a pro-rata share of the net assets on liquidation should be classified as equity.

The following examples illustrate the types of instruments impacted by the new requirements:

Issued financial instrument	Classification under HKAS 32 before amendment	Classification under amended HKAS 32
Share puttable throughout its life at fair value, that is also the most subordinate, does not contain any other obligation, with discretionary dividends based on profits of the issuer	Liability	Equity
Share puttable at fair value, that is not the most subordinate	Liability	Liability
Share puttable at fair value only on liquidation, that is also the most subordinate, but contains a fixed non-discretionary dividend	Liability	Compound (part equity, part liability)
Share puttable at fair value only on liquidation, that is also the most subordinate, but contains a fixed discretionary dividend and does not contain any other obligation	Liability	Equity
Any of the instruments described above issued by a subsidiary held by non-controlling parties, in the consolidated financial statements	Liability	Liability

Even though the amendments permit certain instruments that were previously presented as financial liabilities to now be presented as equity, derivatives over such equity instruments may not be presented as equity.

Puttable instruments and instruments puttable only on liquidation that are classified as equity in the separate or individual financial statements of the issuing entity and represent non-controlling interests should be classified as financial liabilities in the consolidated financial statements of the group.

HKAS 32.25

2.4.2 Financial instruments with contingent settlement provisions

The settlement of some financial instruments depends on events which are beyond the control of both the holder and issuer of the instrument:

(a) The occurrence or non-occurrence of uncertain future events
(b) The outcome of uncertain circumstances

For example, an entity might have to deliver cash instead of issuing equity shares. In this situation it is not immediately clear whether the entity has an equity instrument or a financial liability.

Such financial instruments should be classified as **financial liabilities** unless the possibility of settlement is remote.

HKAS 32.26

2.4.3 Financial instruments with settlement options

When a derivative financial instrument gives one party a **choice** over how it is settled (e.g., the issuer can choose whether to settle in cash or by issuing shares) the instrument is a **financial asset** or a **financial liability** unless **all the alternative choices** would result in it being an equity instrument.

HKAS 32.28,29,32

2.4.4 Compound financial instruments

Topic highlights

Compound instruments are split into equity and liability parts and presented accordingly in the statement of financial position.

Where a financial instrument contains both a liability and an equity element, HKAS 32 requires that these component parts are classified separately according to the substance of the contractual arrangement and the definitions of a financial liability and an equity instrument.

A common type of compound instrument is **convertible debt**. On the issue of such debt, the holder is granted an option to convert it into an equity instrument (usually ordinary shares) of the issuer rather than redeem it. This is the economic equivalent of the issue of conventional debt plus a warrant to acquire shares in the future.

In this case the instrument is presented as part liability, part equity, and the usual way to calculate the split is to:

(a) calculate the value for the liability component based on similar instruments with no conversions rights, and

(b) deduct this from the instrument as a whole to leave a residual value for the equity component.

The reasoning behind this approach is that an entity's equity is its residual interest in its assets amount after deducting all its liabilities.

The **sum of the carrying amounts** assigned to liability and equity will always be equal to the carrying amount that would be ascribed to the instrument **as a whole**.

The following example should make this split clearer.

Example: Valuation of compound instruments

Strauss Co. issues 1,000 convertible bonds at the start of 20X0. The bonds have a three-year term, and are issued at par with a face value of $2,500 per bond, giving total proceeds of $2,500,000. Interest is payable annually in arrears at a nominal annual interest rate of 5%. Each bond is convertible at any time up to maturity into 300 common shares.

When the bonds are issued, the prevailing market interest rate for similar debt without conversion options is 8%. At the issue date, the market price of one common share is $2. The dividends expected over the three-year term of the bonds amount to 11 cents per share at the end of each year. The risk-free annual interest rate for a three-year term is 4%.

Required

What is the value of the equity component in the bond issue?

Solution

The liability component is valued first, and the difference between the proceeds of the bond issue and the fair value of the liability is assigned to the equity component. The present value of the liability component is calculated using a discount rate of 8%, the market interest rate for similar bonds having no conversion rights, as shown.

	$
Present value of the principal: $2,500,000 payable at the end of three years ($\$2.5m \times 1/1.08^3$)*	1,985,000
Present value of the interest: $125,000 payable annually in arrears for three years ($\$125,000 \times (1/1.08 + 1/1.08^2 + 1/1.08^3)$)	322,137
Total liability component	2,307,137
Equity component (balancing figure)	192,863
Proceeds of the bond issue	2,500,000

*** Note.** Both the present value figures can be found using tables using an 8% discount factor for the principal of 0.794 and for the interest of 2.577. In the case of the second (present value of the interest), if tables are used, the present value is $322,125, giving an equity component balancing figure of $192,875. The difference is due to rounding.

The split between the liability and equity components remains the same throughout the term of the instrument, even if there are changes in the **likelihood of the option being exercised**. This is because it is not always possible to predict how a holder will behave. The issuer continues to have an obligation to make future payments until conversion, maturity of the instrument or some other relevant transaction takes place.

Self-test question 3

On 1 January 20X1, an entity issued 100,000 6% convertible bonds at their par value of $20 each. The bonds will be redeemed on 1 January 20X6. Each bond is convertible at the option of the holder at any time during the five-year period. Interest on the bond will be paid annually in arrears.

The prevailing market interest rate for similar debt without conversion options at the date of issue was 8%.

Required

At what value should the equity element of the hybrid financial instrument be recognised in the financial statements of the entity at the date of issue?

(The answer is at the end of the chapter)

Convertible debt instruments where conversion is at the option of the issuing entity are not compound instruments and do not require the split-accounting approach described above. Instead, such instruments are accounted for as a liability in their entirety.

HKAS 32.16

2.4.5 Rights issues

A 2009 amendment to HKAS 32 (effective for periods starting on or after 1 February 2010) requires that **rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments.**

This is a very narrow amendment and does not extend to other instruments that grant the holder the right to purchase the entity's own equity instruments such as the conversion feature in convertible bonds.

Example: Rights issue

Background

On 1 December 20X2, ABC offered all of its existing shareholders rights to acquire one new common share for every three common shares held at a price of $15 per share. ABC's functional currency is Y, and ABC has only one class of shares outstanding. There were a total of 3,000 rights offered and they initially traded at $2 each.

The rights were subject to expiry on 31 December 20X2 and were fully subscribed on that date. On 31 December 20X2, the common share price was $18 per share and the closing fair value of the rights was $3 per share (i.e. $18 – $15).

Exchange rate: $/Y = 1.5/1

Accounting treatment prior to amendment

The rights offered in $ would have been accounted for as derivative liabilities. On 1 December 20X2, a liability of Y4,000 ($2 × 3,000 ÷ 1.5) would have been recognised with a corresponding debit to equity, representing the distribution of the rights to common shareholders. Subsequently, the liability would have been re-measured at fair value, increasing to Y6,000 (3,000 × $3 ÷ 1.5), and a loss of Y2,000 (Y6,000 – Y4,000) would have been recognised in profit or loss. On exercise of the rights, the cash proceeds of Y30,000 ($15 × 3,000 ÷ 1.5) and the closing fair value of the rights of Y6,000 would have been credited to equity.

Accounting treatment after the amendment

The rights offered in $ would be classified as equity. Hence, no liability or gain or loss would be recognised in respect of the rights. On exercise of the rights, the cash proceeds of $30,000 would be credited to equity.

Journal entries for accounting treatment prior to amendment

		Y	Y
1 December 20X2			
DEBIT	Equity (statement of changes in equity)	4,000	
CREDIT	Derivative liability		4,000
Being the issue of rights			
31 December 20X2			
DEBIT	Profit or loss	2,000	
CREDIT	Derivative liability		2,000
Being the remeasurement of the liability to fair value			
31 December 20X2			
DEBIT	Derivative liability	6,000	
	Cash	30,000	
CREDIT	Equity		36,000
Being the exercise of rights in full			

Journal entries for accounting treatment after the amendment

		Y	Y
31 December 20X2			
DEBIT	Cash	30,000	
CREDIT	Equity		30,000
Being the exercise of rights in full			

HKAS 32.42

2.5 Offsetting a financial asset and a financial liability

Financial assets and liabilities are normally presented separately in the statement of financial position. A financial asset and financial liability should **only** be **offset**, with the net amount reported in the statement of financial position, when an entity:

(a) has a legally enforceable right of set off

(b) intends to settle on a net basis, or to realise the asset and settle the liability simultaneously, i.e. at the same moment

This will reflect the expected **future cash flows** of the entity in these specific circumstances. In all other cases, financial assets and financial liabilities are presented separately.

HKAS 32.AG38A-F

An amendment was made to HKAS 32 in December 2011 in order to clarify the existing offsetting rules as detailed above.

- In order to result in the offset of a financial asset and financial liability, a right of set-off must be available immediately rather than being contingent on a future event.
- The right of set-off must be exercisable by either counterparty.

The amendment also clarified situations which may be classified as simultaneous realisation of an asset and settlement of a liability.

HKAS 32.35

2.6 Interest, dividends, losses and gains

Topic highlights

Interest, dividends, losses and gains are treated according to whether they relate to an equity instrument or a financial liability.

The HKAS 32 guidance considered so far all relates to the classification of financial instruments for presentation in the statement of financial position. The standard also considers how financial instruments are presented in the statement of profit or loss and other comprehensive income and statement of changes in equity:

Financial liabilities	Equity instruments
Interest, dividends, gains and losses are recognised in profit or loss.	Dividends are recognised directly in equity (and so disclosed in the statement of changes in equity). Transaction costs are a deduction from equity.

You should look at the requirements of **HKAS 1** *Presentation of Financial Statements* for further details of disclosure, and **HKAS 12** *Income Taxes* for disclosure of tax effects.

2.7 Section summary

- Financial instruments issued to raise capital must be classified as **liabilities** or **equity**.
- The **substance** of the financial instrument is more important than its **legal form**.
- The **critical feature of a financial liability** is the contractual obligation to deliver cash or another financial instrument.
- **Compound instruments** are split into equity and liability parts and presented accordingly.
- **Interest, dividends, losses and** gains are treated according to whether they relate to an equity instrument or a financial liability.

3 HKFRS 9: Recognition of financial instruments

Topic highlights

HKFRS 9 applies to the recognition of financial assets and liabilities.

The guidance on recognition of financial instruments now comes from HKFRS 9.

3.1 Scope

All entities are required to apply HKFRS 9 to all types of financial instruments with the exception of the following:

(a) Investments in **subsidiaries, associates, and joint ventures** that are accounted for under **HKASs 27, 28** and **31**.

(b) **Leases** covered in **HKAS 17**.

(c) **Employee benefit plans** covered in **HKAS 19**.

(d) **Insurance contracts**.

(e) Equity instruments **issued by the entity** e.g. ordinary shares issued, or options and warrants.

(f) **Financial guarantee** contracts.

(g) **Contracts for contingent consideration** in a business combination, covered in **HKFRS 3**.

(h) Contracts requiring payment based on climatic, geological or other **physical variables**.

(i) **Loan commitments** that cannot be settled net in cash or another financial instrument.

(j) Financial instruments, contracts and obligations under **share-based payment transactions,** covered in **HKFRS 2**.

HKFRS 9, 3.1.1

3.2 Initial recognition

Topic highlights

Financial instruments are recognised when the entity becomes a party to the contractual provisions of the instrument.

Financial assets are classified as measured at amortised cost or fair value. Financial liabilities are classified at fair value through profit or loss or amortised cost.

HKFRS 9 requires that financial instruments are recognised in the statement of financial position when the entity becomes a party to the **contractual provisions of the instrument**.

Notice that this is **different** from the recognition criteria in the *Conceptual Framework* and in most other standards. Items are normally recognised when there is a probable inflow or outflow of resources and the item has a cost or value that can be measured reliably.

HKFRS 9, 4.1.1-4.1.2

3.2.1 Classification of financial assets

On recognition, HKFRS 9 requires that financial assets are classified as measured at either:

- amortised cost, or
- fair value

This classification is made on the basis of both:

(a) the entity's business model for managing the financial assets, and
(b) the contractual cash flow characteristics of the financial asset.

A financial asset is classified as measured at amortised cost where:

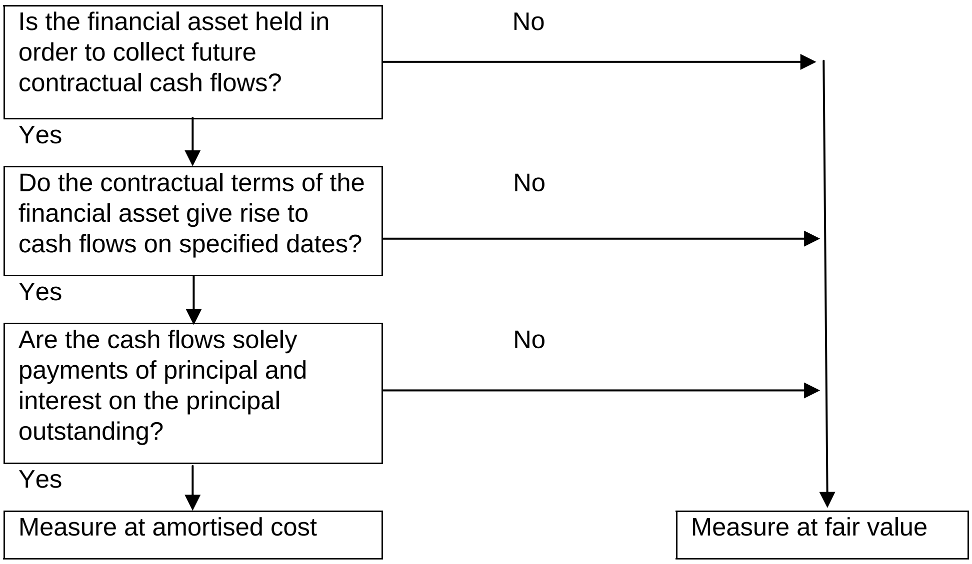
(a) the objective of the business model within which the asset is held is to hold assets in order to collect contractual cash flows, and

(b) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal outstanding.

An application of these rules means that equity investments may not be classified as measured at amortised cost and must be measured at fair value. This is because contractual cash flows on specified dates are not a characteristic of equity instruments. In addition, all derivatives are measured at fair value.

A debt instrument may be classified as measured at either amortised cost or fair value depending on whether it meets the criteria above. Even where the criteria are met at initial recognition, a debt instrument may be classified as measured at fair value through profit or loss if doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an "accounting mismatch") that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases.

The following decision tree may help you to classify financial assets in accordance with HKFRS 9:



Note that the HKFRS 9 requirement to classify financial assets on recognition as one of two types is a significant simplification of the previous HKAS 39 rules. These required financial assets to be classified as one of four types, being:

- at fair value through profit or loss
- held to maturity
- available for sale, and
- loans and receivables

HKFRS 9, 4.2.1

3.2.2 Classification of financial liabilities

On initial recognition, HKFRS 9 requires that financial liabilities are classified as either:

(a) at fair value through profit or loss, or
(b) financial liabilities at amortised cost

A financial liability is classified at fair value through profit or loss if:

(a) it is held for trading, or
(b) upon initial recognition it is designated at fair value through profit or loss.

Derivatives are always measured at fair value through profit or loss.

These classification rules are unchanged from those previously contained within HKAS 39.

HKFRS 9, 4.4.1-4.4.2

3.3 Reclassification of financial assets

Topic highlights

Financial assets may be reclassified from one category to another in certain circumstances.

Although on initial recognition financial assets must be classified in accordance with the requirements of HKFRS 9, in some cases they may be subsequently reclassified.

When an entity changes its business model for managing financial assets, it should reclassify all affected financial assets. This reclassification applies only to debt instruments, as equity instruments must be classified as measured at fair value.

HKFRS 9 prohibits the reclassification of financial liabilities.

HKFRS 9, 3.2.3-3.2.6

3.4 Derecognition

Topic highlights

Financial assets should be derecognised when the **rights to the cash flows** from the asset **expire** or where **substantially all the risks and rewards of ownership are transferred** to another party.

Financial liabilities should be de-recognised when they are extinguished.

HKFRS 9 now provides the rules with regard to derecognition. Derecognition refers to the removal of a previously recognised financial instrument from an entity's statement of financial position.

3.4.1 Derecognition of financial assets

A financial asset should be derecognised by an entity when:

(a) the **contractual rights** to the cash flows from the financial asset **expire, or**
(b) the entity **transfers substantially all the risks and rewards of ownership** of the financial asset to another party

HKFRS 9 includes the following examples of the transfer of substantially all risks and rewards of ownership:

- An unconditional sale of a financial asset
- A sale of a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase

The standard also provides examples of situations where the risks and rewards of ownership have not been transferred:

- A sale and repurchase transaction where the repurchase price is a fixed price or the sale price plus a lender's return

- A sale of a financial asset together with a total return swap that transfers the market risk exposure back to the entity
- A sale of short-term receivables in which the entity guarantees to compensate the transferee for credit losses that are likely to occur.

3.4.2 Derecognition of financial liabilities

A financial liability is derecognised when it is extinguished i.e. when the obligation specified in the contract is discharged or cancelled or expires.

Where an existing borrower and lender of debt instruments exchange one financial instrument for another with substantially different terms, this is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

Similarly, a substantial modification of the terms of an existing financial liability or a part of it should be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

For this purpose, a modification is "substantial" where the discounted present value of cash flows under the new terms, discounted using the original effective interest rate, is at least 10% different from the discounted present value of the cash flows of the original financial liability.

The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, shall be recognised in profit or loss.

Example: Derecognition

A number of years ago Beijing Company issued loan stock with the following terms:

- Interest to be paid annually in arrears at a rate of 5.5%
- Loan to be repaid on 31 December 20X7

Taking into account the transaction costs, the effective interest rate was 6%. Beijing had paid all interest and capital due up to 31 December 20X1, and at that date the carrying amount of the loan was $10 million.

During 20X1, the worldwide economic recession caused Beijing to suffer financial difficulties, and an agreement to revise the terms of the loan stock from 20X2 onwards was reached with lenders. The revised terms included an extension to the term of the loan and an increase to the coupon rate.

The effective interest rate of the revised terms, excluding transaction costs was 8% per annum.

The present value of the cash flows, excluding transaction costs, under the revised terms was $10.5 million at 6% and $9.5 million at 8%.

Transaction costs of $700,000 were payable on 1 January 20X2 in respect of the negotiations for the revised terms.

How should the revision to the terms of the loan be treated in Beijing's financial statements?

Solution

The revised terms negotiated by Beijing are such that the original loan should be derecognised and a new financial liability recognised.

Derecognition of the old loan and recognition of the new liability is required if the present value of the cash flows under the new terms is 10% or more different from the present value of the original loan. The cash flows under the new terms must be discounted at the 6% effective interest rate of the original loan and include the $700,000 transaction costs.

HKFRS 9.B3.3.6

With transaction costs payable at the start of the period of the revised terms, they are added on in full to the $10.5m present value, giving a total of $11.2m. This is 12% different from the $10.0m present value of the old loan, so the original loan should be derecognised and the new financial liability recognised.

Self-test question 4

Discuss whether the following financial instruments would be derecognised.

(a) ABC sells an investment in shares, but retains a call option to repurchase those shares at any time at a price equal to their current market value at the date of repurchase.

(b) DEF enters into a stocklending agreement where an investment is lent to a third party for a fixed period of time for a fee.

(c) XYZ sells title to some of its receivables to a debt factor for an immediate cash payment of 90% of their value. The terms of the agreement are that XYZ has to compensate the factor for any amounts not recovered by the factor after six months.

(The answer is at the end of the chapter)

A financial liability which is extinguished i.e., when the obligation specified in the contract is discharged or cancelled or expires, should be derecognised by an entity.

HKFRS 9, 3.2.2

3.4.3 Partial derecognition

Partial derecognition of a financial asset or liability is possible on condition that the derecognised part comprises only:

(a) identifiable cash flows
(b) a share of the total cash flows on a fully proportionate (pro rata) basis

For example, a holder of bonds has the right to two separate sets of cash inflows: those relating to the principal and those relating to the interest. It could retain the right to receive the principal and sell the right to receive interest to another party.

Where only part of a financial asset is derecognised, the carrying amount of the asset should be allocated between the part retained and the part transferred based on their relative fair values on the date of transfer. A gain or loss should be recognised based on the proceeds for the portion transferred.

On derecognition, the amount to be included in net profit or loss for the period is calculated as follows:

	$	$
Carrying amount of asset/liability (or the portion of asset/liability) transferred		X
Less: proceeds received/paid	X	
any cumulative gain or loss reported as other comprehensive income	X	
		(X)
Profit or loss		X

3.5 Section summary

- HKFRS 9 applies to the recognition of financial assets and liabilities. Financial instruments are recognised when the entity becomes a party to the contractual provisions of the instrument.
- Financial assets are classified as measured at amortised cost or fair value; financial liabilities are classified at fair value through profit or loss or amortised cost.
- Financial assets may be reclassified from one category to another in certain circumstances. Financial liabilities may not be reclassified.

- Financial assets should be derecognised when the **rights to the cash flows** from the asset **expire** or where **substantially all the risks and rewards of ownership are transferred** to another party.
- Financial liabilities should be derecognised when they are extinguished.

4 HKFRS 9: Measurement of financial instruments

Topic highlights

Financial instruments are initially measured at fair value. Transaction costs increase this amount for financial assets classified as measured at amortised cost and decrease this amount for financial liabilities classified as measured at amortised cost.

The classification of financial assets and financial liabilities is of particular importance in terms of how they are measured throughout their life.

HKFRS 9, 5.1.1, 5.1.2A

4.1 Initial measurement

Financial assets

HKFRS 9 requires that financial assets are initially measured at the transaction price, i.e. the fair value of consideration given, except where part of the consideration given is for something other than the financial asset. In this case the financial asset is initially measured at fair value evidenced by a quoted price in an active market for an identical asset (i.e. an HKFRS 13 level 1 input) or based on a valuation technique that uses only data from observable markets. The difference between the fair value at initial recognition and the transaction price is recognised as a gain or loss.

In the case of financial assets classified as measured at amortised cost, transaction costs directly attributable to the acquisition of the financial asset increase this amount.

Financial liabilities

HKFRS 9 requires that financial liabilities are initially measured at transaction price, i.e. the fair value of consideration received except where part of the consideration received is for something other than the financial liability. In this case the financial liability is initially measured at fair value determined as for financial assets (see above). Transaction costs are deducted from this amount for financial liabilities classified as measured at amortised cost.

HKFRS 9, 5.2.1

4.2 Subsequent measurement of financial assets

Topic highlights

Financial assets are subsequently measured at:

- fair value with changes in value normally recognised in profit or loss, or
- amortised cost with interest recognised in profit or loss.

As the classifications suggest, financial assets are measured, subsequent to initial recognition at:

- fair value, or
- amortised cost.

HKFRS 13.76,81,86

4.2.1 Financial assets measured at fair value

Where a financial asset is classified as measured at fair value, fair value is established at each period end in accordance with HKFRS 13 *Fair Value Measurement*. That standard requires that a fair value hierarchy is applied with three levels of input:

Level 1 inputs	Unadjusted quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date.
Level 2 inputs	Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. These may include quoted prices for similar assets or liabilities in active markets or quoted prices for identical or similar assets and liabilities in markets that are not active.
Level 3 inputs	Unobservable inputs for the asset or liability.

Any changes in fair value are normally recognised in profit or loss. There is an exception to this rule where the financial asset is an investment in an equity instrument not held for trading. In this case the entity can make an irrevocable election to recognise changes in the fair value in other comprehensive income.

Example: Asset measurement

On 6 November 20X3 Stripe Co. acquires a listed equity investment with the intention of holding it in the long term. The investment cost $500,000. At Stripe Co.'s year end of 31 December 20X3, the market price of an identical investment is $520,000. How is the asset initially and subsequently measured?

Stripe Co. has elected to present the equity investment in other comprehensive income.

Solution

- The asset is initially recognised at the fair value of the consideration, being $500,000
- At the period end it is remeasured to $520,000
- This results in the recognition of $20,000 in other comprehensive income.

HKAS 39.9

4.2.2 Financial assets measured at amortised cost

HKFRS 9 does not itself define amortised cost, however it does refer to the definition of this and other relevant terms within HKAS 32 and HKAS 39. The example which follows the definitions will help you to understand their application.

Key terms

Amortised cost of a financial asset or financial liability is the amount at which the financial asset or liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectability.

The **effective interest method** is a method of calculating the amortised cost of a financial instrument and of allocating the interest income or interest expense over the relevant period. The **effective interest rate** is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument to the net carrying amount of the financial asset or liability. (*HKAS 39*)

Example: Financial asset measured at amortised cost

On 1 January 20X5 Abacus Bee Co. (ABC) purchases a debt instrument for its fair value of $100,000. The debt instrument is due to mature on 31 December 20X9. The instrument has a principal amount of $125,000 and the instrument carries fixed interest at 4.72% that is paid annually. (The effective interest rate is 10%.)

How should ABC account for the debt instrument over its five-year term?

Solution

ABC will receive interest of $5,900 (125,000 × 4.72%) each year and $125,000 when the instrument matures.

ABC must allocate the discount of $25,000 and the interest receivable over the five-year term at a constant rate on the carrying amount of the debt. To do this, it must apply the effective interest rate of 10%.

The following table shows the allocation over the years:

Year	*Amortised cost at beginning of year*	*Profit or loss: Interest income for year (@10%)*	*Interest received during year (cash inflow)*	*Amortised cost at end of year*
	$	$	$	$
20X5	100,000	10,000	(5,900)	104,100
20X6	104,100	10,410	(5,900)	108,610
20X7	108,610	10,861	(5,900)	113,571
20X8	113,571	11,357	(5,900)	119,028
20X9	119,028	11,872	(125,000 + 5,900)	–

Each year the carrying amount of the financial asset is increased by the interest income for the year and reduced by the interest actually received during the year.

Investments whose **fair value cannot be reliably measured** should be measured at **cost**.

Note that interest income is recognised in profit or loss each year, being the amount of interest actually received plus the interest income related to the winding up of the financial asset to its redemption value.

4.2.3 "Old" rules for subsequent measurement of financial assets

As we have already said, HKFRS 9 has superseded HKAS 39 in respect of providing guidance for the accounting for financial assets. An understanding of the "old" rules with regard to subsequent accounting for financial assets will help you to understand the reduction in complexity afforded by the introduction of HKFRS 9.

Old HKAS 39 Category	Measured at	Gains and losses
Financial asset at fair value through profit or loss	Fair value	Profit or loss
Available for sale financial asset	Fair value	Other comprehensive income
Financial asset held to maturity	Amortised cost	Profit or loss
Loans and receivables	Amortised cost	Profit or loss

While the treatment under HKAS 39 seems very similar to that under HKFRS 9, the initial classification of each financial instrument was more complex as certain instruments could fall into more than one category or indeed fall foul of strict classification rules after initial classification and have to be reclassified.

The transition to HKFRS 9 must be applied retrospectively, although the business model assessment need only be made on the date of initial application of the new standard.

Self-test question 5

St Ives purchased a $20 million 6% debenture at par on 1 January 20X1 when the market rate of interest was 6%. Interest is paid annually on 31 December. The debenture is redeemable at par on 31 December 20X2.

The market rate of interest on debentures of equivalent term and risk changed to 7% on 31 December 20X1.

Required

Show the charge or credit to profit or loss for each of the two years to 31 December 20X2 if the debentures are classified as:

(a) financial assets at amortised cost.
(b) financial assets at fair value through profit or loss.

Fair value is to be calculated using discounted cash flow techniques.

(The answer is at the end of the chapter)

HKFRS 9, 5.3.1

4.3 Subsequent measurement of financial liabilities

Topic highlights

Financial liabilities are subsequently measured at fair value or amortised cost with gains and losses recognised in profit or loss.

Except for financial liabilities at fair value through profit or loss (including most derivatives), all financial liabilities should be recognised and measured at amortised cost. The exceptions should be measured at fair value. However, if the fair value cannot be measured reliably, they should then be measured at cost.

4.3.1 Financial liabilities measured at amortised cost

The definitions seen above in relation to financial assets at amortised cost remain relevant here. Again, their application is best seen through examples.

Example: Finance cost

On 1 January 20X5 a company issued $200,000 loan notes. Issue costs were $320. The loan notes do not carry interest, but are redeemable at a premium of $41,613 on 31 December 20X6. The effective finance cost of the loan notes is 10%.

What is the finance cost in respect of the loan notes for the year ended 31 December 20X6, and what is the carrying amount of the loan notes at that date?

Solution

The premium on redemption of the loan notes represents a finance cost. The effective rate of interest must be applied so that the debt is measured at amortised cost.

At the time of issue, the loan notes are recognised at their net proceeds of:

$199,680 (200,000 – 320).

The finance cost for the year ended 31 December 20X6 is calculated as follows:

	B/f	*Interest @ 10%*	*C/f*
	$	$	$
20X5	199,680	19,968	219,648
20X6	219,648	21,965	241,613

Self-test question 6

On 1 January 20X2, an entity issued a debt instrument with a coupon rate of 5% at a par value of $1,000,000. The directly attributable costs of issue were $30,000. The debt instrument is repayable on 31 December 20X8 at a premium of $260,000.

Required

What is the total amount of the finance cost associated with the debt instrument?

A $294,000
B $318,000
C $514,000
D $640,000

(The answer is at the end of the chapter)

Self-test question 7

Grumble Co. issues a bond for $839,619 on 1 January 20X2. No interest is payable on the bond, but it will be held to maturity and redeemed on 31 December 20X4 for $1m. The bond has not been designated as at fair value through profit or loss.

Required

Calculate the charge to profit or loss of Grumble Co. for the year ended 31 December 20X2 and the balance outstanding at 31 December 20X2.

(The answer is at the end of the chapter)

HKFRS 9, 5.7.1

4.3.2 Financial liabilities at fair value through profit or loss

Financial liabilities which are held for trading and classified as fair value through profit or loss are remeasured to fair value each year in accordance with HKFRS 13 (see section 4.2.1) with any gain or loss recognised in profit or loss.

HKFRS 9 B5.7.16

HKFRS 9 requires that financial liabilities which are designated as measured at fair value through profit or loss are treated differently. In this case the gain or loss in a period must be classified into:

- gain or loss resulting from credit risk; and
- other gain or loss.

The gain or loss resulting from credit risk is established either:

1. as the amount of change in the fair value that is not attributable to changes in market conditions giving rise to market risk, or
2. using an alternative method which an entity believes to more faithfully represent changes in value due to credit risk.

The gain or loss as a result of credit risk is recognised in other comprehensive income, unless it creates or enlarges an accounting mismatch (in which case it is recognised in profit or loss). The other gain or loss is recognised in profit or loss.

On derecognition any gains or losses recognised in other comprehensive income are **not** recycled to profit or loss.

HKFRS 9, 3.1.2-3.1.6, Appendix A

4.4 Trade date v settlement date accounting

A regular way purchase or sale of financial assets shall be recognised and derecognised using trade date accounting or settlement date accounting.

Key terms

A **regular way purchase or sale** is a purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned.

HKFRS 9 refers to two methods of accounting, being **trade date** and **settlement date accounting**. An entity shall apply the same method consistently for all purchase and sales of financial assets that are classified in the same way in accordance with HKFRS 9. For this purpose, assets that the definition of held for trading form a separate classification from assets designated as measured at fair value through profit or loss. In addition, investments in equity instruments accounted for using the option provided in HKFRS 9 (irrevocable election to present in other comprehensive income subsequent changes in the fair value of an investment in an equity instrument) form a separate classification.

The **trade date** is the date on which an entity commits to purchase or sell an asset, and trade date accounting results in:

- the recognition of an asset to be received and liability to pay for it on the trade date, and
- the derecognition of an asset to be sold and corresponding receivable on the trade date (together with any gain or loss).

The **settlement date** is the date on which an asset is delivered to or by an entity, and settlement date accounting results in:

- the recognition of an asset on the settlement date and
- the derecognition of an asset on the settlement date.

When trade date accounting is used interest does not start to accrue until the settlement date when title passes.

When settlement date accounting is used:

(a) An asset subsequently measured at amortised cost is recognised initially at its fair value on the trade date.

(b) Any change in the fair value of the asset to be received between the trade and settlement date is not recognised for assets measured at amortised cost.

(c) Any change in the fair value of the asset to be received between the trade and settlement date is recognised in profit or loss or other comprehensive income for assets measured at fair value.

Example: Trade date and settlement date accounting

Gaylord entered into a contractual commitment on 27 December 20X4 to purchase a financial asset for $1,000. On 31 December 20X4, the entity's reporting date, the fair value was $1,005. The transaction was settled on 5 January 20X5 when the fair value was $1,007. The entity has classified the asset as at fair value through profit or loss.

Required

How should the transactions be accounted for under trade date accounting and settlement date accounting?

Solution

Trade date accounting

- On 27 December 20X4, the entity should recognise the financial asset and the liability to the counterparty at $1,000.
- At 31 December 20X4, the financial asset should be remeasured to $1,005 and a gain of $5 recognised in profit or loss.
- On 5 January 20X5, the liability to the counterparty of $1,000 will be paid in cash. The fair value of the financial asset should be remeasured to $1,007 and a further gain of $2 recognised in profit or loss.

Settlement date accounting

- No transaction should be recognised on 27 December 20X4.
- On 31 December 20X4, a receivable of $5 should be recognised (equal to the fair value movement since the trade date) and the gain recognised in profit or loss.
- On 5 January 20X5, the financial asset should be recognised at its fair value of $1,007. The receivable should be derecognised, the payment of cash to the counterparty recognised and the further gain of $2 recognised in profit or loss.

HKAS 39.58

4.4.1 Impairment and uncollectability of financial assets

Topic highlights

Financial assets measured at amortised cost must be tested for impairment when there is objective evidence of impairment. Any loss is recognised in profit or loss.

At each year end, an entity should assess whether there is any objective evidence that a financial asset or group of assets is impaired. Although HKFRS 9 now applies to the recognition and measurement of financial assets, HKAS 39 continues to provide the guidance on impairments.

Due to the reduced number of classifications of financial assets under HKFRS 9, this area is less complex than it was prior to the issue of the new standard, and only those financial assets classified as measured at amortised cost need be tested for impairment.

Self-test question 8

Can you think of three examples of indications that a financial asset or group of assets may be impaired?

(The answer is at the end of the chapter)

HKAS 39.59-60

4.4.2 Objective evidence of impairment

Where there is objective evidence of impairment, an entity should **determine the amount** of any impairment loss.

It may not be possible to identify a single, discrete event that caused the impairment. Rather the combined effect of several events may have caused the impairment. Losses expected as a result of future events, no matter how likely, are not recognised.

Objective evidence that a financial asset or group of assets is impaired includes observable data that comes to the attention of the holder of the asset about the following events:

(a) Significant financial difficulty of the issuer or obligor.

(b) A breach of contract, such as a default or delinquency in interest or principal payments.

(c) The lender, for economic or legal reasons relating to the borrower's financial difficulty, granting to the borrower a concession that the lender would not otherwise consider.

(d) It becoming probable that the borrower will enter bankruptcy or other financial reorganisation.

(e) The disappearance of an active market for that financial asset because of financial difficulties.

(f) Observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including:

(i) Adverse changes in the payment status of borrowers in the group (e.g. an increased number of delayed payments or an increased number of credit card borrowers who have reached their credit limit and are paying the minimum monthly amount).

(ii) National or local economic conditions that correlate with defaults on the assets in the group (e.g. an increase in the unemployment rate in the geographical area of the borrowers, a decrease in property prices for mortgages in the relevant area, a decrease in oil prices for loan assets to oil producers, or adverse changes in industry conditions that affect the borrowers in the group).

The disappearance of an active market because an entity's financial instruments are no longer publicly traded is not evidence of impairment. A downgrade of an entity's credit rating is not, of itself, evidence of impairment, although it may be evidence of impairment when considered with other available information. A decline in the fair value of a financial asset below its cost or amortised cost is not necessarily evidence of impairment (for example, a decline in the fair value of an investment in a debt instrument that results from an increase in the risk-free interest rate).

HKAS 39.63-65

4.4.3 Impairment of financial assets carried at amortised cost

The impairment loss is the **difference** between the asset's **carrying amount** and its **recoverable amount**. The asset's recoverable amount is the present value of estimated future cash flows, discounted at the financial instrument's **original** effective interest rate.

The amount of the loss should be **recognised in profit or loss**.

If the impairment loss decreases at a later date (and the decrease relates to an event occurring **after** the impairment was recognised) the reversal is recognised in profit or loss. The carrying amount of the asset must not exceed the original amortised cost.

Example: Impairment

Floribunda has a 7% loan receivable of $1m. Interest is payable annually in arrears and the principal is repayable in three years' time. The amortised cost of the loan is $1m. The original effective rate of interest was 7% and the current effective interest rate is 8%.

The borrower is in financial difficulty and Floribunda has granted a concession in that no annual interest is payable and the principal will be repaid in three years' time at a premium of 10%.

Required

Explain how the carrying amount of the loan should be calculated.

Solution

- The financial difficulty of, and the granting of a concession to, the issuer are both objective evidence of impairment.
- The recoverable amount should be calculated as $839,185 by discounting the $1.1m agreed repayment at the original effective interest rate of 7% over a four-year period.
- An impairment loss of $160,815 is therefore recognised in profit or loss.
- In Year 1, interest income of $58,743 (7% × $839,185) should be recognised and the carrying amount of the loan increased to $897,928. This process should be repeated through Years 2 to 4, at which point the loan will be carried at $1.1m immediately prior to repayment.

HKFRS 9, 5.6.1-5.6.3

4.5 Reclassification

Earlier we saw that an entity may reclassify financial assets from one category to another.

Where financial assets are reclassified, that reclassification is applied prospectively from the reclassification date. Previously recognised gains, losses or interest are not restated.

If an entity reclassifies a financial asset so that it is now measured at fair value, its fair value is determined at the reclassification date. Any gain or loss arising from a difference between the previous carrying amount and fair value is recognised in profit or loss.

If an entity reclassifies a financial asset so that it is now measured at amortised cost, its fair value at the reclassification date becomes its new carrying amount.

4.6 Section summary

- Financial instruments are initially measured at fair value. Transaction costs increase this amount for financial assets classified as measured at amortised cost and decrease this amount for financial liabilities classified as measured at amortised cost.
- Financial assets are subsequently measured at:
  - fair value with changes in value normally recognised in profit or loss, or
  - amortised cost with interest recognised in profit or loss.
- Financial liabilities are subsequently measured at fair value or amortised cost with gains and losses recognised in profit or loss.
- Financial assets measured at amortised cost must be tested for impairment when there is objective evidence of impairment. Any loss is recognised in profit or loss.

5 HKFRS 9: Embedded derivatives

Topic highlights

Embedded derivatives are derivative instruments that are embedded within a host contract that may or may not be a financial instrument.

Derivative contracts may be "embedded" in contracts that are not themselves derivatives (and may not be financial instruments). These non-derivatives are known as host contracts, and may comprise:

- leases
- sale or purchase contracts
- insurance contracts
- construction contracts
- a debt or equity instrument

5.1 Examples of embedded derivatives

Possible examples include:

(a) Contingent rentals based on sales included as a term in a lease of retail premises:

"Host" contract	Lease	⇨	Accounted for as normal
Embedded derivative	Contingent rentals	⇨	Treat as derivative, i.e. re-measured to fair value with changes recognised in profit or loss

(b) A bond which is redeemable in five years' time with part of the redemption price based on the increase in the Hong Kong Index.

(c) An embedded derivative caused by changes in the foreign exchange can be found in a construction contract which is priced in a foreign currency.

HKFRS 9, 4.3.2-4.3.4

5.2 Accounting treatment of embedded derivatives

Topic highlights

Where the host contract is within the scope of HKFRS 9 the hybrid contract is accounted for as one instrument. Otherwise, HKFRS 9 requires that the embedded derivative is separated from the host contract where certain conditions are met and accounted for separately.

HKFRS 9 now provides the accounting guidance in relation to embedded derivatives.

Unless the host contract is a financial asset within the scope of the standard, HKFRS 9 requires that an embedded derivative is **separated from its host contract** and accounted for as a derivative when the following conditions are met:

(a) The economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract.

(b) A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative.

(c) The hybrid (combined) instrument is not measured at fair value with changes in fair value recognised in profit or loss (a derivative embedded in a financial liability need not be separated out if the entity holds the combined instrument at fair value through profit or loss).

The host contract is accounted for in accordance with relevant accounting standards.

HKFRS 9, 4.3.2

5.2.1 Financial asset host contract

Where the host contract is a financial asset within the scope of the standard, the classification and measurement rules of the standard are applied to the entire hybrid contract.

This is a simplification of the rules which applied to financial assets as well as other host contracts prior to the issue of HKFRS 9.

HKFRS 9, B4.3.1

5.3 Reassessment of embedded derivatives

As a result of the expansion of HKFRS 9, the contents of HK(IFRIC) Int-9 *Reassessment of Embedded Derivatives* have been incorporated into the standard and the Interpretation itself has been withdrawn.

The standard states that an entity is not permitted to reassess the treatment of an embedded derivative throughout the life of a contract unless there is a significant change to the terms of the contract.

6 HKAS 39: Hedging

Topic highlights

Hedge accounting means designating one or more instruments so that their change in fair value is **offset** by the change in fair value or cash flows of another item.

6.1 Introduction

It is normal business practice for a company to engage in hedging activities in order to reduce their exposure to risk and uncertainty, such as changes in prices, interest rates or foreign exchange rates. For example, an entity may have a fixed amount of foreign currency to pay on a particular date, and hedge against unfavourable exchange rate movements by taking out a forward contract to purchase the currency it needs to meet its obligation from a third party at a particular exchange rate.

In this instance the forward contract is a derivative and so measured at fair value with changes in value recognised in profit or loss. An accounting hedge involves recognising these changes in value at the same time as any opposite gain or loss on a year end revaluation and then settlement of the payable so as to minimise the impact on profit or loss of the transaction. This is an example of a hedge that happens automatically.

HKAS 39 provides the guidance relating to hedging and **requires hedge accounting** where there is a **designated hedging relationship** between a hedging instrument and a hedged item. It is **prohibited otherwise**.

HKAS 39.9

6.2 Definitions

The definitions in HKAS 39 relevant to hedging are given below.

Key terms

Hedging, for accounting purposes, means designating one or more hedging instruments so that their change in fair value is an offset, in whole or in part, to the change in fair value or cash flows of a hedged item.

A **hedged item** is an asset, liability, firm commitment, or forecasted future transaction that:

(a) exposes the entity to risk of changes in fair value or changes in future cash flows, and that

(b) is designated as being hedged.

A **hedging instrument** is a designated derivative or (in limited circumstances) another financial asset or liability whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item. (A non-derivative financial asset or liability may be designated as a hedging instrument for hedge accounting purposes only if it hedges the risk of changes in foreign currency exchange rates.)

Hedge effectiveness is the degree to which changes in the fair value or cash flows of the hedged item attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument. (*HKAS 39*)

Generally only assets, liabilities etc. that involve external parties can be designated as hedged items. The foreign currency risk of an intragroup monetary item (e.g. payable/receivable between two subsidiaries) may qualify as a hedged item in the group financial statements if it results in an exposure to foreign exchange rate gains or losses that are not fully eliminated on consolidation. This can happen (per **HKAS 21**) when the transaction is between entities with different functional currencies.

In addition, the foreign currency risk of a highly probable group transaction may qualify as a hedged item if it is in a currency other than the functional currency of the entity and the foreign currency risk will affect profit or loss.

HKAS 39.86

6.3 Types of hedge

There are three types of hedge covered by HKAS 39:

(a) Fair value hedges, which involve hedging against a change in the value of a recognised asset or liability (the above example involving a foreign currency payable is an example of a fair value hedge)

(b) Cash flow hedges, which involve hedging against a change in the value of future certain cash flows (for example, where an entity is due to receive a payment in foreign currency), and

(c) Net investment hedges, which involves hedging an investment in a foreign group company.

The formal definitions of each type of hedge are as follows:

Key terms

Fair value hedge. A hedge of the exposure to changes in the fair value of a recognised asset or liability, or an identified portion of such an asset or liability, that is attributable to a particular risk and could affect profit or loss.

Cash flow hedge. A hedge of the exposure to variability in cash flows that:

(a) is attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction (such as an anticipated purchase or sale), and that

(b) could affect profit or loss.

Hedge of a net investment in a foreign operation. **HKAS 21** defines a net investment in a foreign operation as the amount of the reporting entity's interest in the net assets of that operation.

(*HKAS 39*)

We shall consider each type of hedge in detail in a moment, but first it is important to understand the conditions for hedge accounting.

HKAS 39.88

6.4 Conditions for hedge accounting

Topic highlights

Hedge accounting is permitted in certain circumstances, provided the hedging relationship is clearly defined, measurable and actually effective.

Before a hedging relationship qualifies for hedge accounting, **all** of the following **conditions** must be met:

(a) The hedging relationship must be formally documented (including the identification of the hedged item, the hedging instrument, the nature of the hedged risk and the assessment of the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk). The hedging relationship must also be designated at its inception as a hedge based on the entity's risk management objective and strategy.

(b) There is an expectation that the hedge is highly effective in offsetting changes in fair value or cash flows ascribed to the hedged risk. (**Note.** The hedge does not have to be *fully* effective.)

(c) For cash flow hedges, it must be highly probable that there is a forecast transaction since such a transaction is the subject of the hedge. In addition, the transaction must present an exposure to variations in cash flows that could eventually affect profit and loss.

(d) Reliable measurement of the effectiveness of the hedge.

(e) The assessment of the hedge is carried out on an ongoing basis (annually) and it has been effective during the reporting period.

Effectiveness

Hedge effectiveness must be tested regularly and must fall within the range 80% to 125%. If it falls outside e.g. 75% or 130%, then hedge accounting cannot be applied. Both the hedged item and hedging instrument will be accounted for based on their respective accounting standard.

$$\text{Hedge effectiveness} = \frac{\text{Change in hedging instrument}}{\text{Change in hedged item}}$$

6.5 Accounting treatment

Topic highlights

There are three types of hedge: fair value hedge; cash flow hedge; hedge of a net investment in a foreign operation. The accounting treatment of a hedge depends on its type.

HKAS 39.89

6.5.1 Fair value hedges

In a fair value hedge, the hedged item is a recognised asset or liability. When hedge accounting is applied, this is remeasured to fair value at the period end in accordance with HKFRS 13 *Fair Value Measurement* and any gain or loss on the hedged item attributable to the **hedged risk is recognised in profit or loss**.

The hedging instrument is a derivative and in accordance with HKAS 39 / HKFRS 9 any **gain or loss** resulting from **re-measuring** the hedging instrument at fair value is also **recognised in profit or loss**.

Example: Fair value hedge (1)

A company owns inventories of 30,000 gallons of oil which cost $660,000 on 1 December 20X8.

In order to hedge the fluctuation in the market value of the oil the company signs a futures contract to deliver 30,000 gallons of oil on 31 March 20X9 at the futures price of $25 per gallon.

The market price of oil on 31 December 20X8 is $27 per gallon and the futures price for delivery on 31 March 20X9 is $30 per gallon.

Required

Explain the impact of the transactions on the financial statements of the company:

(a) without hedge accounting
(b) with hedge accounting.

Solution

The futures contract was intended to protect the company from a fall in oil prices (which would have reduced the profit when the oil was eventually sold). However, oil prices have actually risen, so that the company has made a loss on the contract.

Without hedge accounting

The futures contract is a derivative and therefore must be remeasured to fair value at 31 December 20X8 under **HKAS 39**. The loss on the futures contract is recognised in profit or loss:

		$	$
DEBIT	Profit or loss (30,000 × (30 – 25))	150,000	
CREDIT	Financial liability		150,000

With hedge accounting

The loss on the futures contract is recognised in profit or loss as before, however with hedge accounting, the inventories are also remeasured to fair value:

	$
Fair value at 31 December 20X8 (30,000 × 27)	810,000
Cost	(660,000)
Gain	150,000

The gain is also recognised in profit or loss:

		$	$
DEBIT	Inventory	150,000	
CREDIT	Profit or loss		150,000

With hedging the net effect on profit or loss is zero compared with a loss of $150,000 without hedging.

Example: Fair value hedge (2)

As at 1 January 20X3, a company purchases a debt instrument that has a principal amount of $1 million at a fixed interest rate of 6% per year. The instrument is classified as a financial asset measured at fair value. The fair value of the instrument is $1 million.

The company is exposed to a risk of the decline in the fair value of the instrument if the market interest rate increases because of the fixed interest rate.

The company enters into an interest rate swap. It exchanges the fixed interest rate payments it receives on the bond for floating interest rate payments, in order to offset the risk of a decline in fair value. If the derivative hedging instrument is effective, any decline in the fair value of the bond should be offset by opposite increases in the fair value of the derivative instrument. The company designates and documents the swap as a hedging instrument. On entering into the swap, the swap has a fair value of zero.

Assuming market interest rates have increased to 7%, the fair value of the bond will have decreased to $960,000.

At the same time, the company determines that the fair value of the swap has increased by $40,000. Since the swap is a derivative, it is measured at fair value with changes in fair value recognised in profit or loss. The changes in fair value of the hedged item and the hedging instrument exactly offset each other; the hedge is 100% effective and the net effect on profit or loss is zero.

Required

Explain the impact of the transactions on the financial statements of the company with hedge accounting.

Solution

STATEMENT OF FINANCIAL POSITION

	1 January 20X3		*31 December 20X3*
	$'000	$'000	$'000
Debt instrument (hedged item)	1,000	(40)	960
Derivative asset (hedging instrument)	–	40	40
Cash	(1,000)		

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

	$'000
Loss on debt instrument	(40)
Gain on derivative	40
No ineffectiveness	–

Gains and losses on hedged item and hedging instrument are both taken to the statement of profit or loss.

Example: Fair value hedge (3)

Assuming the information is the same as above. However, the company determines that the fair value of the swap has increased by $45,000 instead of $40,000.

Required

Explain the impact of the transactions on the financial statements of the company.

Solution

$$\text{Hedge effectiveness} = \frac{\text{Change in hedging instrument}}{\text{Change in hedged item}}$$

$$= \frac{\$45{,}000}{\$40{,}000}$$

$$= 112.5\%$$

Hedge effectiveness of 112.5% is still within the window of 80% – 125%. Thus, hedge accounting may be applied.

STATEMENT OF FINANCIAL POSITION

	1 January 20X3		*31 December 20X3*
	$'000	$'000	$'000
Debt instrument (hedged item)	1,000	(40)	960
Derivative asset (hedging instrument)	–	45	45
Cash	(1,000)		

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

	$'000
Loss on debt instrument	(40)
Gain on derivative	45
Ineffective hedge	5

This results in an ineffective hedge of $5,000 gain recognised in profit or loss.

HKAS 39.95

6.5.2 Cash flow hedges

A cash flow hedge involves hedging future cash flows. Initially therefore, only the hedging instrument (the derivative) is recognised.

The part of the gain or loss arising from an **effective** hedge of a hedging instrument is **recognised in other comprehensive income** while the **ineffective portion** of the gain or loss on the hedging instrument should **be recognised in profit and loss**.

In the case where a hedging transaction results in the recognition of a non-financial asset or liability, changes in the value of the hedging instrument recognised in other comprehensive income:

(a) are adjusted against the carrying value of the asset or liability

(b) are reclassified from equity to profit or loss as a reclassification adjustment in the same period or periods during which the hedged forecast cash flows affect profit or loss (such as in the periods that depreciation expense is recognised).

Example: Basic cash flow hedge

Randall Co. expected to purchase an item of plant for 20 million South African Rand in one year's time on 31 August 20X2. In order to offset the risk of movement in the exchange rate, Randall enters into a forward contract to purchase Rand 20 million in one year for a fixed amount ($20,500,000). The forward contract is designated as a cash flow hedge and has an initial fair value of zero.

At the year end (31 December 20X1), the Rand has appreciated and the value of Rand 20 million is $20,650,000. The machine will still cost Rand 20 million so the company concludes that the hedge is 100% effective. Thus the entire change in the fair value of the hedging instrument is recognised directly in other comprehensive income:

		$	$
DEBIT	Forward contract	150,000	
CREDIT	Other comprehensive income		150,000

The effect of the cash flow hedge is to lock in the price of Rand 20 million for the item of plant. The other comprehensive income of $150,000 will either:

(i) be reclassified to profit or loss as the machine is depreciated, or
(ii) be deducted from the initial carrying amount of the machine.

Example: Cash flow hedge

Sparkle is a manufacturer and retailer of gold jewellery.

On 31 October 20X1, the cost of Sparkle's inventories of finished jewellery was $8.280 million with a gold content of 24,000 troy ounces. At that date their sales value was $9.938 million.

The selling price of gold jewellery is heavily dependent on the current market price of gold (plus a standard percentage for design and production costs).

Sparkle's management wished to reduce their business risk of fluctuations in future cash inflow from sale of the jewellery by hedging the value of the gold content of the jewellery. In the past this has proved to be an effective strategy.

Therefore, it sold futures contracts for 24,000 troy ounces of gold at $388 per troy ounce at 31 October 20X1. The contracts mature on 30 October 20X2.

On 30 September 20X2 the fair value of the jewellery was $9.186m and the forward price of gold per troy ounce for delivery on 30 October 20X2 was $352.

Required

Explain how the above transactions would be treated in Sparkle's financial statements for the year ended 30 September 20X2.

Solution

Sparkle is hedging the volatility of the future cash inflow from selling the gold jewellery. The futures contracts can be accounted for as a cash flow hedge in respect of those inflows, providing the criteria for hedge accounting are met.

The gain on the forward contract should be calculated as:

	$
Forward value of contract at 31.10.X1 (24,000 × $388)	9,312,000
Forward value of contract at 30.9.X2 (24,000 × $352)	8,448,000
Gain on contract	864,000

The change in the fair value of the expected future cash flows on the hedged item (which is not recognised in the financial statements) should be calculated as:

	$
At 31.10.X1	9,938,000
At 30.9.X2	9,186,000
	752,000

As this change in fair value is less than the gain on the forward contract, the hedge is not fully effective and only $752,000 of the gain on the forward should be recognised in other comprehensive income. The remainder should be recognised in profit or loss:

		$	$
DEBIT	Financial asset (Forward a/c)	864,000	
CREDIT	Other comprehensive income		752,000
	Profit or loss		112,000

Note that the hedge is still highly effective (and hence hedge accounting should continue to be used):

$864,000/$752,000 = 115% which is within the 80% – 125% range.

Example: Cash flow hedge – interest rate swap

On 1 January 20X1, Arlington Co. lends $10 million to another entity, with a maturity date of three years later on 31 December 20X3. The interest rate attached to the loan is variable at HIBOR + 2%, and interest is due annually on 31 December.

Arlington expects interest rates to decline and so simultaneously enters an interest rate swap on 1 January 20X1 in order to hedge its position.

The terms of the swap are as follows:

- There is no initial cost
- The notional principal is $10 million
- Arlington will receive fixed interest at 7%
- Arlington will pay variable interest at HIBOR
- Net settlement is made annually on 31 December, and the swap is also repriced on this date.

The fair value of the swap, determined by projecting future settlement amounts using the current year's variable rate and discounting these to present value is:

31 December 20X1	$300,000
31 December 20X2	$125,000
31 December 20X3	nil

HIBOR at each of these dates is:

31 December 20X1	7%
31 December 20X2	6%
31 December 20X3	5%

All criteria for cash flow hedge accounting have been met and the hedging relationship is expected to be 100% effective at inception and on an ongoing basis.

What journal entries are required in respect of the loan and cash flow hedge throughout the three-year term?

Solution

The purpose of the cash flow hedge is to fix the interest receivable at 9%. Interest receivable per the terms of the loan agreement is:

31 December 20X1	$10m × (7% + 2%) =	$900,000
31 December 20X2	$10m × (6% + 2%) =	$800,000
31 December 20X3	$10m × (5% + 2%) =	$700,000

The net settlement in respect of the swap on each of these dates is:

Date	*Swap receipt at 7%*	*Swap payment at HIBOR*	*Swap net*
	$	$	$
31 December 20X1	700,000	(700,000)	Nil
31 December 20X2	700,000	(600,000)	100,000
31 December 20X3	700,000	(500,000)	200,000

Therefore, in each of the three years, the total amount of the interest income (i.e. loan interest income + net position on the swap) is $900,000.

The journal entries are as follows:

1 January 20X1

		$	$
DEBIT	Loan receivable	10,000,000	
CREDIT	Cash		10,000,000

To record the inception of the loan.
(**Note**. No entry is required in respect of the swap as it was acquired at no cost)

31 December 20X1

DEBIT	Cash	900,000	
CREDIT	Interest income		900,000

To record the receipt of interest in respect of the loan.

DEBIT	Interest rate swap	300,000	
CREDIT	Other comprehensive income		300,000

To record the fair value of the interest rate swap.

31 December 20X2

DEBIT	Cash	800,000	
CREDIT	Interest income		800,000

To record the receipt of interest in respect of the loan.

DEBIT	Cash	100,000	
CREDIT	Other comprehensive income		100,000

To record the cash received on net settlement of the interest rate swap.

DEBIT	Other comprehensive income	100,000	
CREDIT	Interest income		100,000

To recycle into earnings amounts in OCI on account of the cash flow hedge, so that they are matched with the relevant cash flow.

DEBIT	Other comprehensive income	175,000	
CREDIT	Interest rate swap		175,000

To reduce the carrying value of the interest rate swap from its initial fair value of $300,000 to current fair value of $125,000.

31 December 20X3

DEBIT	Cash	700,000	
CREDIT	Interest income		700,000

To record the receipt of interest in respect of the loan.

DEBIT	Cash	200,000	
CREDIT	Other comprehensive income		200,000

To record the cash received on net settlement of the interest rate swap.

DEBIT	Other comprehensive income	200,000	
CREDIT	Interest income		200,000

To recycle into earnings amounts in OCI on account of the cash flow hedge, so that they are matched with the relevant cash flow.

DEBIT	Other comprehensive income	125,000	
CREDIT	Interest rate swap		125,000

To adjust the carrying value of the interest rate swap to current fair value.

DEBIT	Cash	10,000,000	
CREDIT	Loan receivable		10,000,000

To record repayment of the loan at the maturity date.

HKAS 39.102

6.5.3 Hedges of a net investment

Hedges of a net investment arise in the consolidated accounts where a parent company takes a foreign currency loan in order to buy shares in a foreign subsidiary. The loan and the investment need not be denominated in the same currency, however assuming that the currencies perform similarly against the parent company's own currency, it should be the case that fluctuations in the exchange rate affect the asset (the net assets of the subsidiary) and the liability (the loan) in opposite ways, hence gains and losses are hedged.

In this type of accounting hedge, the hedging instrument is the foreign currency loan rather than a derivative.

You may understand this type of hedge better after studying Chapter 30, Foreign Currency Transactions, but in a simple sense, without applying hedging rules:

(a) The loan would be retranslated to the parent's own currency at the year end using the spot exchange rate; any resultant gain or loss would be recognised in profit or loss.

(b) Prior to consolidation, the subsidiary's accounts would be translated into the parent's own currency with any gain or loss recognised in other comprehensive income.

(c) On consolidation, the gain or loss on the loan would affect consolidated profit or loss and the loss or gain on the translation of the subsidiary's net assets would affect consolidated reserves.

The net investment hedge ensures that the gains and losses are both recognised in other comprehensive income and accumulated in reserves by:

- recognising the portion of the gain or loss on the hedging instrument that is determined to be effective in other comprehensive income
- recognising the ineffective portion in profit or loss

Any gain or loss recognised in other comprehensive income is reclassified to profit or loss on the disposal or partial disposal of the foreign operation.

6.6 Exposures qualifying for hedge accounting

HKAS 39 was amended in 2008 to clarify what can be designated as a hedged risk and when an entity may designate a portion of the cash flows of a financial instrument as a hedged item.

The **risks specified** are:

- interest rate risk
- foreign currency rate risk
- credit risk
- prepayment risk

The **portions of the cash flows** of a financial instrument that may be designated as a hedged item are one or more of the following:

(a) The cash flows of a financial instrument for part of its time period to maturity.

(b) A percentage of the cash flows of a financial instrument.

(c) The cash flows of a financial instrument associated with a one-sided risk of that instrument.

(d) Any contractually specified cash flows of a financial instrument that are independent from the other cash flows of that instrument.

(e) The portion of the cash flows of an interest bearing financial instrument that is equivalent to a financial instrument with a risk-free rate.

(f) The portion of the cash flows of an interest bearing financial instrument that is equivalent to a financial instrument with a quoted or variable inter-bank rate.

6.7 Recap

- **Hedge accounting** means designating one or more instruments so that their change in fair value is **offset** by the change in fair value or cash flows of another item.
- **Hedge accounting** is permitted in certain circumstances, provided the hedging relationship is **clearly defined**, **measurable** and actually **effective**.
- There are three types of hedge: **fair value** hedge; **cash flow** hedge; hedge of a **net investment in a foreign operation**.
- The accounting treatment of a hedge **depends on its type**.

7 HKFRS 7: Disclosure of financial instruments

Topic highlights

HKFRS 7 specifies the **disclosures** required for financial instruments. In addition, HKFRS 13 disclosures are applied where financial instruments are measured at fair value. HKFRS 7 requires qualitative and quantitative disclosures about exposure to risks arising from financial instruments and specifies minimum disclosures about credit risk, liquidity risk and market risk.

HKFRS 7 was issued in 2005 to replace the disclosure requirements of HKAS 32. In doing so it has revised and enhanced disclosure requirements in response to new techniques and approaches to measuring risk management. The standard requires **qualitative and quantitative disclosures about exposure to risks** arising from financial instruments, and specifies minimum disclosures about **credit risk**, **liquidity risk** and **market risk**.

The HKICPA maintains that users of financial instruments need information about an entity's exposures to risks and how those risks are managed, as this information can **influence a user's assessment of the financial position and financial performance of an entity** or of the amount, timing and uncertainty of its **future cash flows**.

In June 2011 HKFRS 13 *Fair Value Measurement* was issued. As a result, disclosures in relation to financial instruments measured at fair value were relocated from HKFRS 7 to HKFRS 13.

HKFRS 7.1

7.1 Objective

The objective of HKFRS 7 is to require entities to provide disclosures in their financial statements that enable users to evaluate:

(a) the significance of financial instruments for the entity's financial position and performance.

(b) the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the reporting date, and how the entity manages those risks.

The principles in **HKFRS 7** complement the principles for recognising, measuring and presenting financial assets and financial liabilities in HKAS 32 *Financial Instruments: Presentation*, HKAS 39 *Financial Instruments: Recognition and Measurement* and HKFRS 9 *Financial Instruments*.

HKFRS 7.6

7.2 Classes of financial instruments and levels of disclosure

When HKFRS 7 requires disclosures by class of financial instrument, an entity must group financial instruments into classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those financial instruments. Sufficient information should be provided to permit reconciliation to the line items presented in the statement of financial position.

HKFRS 7.7-19

7.3 Statement of financial position disclosures

The following must be disclosed in the notes to the financial statements:

(a) **Carrying amount** of financial assets and liabilities by **HKAS 39 or HKFRS 9** category.

(b) Details of financial instruments designated as at fair value through profit or loss and financial assets designated as at fair value through other comprehensive income.

(c) **Reason for any reclassification** between fair value and amortised cost (and *vice versa*).

(d) The **carrying amount** of financial assets the entity has **pledged as collateral** for liabilities or contingent liabilities and the associated terms and conditions.

(e) When financial assets are impaired by credit losses and the entity records the impairment in a separate account (e.g. an **allowance account** used to record individual impairments or a similar account used to record a collective impairment of assets) rather than directly reducing the carrying amount of the asset, it must disclose a **reconciliation** of changes in that account during the period for each class of financial assets.

(f) The **existence of multiple embedded derivatives**, where compound instruments contain these.

(g) Defaults and breaches.

HKFRS 7.13C

The December 2011 amendment to HKFRS 7 in respect of offsetting financial assets and financial liabilities requires an entity to disclose information about rights of offset and related arrangements. As a minimum the following should be disclosed:

(a) The gross amounts of financial assets and financial liabilities under an enforceable master netting agreement (i.e. an agreement whereby a single net settlement of all financial instruments covered by the arrangement may be made) or similar;

(b) Amounts offset in accordance with the HKAS 32 criteria;

(c) Net amounts presented in the statement of financial position;

(d) Amounts subject to an enforceable master netting agreement not included in (b);

(e) The net amount after deducting (d) from (c).

HKFRS 7.20

7.4 Statement of profit or loss and other comprehensive income disclosures

The entity must disclose the following **items of income, expense, gains or losses**, either on the face of the financial statements or in the notes:

(a) Net gains/losses by **HKAS 39 or HKFRS 9** category (broken down as appropriate: for example, interest, fair value changes, dividend income)

(b) Interest income/expense

(c) Impairment losses by class of financial asset.

HKFRS 7.21

7.5 Other disclosures

Entities must disclose in the summary of **significant accounting policies** the measurement basis used in preparing the financial statements and the other accounting policies that are relevant to an understanding of the financial statements.

HKFRS 7.22-24

7.5.1 Hedge accounting

Disclosures must be made relating to **hedge accounting**, as follows:

(a) Description of hedge.

(b) Description of financial instruments designated as **hedging instruments** and their fair value at the reporting date.

(c) The **nature of the risks** being hedged.

(d) For **cash flow hedges**, periods **when the cash flows will occur** and when they will affect profit or loss.

(e) For fair value hedges, gains or losses on the hedging instrument and the hedged item.

(f) The **ineffectiveness recognised in profit or loss** arising from cash flow hedges and net investments in foreign operations.

HKFRS 7.25, 26,29

7.5.2 Fair value

HKFRS 7 retains the following general requirements in relation to the disclosure of fair value for those financial instruments measured at amortised cost:

(a) For each class of **financial assets** and **financial liabilities** an entity shall disclose the **fair value** of that class of assets and liabilities in a way that permits it to be compared with its carrying amount.

(b) In disclosing **fair values**, an entity shall group **financial assets** and **financial liabilities** into classes, but shall offset them only to the extent that their carrying amounts are offset in the statement of financial position.

It also states that disclosure of fair value is not required where:

- carrying amount is a reasonable approximation of fair value
- for investments in equity instruments that do not have a quoted market price in an active market for an identical instrument, or derivatives linked to such equity instruments

HKFRS 13.91,93, 95, 97

HKFRS 13 provides disclosure requirements in respect of the fair value of financial instruments measured at fair value. It requires that information is disclosed to help users assess:

(a) for assets and liabilities measured at fair value after initial recognition, the valuation techniques and inputs used to develop those measurements.

(b) for recurring fair value measurements (i.e. those measured at each period end) using significant unobservable (level 3) inputs, the effect of the measurements on profit or loss or other comprehensive income for the period.

In order to achieve this, the following should be disclosed as a minimum for each class of financial assets and liabilities measured at fair value (asterisked disclosures are also required for financial assets and liabilities measured at amortised cost but for which fair value is disclosed):

1 The fair value measurement at the end of the period

2 The level of the fair value hierarchy within which the fair value measurements are categorised in their entirety

3 For assets and liabilities measured at fair value at each reporting date (recurring fair value measurements), the amounts of any transfers between level 1 and level 2 of the fair value hierarchy and reasons for the transfers

4 For fair value measurements categorised within level 2 and 3 of the hierarchy, a description of the valuation techniques and inputs used in the fair value measurement, plus details of any changes in valuation techniques

5 For recurring fair value measurements categorised within level 3 of the fair value hierarchy

6 A reconciliation from the opening to closing balances

7 The amount of unrealised gains or losses recognised in profit or loss in the period and the line item in which they are recognised

8 A narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs

9 For recurring and non-recurring fair value measurements categorised within level 3 of the fair value hierarchy, a description of the valuation processes used by the entity.

An entity should also disclose its policy for determining when transfers between levels of the fair value hierarchy are deemed to have occurred.

Example: Fair value disclosures

For assets and liabilities measured at fair value at the end of the reporting period, the HKFRS requires quantitative disclosures about the fair value measurements for each class of assets and liabilities. An entity might disclose the following for assets to comply with points 1 and 2 above:

HK$'000		*Fair value measurements at the end of the reporting period using*		
Description	*31.12.X9*	*Level 1 inputs*	*Level 2 inputs*	*Level 3 inputs*
Trading equity securities	45	45	–	–
Non-trading equity securities	32	–	–	32
Corporate securities	90	9	81	–
Derivatives – interest rate contracts	78	–	78	–
Total recurring fair value measurements	245	54	159	32

7.6 Nature and extent of risks arising from financial instruments

In undertaking transactions in financial instruments, an entity may assume or transfer to another party one or more of **different types of financial risk** as defined below. The disclosures required by the standard show the extent to which an entity is exposed to these different types of risk, relating to both recognised and unrecognised financial instruments.

Credit risk	The risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.
Currency risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.
Interest rate risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates.
Liquidity risk	The risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities.
Loans payable	Loans payable are financial liabilities, other than short-term trade payables on normal credit terms.
Market risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: currency risk, interest rate risk and other price risk.

Other price risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from interest rate risk or currency risk), whether those changes are caused by factors specific to the individual financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market.
Past due	A financial asset is past due when a counterparty has failed to make a payment when contractually due.

HKFRS 7.33

7.6.1 Qualitative disclosures

For each type of risk arising from financial instruments, an entity must disclose:

(a) the **exposures to risk** and how they arise.

(b) its objectives, policies and processes for managing the risk and the methods used to measure the risk.

(c) any changes in (a) or (b) from the previous period.

HKFRS 7.34-38

7.6.2 Quantitative disclosures

For each financial instrument risk, **summary quantitative data** about risk exposure must be disclosed. This should be based on the information provided internally to key management personnel. More information should be provided if this is unrepresentative of an entity's exposure to risk.

Information about **credit risk** must be disclosed by class of financial instrument:

(a) Maximum exposure at the year end without taking account of collateral held or other credit enhancements. (This disclosure is not required where the carrying amount of financial instruments best represents the maximum exposure to credit risk.)

(b) A description of collateral held as security and of other credit enhancements, and their financial effect, in respect of the maximum exposure to credit risk (whether as disclosed in (a) or represented by carrying amount).

(c) Information about the credit quality of financial assets that are neither **past due** nor impaired.

(d) Information about the credit quality of financial assets whose terms have been renegotiated.

(e) An analysis of the age of financial assets that are past due as at the end of the reporting period but not impaired.

(f) An analysis of financial assets that are individually determined to be impaired as at the end of the reporting period, including the factors the entity considered in determining that they are impaired.

(g) Collateral and other credit enhancements obtained during the reporting period and held at the reporting date, including the nature and carrying amount of the assets and policy for disposing of assets not readily convertible into cash.

Example: Credit risk disclosure (1)

An entity holds equity investments in other entities. Its management asserts that the **HKFRS 7** credit risk disclosures are not relevant.

Do the credit risk disclosures required by **HKFRS 7** apply to an entity's holdings of equity investments?

Solution

The definition of equity in **HKAS 32** requires the issuer to have no obligation to pay cash or transfer other assets. It follows that such equity investments are subject to price risk, not credit risk. Most of the **HKFRS 7** credit risk disclosures are not therefore relevant to investments in equity instruments.

However, **HKFRS 7** requires entities to disclose an analysis of financial assets that are impaired. This disclosure is relevant and should be given for impaired equity investments that are available for sale.

Example: Credit risk disclosure (2)

HKFRS 7 defines credit risk as "the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation". If an entity issues a financial guarantee, the financial loss will not result from a default by the other party of the contract (the holder), but from a default by the third party (the debtor). Does this mean that the credit risk of financial guarantees can be excluded from the disclosure of the maximum exposure to credit risk?

Solution

No, the credit risk of financial guarantees should be included in the disclosures, as **HKFRS 7** clarifies that the definition of credit risk includes that arising from financial guarantees.

HKFRS 7.39

7.6.3 Liquidity risk

For **liquidity risk** entities must disclose:

- a maturity analysis of both derivative and non-derivative financial liabilities
- a description of the way risk is managed

Within the maturity analysis, any amounts repayable under a loan agreement that includes a clause giving the lender the unconditional right to demand repayment at any time must be classified in the earliest time bracket.

Example: Liquidity risk (1)

HKFRS 7 requires the disclosure of a maturity analysis for financial liabilities that shows the remaining contractual maturities.

Should the following financial instruments be shown in one maturity bracket, or split across the maturity brackets in which the cash flows occur?

(a) A derivative which has multiple cash flows
(b) A loan which has annual contractual interest payments
(c) A loan which has annual contractual interest and principal repayments

Solution

All the financial instruments should be split across the maturity brackets in which the cash flows occur. The requirement is to disclose each of the contractual payments in the period when they are due (including principal and interest payments). The objective of this particular disclosure is to show the liquidity risk of the entity.

Example: Liquidity risk (2)

HKFRS 7 requires entities to disclose (a) a maturity analysis for financial liabilities that shows the remaining contractual maturities; and (b) a description of how it manages the liquidity risk inherent in (a).

Does this mean that a maturity analysis for financial assets based on remaining contractual maturities, is no longer required?

Solution

Yes, **HKFRS 7** requires a maturity analysis based on the remaining contractual maturity only for financial liabilities. Management can choose to disclose the maturity analysis showing remaining contractual maturity for financial assets also as one of the disclosures to comply with the requirement in HKFRS 7. However, it is not obligatory.

In practice, an entity should disclose a maturity analysis of financial assets and financial liabilities showing expected maturity if this is the information provided to key management personnel to manage the business. However, a maturity analysis based on the remaining contractual maturity for financial liabilities should be disclosed.

HKFRS 7.40-41

7.6.4 Market risk: sensitivity analysis

An entity shall disclose a sensitivity analysis for each type of market risk to which the entity is exposed at the reporting date, showing how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date; the methods and assumptions used in preparing the sensitivity analysis; and changes from the previous period in the methods and assumptions used, and the reasons for such changes.

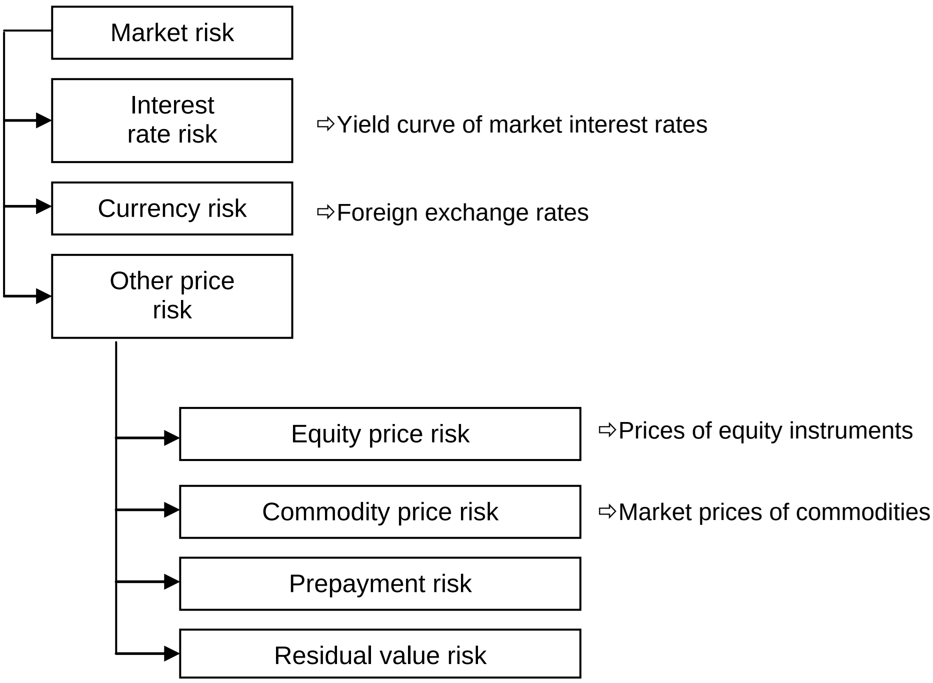
Assuming that a reasonably possible change in the relevant risk variable had occurred at the reporting date and had been applied to the risk exposures in existence at that date:

Disclosures required in connection with **market risk** are:

(a) sensitivity analysis, showing the effects on profit or loss of changes in each market risk.

(b) if the sensitivity analysis reflects interdependencies between risk variables, such as interest rates and exchange rates the method, **assumptions and limitations** must be disclosed.

7.6.5 Risk variables that are relevant to disclosing market risk



7.7 Capital disclosures

Certain disclosures about **capital** are required. An entity's capital does not relate solely to financial instruments, but has more general relevance. Accordingly, those disclosures are included in **HKAS 1**, rather than in **HKFRS 7**.

8 Current developments

8.1 IFRS 9 development

The issue of IFRS 9 (HKFRS 9) and its subsequent expansion in 2010 represent the first stages of the culmination of a long-standing project carried out by the IASB and FASB concerned with reducing the complexity surrounding financial instruments.

HKICPA are following the lead of the IASB and it is intended that HKFRS 9 will ultimately replace HKAS 39 in its entirety. The IASB continue to work on the replacement project and in response to requests from interested parties that the accounting for financial instruments should be improved quickly, the project to replace IAS 39 (and in turn HKAS 39) has been divided into phases.

As each phase is completed, the relevant portions of IAS 39 will be deleted and chapters in IFRS 9 will be created to replace the requirements in IAS 39. As the IASB issues new sections of IFRS 9, HKICPA will adopt these to form HKFRS 9.

Phases 1 and 2 of the project relating to the classification and measurement of financial assets and financial liabilities are now obviously complete.

Phase 3 of the project relates to impairment methodology. The Request for Information on the feasibility of an expected loss model for the impairment of financial assets was published on 25 June 2009. This formed the basis of an Exposure Draft, *Financial Instruments: Amortised Cost and Impairment*, published in November 2009. A supplement to the ED was issued in January 2011 and the topic was re-exposed in March 2013. The latest exposure draft builds upon previous EDs to develop a more forward-looking provisioning model which recognises credit losses on a more timely basis. IAS 39 currently applies an incurred loss model, requiring that credit losses (impairments) are recognised only when a credit loss event has occurred; the ED proposes that credit losses are recognised **before** a credit loss event occurs.

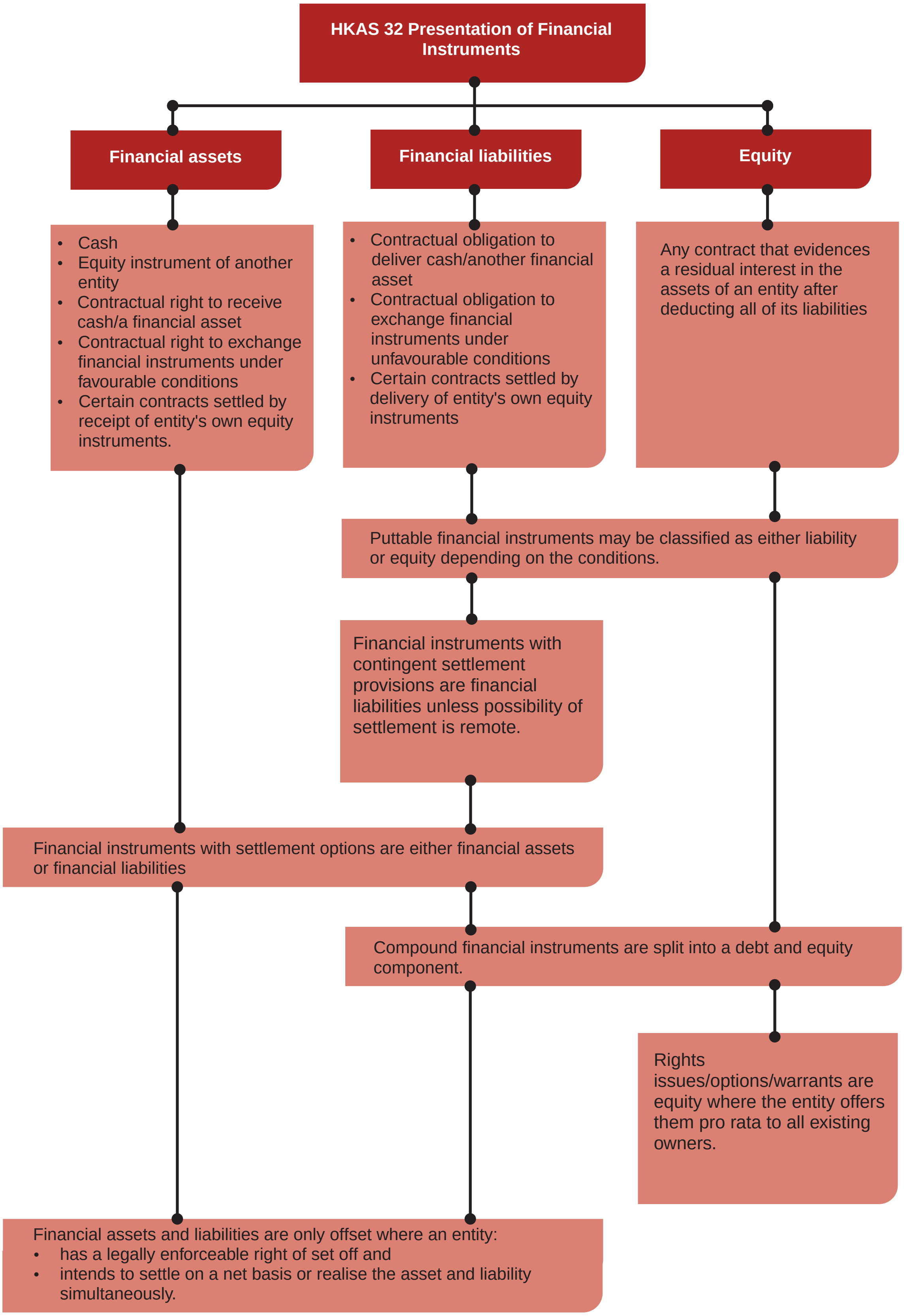
Phase 4 of the project relates to hedge accounting. Proposals in respect of general hedge accounting have been exposed and final amendments to IFRS 9 are expected during the course of 2013. As a result of the proposed new hedge accounting requirements, companies will be able to reflect their risk management activities better in the financial statements, and there will be enhanced presentation and disclosure requirements.

8.2 Other proposals

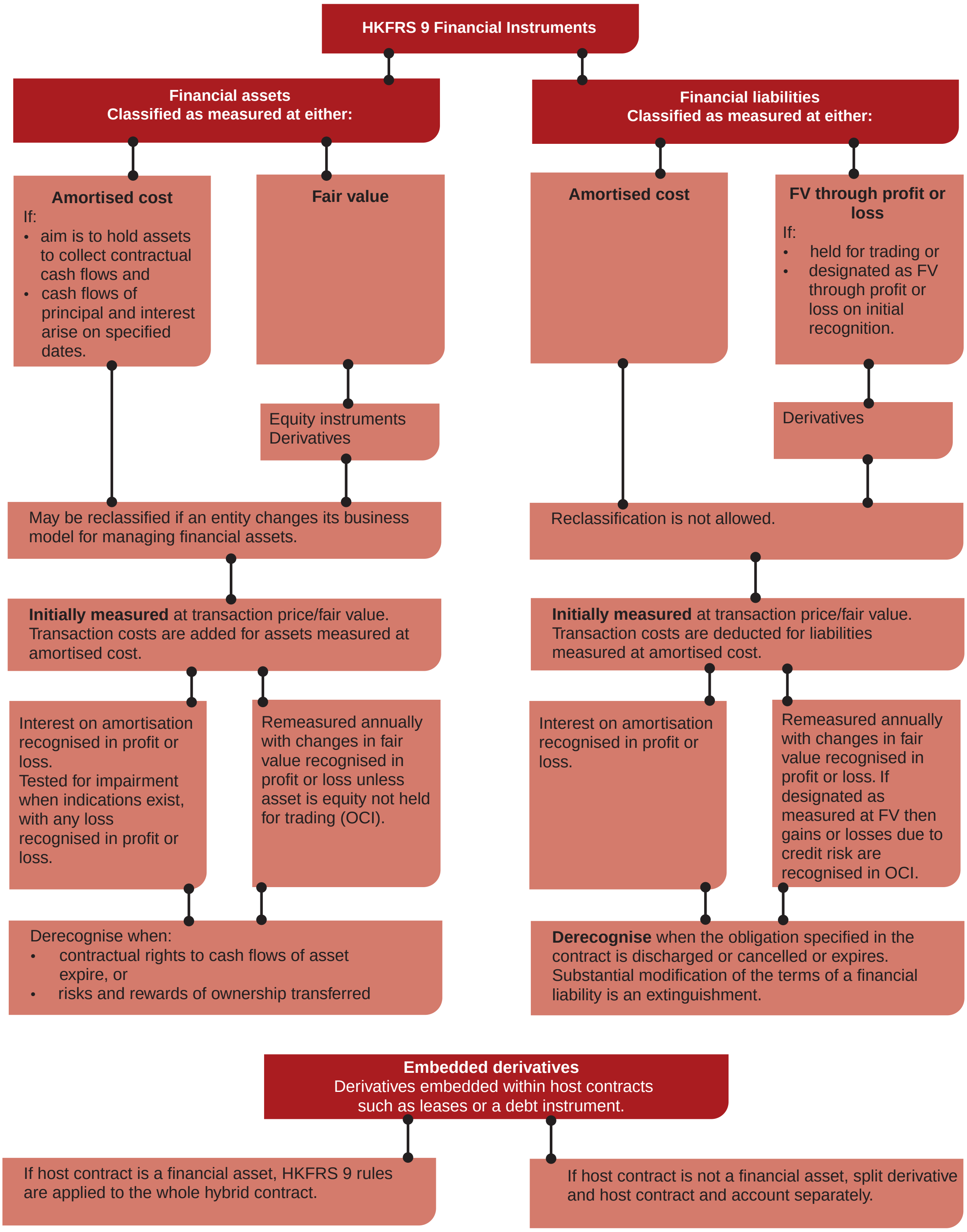
In addition to the on-going development of IFRS 9, limited amendments to the classification and measurement requirements of IFRS 9 which are already in issue have also been proposed. These address application questions raised by entities which have adopted the standard early on a voluntary basis. They also reduce the differences between IFRS and US GAAP in accounting for financial instruments. The proposed amendments would:

- Improve the contractual cash flow test and
- Introduce a fair value through OCI category for simple debt instruments.

Topic recap



HKAS 32 Presentation of Financial Instruments
Financial assets
Financial liabilities
Equity
• Cash
• Equity instrument of another entity
• Contractual right to receive cash/a financial asset
• Contractual right to exchange financial instruments under favourable conditions
• Certain contracts settled by receipt of entity's own equity instruments.
• Contractual obligation to deliver cash/another financial asset
• Contractual obligation to exchange financial instruments under unfavourable conditions
• Certain contracts settled by delivery of entity's own equity instruments
Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities
Puttable financial instruments may be classified as either liability or equity depending on the conditions.
Financial instruments with contingent settlement provisions are financial liabilities unless possibility of settlement is remote.
Financial instruments with settlement options are either financial assets or financial liabilities
Compound financial instruments are split into a debt and equity component.
Rights issues/options/warrants are equity where the entity offers them pro rata to all existing owners.
Financial assets and liabilities are only offset where an entity:
• has a legally enforceable right of set off and
• intends to settle on a net basis or realise the asset and liability simultaneously.


HKFRS 9 Financial Instruments
Financial assets
Classified as measured at either:
Amortised cost
If:
• aim is to hold assets to collect contractual cash flows and
• cash flows of principal and interest arise on specified dates.
Fair value
Equity instruments
Derivatives
May be reclassified if an entity changes its business model for managing financial assets.
Initially measured at transaction price/fair value. Transaction costs are added for assets measured at amortised cost.
Interest on amortisation recognised in profit or loss.
Tested for impairment when indications exist, with any loss recognised in profit or loss.
Remeasured annually with changes in fair value recognised in profit or loss unless asset is equity not held for trading (OCI).
Derecognise when:
• contractual rights to cash flows of asset expire, or
• risks and rewards of ownership transferred
Financial liabilities
Classified as measured at either:
Amortised cost
FV through profit or loss
If:
• held for trading or
• designated as FV through profit or loss on initial recognition.
Derivatives
Reclassification is not allowed.
Initially measured at transaction price/fair value. Transaction costs are deducted for liabilities measured at amortised cost.
Interest on amortisation recognised in profit or loss.
Remeasured annually with changes in fair value recognised in profit or loss. If designated as measured at FV then gains or losses due to credit risk are recognised in OCI.
Derecognise when the obligation specified in the contract is discharged or cancelled or expires. Substantial modification of the terms of a financial liability is an extinguishment.
Embedded derivatives
Derivatives embedded within host contracts such as leases or a debt instrument.
If host contract is a financial asset, HKFRS 9 rules are applied to the whole hybrid contract.
If host contract is not a financial asset, split derivative and host contract and account separately.

HKAS 39 Hedging

Conditions for hedge accounting:

1. Hedge is formally documented
2. Hedge is expected to be highly effective (80% – 125%)
3. Forecast transaction is highly probable (cash flow hedges)
4. Effectiveness of hedge can be measured reliably assessment of hedge carried out on ongoing basis and effective during period.

Fair value hedge

Hedged item (an asset or liability) is remeasured to fair value at the period end and the gain or loss recognised in profit or loss.

Hedging instrument (derivative) is also remeasured to fair value and the gain or loss recognised in profit or loss.

Cash flow hedge

Hedged item is a future cash flow.

Hedging instrument (derivative) is remeasured to fair value and the effective gain or loss is recognised in OCI.

This is reclassified to profit or loss when the effect of the future cash flow is recognised in profit or loss.

Net investment hedge

Hedged item is the investment in a foreign subsidiary within consolidated accounts.

Hedging instrument is the loan taken to fund the acquisition of the subsidiary.

Gains and losses on both are matched in other comprehensive income.

HKFRS 7 Disclosure of Financial Instruments

Significance of financial instruments on financial position and performance

- Statement of financial position disclosures
- Statement of comprehensive income disclosures
- Hedge accounting
- Fair value of financial instruments at amortised cost

Nature and extent of risks arising from financial instruments and their management

Qualitative and quantitative disclosure for:

- credit risk
- currency risk
- interest rate risk
- liquidity risk
- loans payable
- market risk
- other price risk
- past due (overdue asset)

Answers to self-test questions

Answer 1

Refer to the definitions of financial assets and liabilities given in section 1.2:

(a) **Physical assets**: control of these creates an opportunity to generate an inflow of cash or other assets, but it does not give rise to a present right to receive cash or other financial assets.

(b) **Prepaid expenses, etc.**: the future economic benefit is the receipt of goods/services rather than the right to receive cash or other financial assets.

Answer 2

Liability. The preference shares require regular distributions to the holders but more importantly have the debt characteristic of being redeemable. Therefore, according to **HKAS 32** *Financial Instruments: Presentation* they must be classified as liability.

Answer 3

Note. The method to use here is to find the present value of the principal value of the bond, $2m (100,000 × $20) and the interest payments of $120,000 annually (6% × $2m) at the market rate for non-convertible bonds of 8%, using the discount factor tables. The difference between this total and the principal amount of $2m is the equity element.

	$
Present value of principal $2m × 0.681	1,362,000
Present value of interest $120,000 × 3.993	479,160
Liability value	1,841,160
Principal amount	2,000,000
Equity element	158,840

Answer 4

(a) ABC should derecognise the asset as its option to repurchase is at the prevailing market value.

(b) DEF should not derecognise the asset as it has retained substantially all the risks and rewards of ownership. The stock should be retained in its books even though legal title is temporarily transferred.

(c) XYZ has received 90% of its transferred receivables in cash, but whether it can retain this amount permanently is dependent on the performance of the factor in recovering all of the receivables. XYZ may have to repay some of it and therefore retains the risks and rewards of 100% of the receivables amount. The receivables should not be derecognised. The cash received should be treated as a loan.

The 10% of the receivables that XYZ will never receive in cash should be treated as interest over the six-month period; it should be recognised as an expense in profit or loss and increase the carrying amount of the loan.

At the end of the six months, the receivables should be derecognised by netting them against the amount of the loan that does not need to be repaid to the factor. The amount remaining is bad debts which should be recognised as an expense in profit or loss.

Answer 5

	(a) Amortised cost		(b) FV through P/L	
	20X1	*20X2*	*20X1*	*20X2*
	$'000	$'000	$'000	$'000
Profit or loss				
Interest income (W1)/(W2)	1,200	1,200	1,200	1,387
Gain/(loss) due to change in FV (W2)	–	–	(187)	–
	1,200	1,200	1,013	1,387
Statement of financial position				
Financial asset (W1)/(W2)	20,000	–	19,813	–

WORKINGS

1 **Amortised cost**

	$'000
Cash – 1.1.20X1	20,000
Effective interest at 6% (same as nominal as no discount on issue/premium on redemption)	1,200
Coupon received (nominal interest 6% × 20m)	(1,200)
At 31.12.20X1	20,000
Effective interest at 6%	1,200
Coupon and capital received ((6% × 20m) + 20m)	(21,200)
At 31.12.20X2	–

2 **Fair value**

	$'000
Cash	20,000
Effective interest (as above)	1,200
Coupon received (as above)	(1,200)
Fair value loss (balancing figure)	(187)
At 31.12.20X1 (W3)	19,813
Interest at 7% (7% × 19,813)	1,387
Coupon and capital received ((6% × 20m) + 20m)	(21,200)
At 31.12.20X2	–

3 **Fair value at 31.12.20X1**

	$'000
Interest and capital due on 31.12.20X2 at new market rate (21.2m/1.07)	19,813

Answer 6

D

	$
Issue costs	30,000
Interest $1,000,000 × 5% × 7	350,000
Premium on redemption	260,000
Total finance cost	640,000

Answer 7

The bond is a "deep discount" bond and is a financial liability of Grumble Co.. It is measured at amortised cost. Although there is no interest as such, the difference between the initial cost of the bond and the price at which it will be redeemed is a finance cost. This must be allocated over the term of the bond at a constant rate on the carrying amount.

To calculate amortised cost we need to calculate the effective interest rate of the bond:

$$\frac{1{,}000{,}000}{839{,}619} = 1.191 \text{ over three years}$$

To calculate an annual rate, we take the cube root, $(1.191)^{1/3} = 1.06$, so the annual interest rate is 6%

The charge to the statement of profit or loss and other comprehensive income is $50,377 ($839,619 × 6%)

The balance outstanding at 31 December 20X2 is $889,996 ($839,619 + $50,377)

Answer 8

A financial asset or group of assets is impaired when its recoverable amount is less than its carrying amount. Possible indications would be:

(a) a trade receivable balance where it is now learnt that the credit customer is in financial difficulties

(b) a borrower not paying an interest payment on time

(c) an investment in shares where the underlying company has filed for bankruptcy protection

Exam practice

Sonna Inc. 30 minutes

(a) On 1 January 20X1, Sonna Inc. (SC) issued HK$2,000 million of three-year Hong Kong Interbank Borrowing Rate (HIBOR) plus 180 basis points variable rate bond at par value. Interest is payable annually. On the same date, SC entered into an interest rate swap with a bank by paying 2 per cent fixed interest amount and receiving HIBOR plus 180 basis points for three-year and exchange at the dates of interest payment dates. SC measures the bond at amortised cost.

Required:

(i) Explain the difference between the fair value interest rate risk and the cash flow interest rate risk in the context of a bank loan. **(2 marks)**

(ii) Explain what a hedged item and hedging instrument are and discuss how hedge accounting affects the accounting treatment of a hedging instrument in the financial statements under cash flow hedges. **(6 marks)**

(iii) Assuming hedge accounting is not adopted, explain the accounting treatment for the bond and interest rate swap if the market interest rate is increased by 0.5% on 30 September 20X1, the current year end date (no quantification of the effect is required). **(5 marks)**

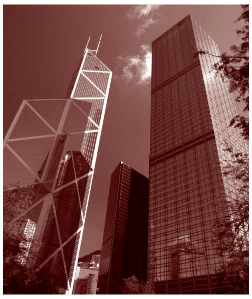
(b) On 1 August 20X1, SC entered into a non-cancellable purchase order to acquire equipment from Monta Corporation, a Japanese entity, at Yen 300 million. Payment is made upon delivery of the equipment to Hong Kong on 31 December 20X1. On 30 September 20X1, SC entered into a forward contract to exchange Yen 300 million at a pre-determined exchange rate between the Yen and Hong Kong dollar on 31 December 20X1. The functional currency of SC is the Hong Kong dollar.

Required

Discuss the accounting implications for the purchase contract and forward contract if fair value hedge accounting is adopted. **(4 marks)**

(Total = 17 marks)

HKICPA June 2012 (amended)


chapter 19

Statements of cash flows

Topic list

Learning focus

Statements of cash flows are very relevant in practice. They are a required element of a set of financial statements and often provide more useful information than that within the other financial statements with regard to liquidity.

Learning outcomes

In this chapter you will cover the following learning outcomes:

		Competency level
Prepare the financial statements for an individual entity in accordance with Hong Kong Financial Reporting Standards and statutory reporting requirements		
4.01	**Primary financial statement preparation**	3
4.01.01	Prepare the statement of cash flows of an entity in accordance with Hong Kong accounting standards	
4.09	**Consolidated financial statement preparation**	3
4.09.03	Prepare a consolidated statement of cash flows	

1 Cash flows and HKAS 7

Topic highlights

Statements of cash flows are a useful addition to the financial statements of companies because it is recognised that accounting profit is not the only indicator of a company's performance.

A statement of cash flows focuses on the sources and uses of cash and is a useful indicator of company’s **liquidity** and **solvency**.

Cash is a key element of any business. It must be monitored and managed in order to maintain a liquid position. While the statement of financial position provides a period end cash balance, this in itself does not provide any indication of how an entity generates, uses and manages its cash. Similarly, profit, while providing a good indication of the performance of an entity does not provide any indication of the liquidity of a business, since it is calculated using the accrual basis.

The statement of cash flows is therefore required to form part of a set of financial statements by HKAS 1. HKAS 1 does not, however, prescribe the format and content of a statement of cash flows. This guidance is provided within HKAS 7 *Statement of Cash Flows*.

Before considering the standard, it is important to appreciate the advantages of cash flow information.

1.1 Cash flows: advantages

The main advantages of using cash flow accounting (including both historical and forecast cash flows) are as follows.

(a) A company's ability to generate cash affects its survival. Cash flow accounting addresses this critical issue.

(b) Since "profit" is dependent on accounting conventions and concepts, cash flow is viewed as more comprehensive.

(c) Cash flow is factual, objective and is not subject to as much manipulation as profits.

(d) Both long-and short-term creditors have more interest in an entity's ability to repay them than in its profitability. Cash flow accounting is more direct than "profits" in pointing out the availability of cash.

(e) Cash flow reporting is better than traditional profit reporting in the comparison of the results of different companies.

(f) The needs of all users are better satisfied by cash flow reporting.

  (i) It provides management with information that is useful in decision making ("relevant costs" to a decision are future cash flows in management accounting). Traditional profit accounting does not provide exclusive help in decision making.

  (ii) A satisfactory basis for stewardship accounting is provided by cash flow accounting for shareholders and auditors.

  (iii) Cash flow accounting better serves the information needs of creditors and employees.

(g) When compared with profit forecasts, cash flow forecasts are more useful and easier to prepare.

(h) It is easier to audit cash flow accounts than accounts prepared based on the accruals concept.

(i) The accrual concept can be confusing whereas cash flows are easily understood.

(j) Cash flow accounting can be retrospective and also prospective in providing a forecast for the future. This information can be of great value to all users of accounting information.

(k) Variance statements, which compare actual cash flows against the forecast, can be used to monitor forecasts.

Looking at the same question from a different angle, readers of accounts can be **misled** by the profit figure.

(a) Shareholders might believe that if a company makes a profit after tax of, say $1 million then this is the amount which it could afford to pay as a **dividend**. Unless the company has sufficient cash available to stay in business and also to pay a dividend, the shareholders' expectations would be wrong.

(b) Employees might believe that if a company makes profits, it can afford to pay **higher wages** next year. This opinion may not be correct: the ability to pay wages depends on the availability of cash.

(c) Creditors might consider that a profitable company is a **going concern**.

  (i) If a company builds up large amounts of **unsold inventories** of goods, their cost would not be chargeable against profits, but cash would have been used up in making them, thus weakening the company's liquid resources.

  (ii) A company might capitalise large **development costs**, having spent considerable amounts of money on research and development, but only charge small amounts against current profits. As a result, the company might show reasonable profits, but get into severe difficulties with its liquidity position.

(d) Management might suppose that if their company makes a historical cost profit, and reinvests some of those profits, then the company must be **expanding**. This is not the case: in a period of inflation, a company might have a historical cost profit but a current cost accounting loss, which means that the operating capability of the firm will be declining.

(e) **Survival** of a business entity depends not so much on profits as on its ability to pay its debts when they fall due. Such payments might include "profit and loss" items such as material purchases, wages, interest and taxation etc., but also capital payments for new non-current assets and the repayment of loan capital when this falls due (e.g. on the redemption of debentures).

1.2 HKAS 7 *Statement of Cash Flows*

Topic highlights

HKAS 7 provides the format of a statement of cash flows and guidance on the required content.

1.2.1 Objective

The objective of this standard is to require the provision of information about the historical changes in cash and cash equivalents of an entity by means of a statement of cash flows which classifies cash flows during the period from **operating**, **investing** and **financing activities**.

1.2.2 Scope

Users of an entity's financial statements are interested in how the entity generates and uses **cash** and **cash equivalents**. This is the case regardless of the nature of the entity's activities. Therefore, all entities must provide a statement of cash flows as an **integral part** of an entity's financial statements.

HKAS 7.6-9

1.2.3 Definitions

The standard gives the following definitions, the most important of which are **cash** and **cash equivalents**.

Key terms

Cash comprises cash on hand and demand deposits.

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

Cash flows are inflows and outflows of cash and cash equivalents.

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

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

Financing activities are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity. *(HKAS 7)*

The standard expands on the definition of cash equivalents: they are held to meet short-term cash commitments rather than for investment or other long-term purposes. They are required to:

1 be readily convertible to a known amount of **cash** and therefore their maturity date should normally be three months from its acquisition date

2 be subject to an insignificant risk of changes in value.

Based on the definition, therefore:

- **Deposits available on demand** are cash equivalents;
- **Deposits with a fixed maturity of more than three months** are *not* cash equivalents;
- **Pledged deposits (amounts held by banks as security)** are *not* cash equivalents;
- **Money market holdings, short-term government bonds** and **treasury bills** are cash equivalents;
- **Equity investments** (i.e. holdings of ordinary shares in other companies) are *not* cash equivalents;
- **Preference share investments** are cash equivalents where acquired within a short period of their maturity and with a specified redemption date;
- Where **bank overdrafts** are repayable on demand and are treated as part of an entity's total cash management system, an overdrawn balance is included in cash and cash equivalents;
- **Loans and other borrowings** are *not* cash equivalents, but instead are classified as cash flows from financing activities.

Movements between different types of cash and cash equivalents are not included in cash flows. The investment of surplus cash in cash equivalents is part of cash management, not part of operating, investing or financing activities.

2 Single company statements of cash flows

Topic highlights

Cash flows are classified as cash flows from operating, investing and financing activities in a statement of cash flows. Cash flows from operating activities may be calculated using the direct or indirect method.

HKAS 7.10,11

2.1 Presentation of a statement of cash flows

According to HKAS 7, reported cash flows during a period should be classified into operating, investing and financing activities in a statement of cash flows.

The way of presenting cash flows under operating, investing and financing activities is dependent on the nature of the reporting entity. The classification enables users to understand the impact of each activity on cash and cash equivalents and their interrelationship.

HKAS 7.13-15

2.1.1 Operating activities

This section of the statement of cash flows shows whether, and to what extent, companies can **generate cash from their operations**. It is this cash from day-to-day trading which must, in the end pay for all cash outflows relating to other activities, such as paying loan interest, tax and dividends.

The standard gives the following as examples of cash flows from operating activities.

- Cash receipts from the sale of goods and the rendering of services
- Cash receipts from royalties, fees, commissions and other revenue
- Cash payments to suppliers for goods and services
- Cash payments to and on behalf of employees
- Cash payments/refunds of income taxes unless they can be specifically identified with financing or investing activities
- Cash receipts and payments from contracts held for dealing or trading purposes

The effects of these transactions are all included in the calculation of profit or loss, however certain items may be included in the net profit or loss for the period which do *not* relate to operational cash flows. For example, the profit or loss on the disposal of property, plant and equipment will be included in net profit or loss, but the cash flows will be classed as **investing**. However, cash payments to manufacture or acquire assets held for rental to others and subsequently held for sale as described in paragraph 68A of HKAS 16 *Property, Plant and Equipment* are cash flows from operating activities. The cash receipts from rents and subsequent sales of such assets are also cash flows from operating activities.

HKAS 7.16

2.1.2 Investing activities

Cash flows from investing activities show the extent of new investment in assets that will generate future income and cash flows. Only expenditures that result in a recognised asset in the statement of financial position are eligible for classification as investing activities.

The standard gives the following examples of cash flows arising from investing activities.

- Cash payments to acquire property, plant and equipment, intangibles and other long-term assets, including those relating to capitalised development costs and self-constructed property, plant and equipment
- Cash receipts from sales of property, plant and equipment, intangibles and other long-term assets
- Cash payments to acquire shares or debentures of other entities
- Cash receipts from sales of shares or debentures of other entities
- Cash advances and loans made to other parties
- Cash receipts from the repayment of advances and loans made to other parties
- Cash payments for or receipts from futures/forward/option/swap contracts except when the contracts are held for dealing purposes, or the payments/receipts are classified as financing activities

HKAS 7.17

2.1.3 Financing activities

Cash flows from financing activities show the share of cash claimed by capital providers during the period. This serves as an indicator of likely future interest and dividend payments.

The standard gives the following examples of cash flows which might arise under these headings:

- Cash proceeds from issuing shares
- Cash payments to owners to acquire or redeem the entity's shares
- Cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other short- or long-term borrowings
- Cash repayments of amounts borrowed
- Cash payments by a lessee for the reduction of the outstanding liability relating to a finance lease

2.1.4 Example of statement of cash flows

STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 20X9

	$'000	$'000
Cash flows from operating activities		
Cash receipts from customers	34,630	
Cash paid to suppliers and employees	(32,400)	
Cash generated from operations	2,230	
Interest paid	(320)	
Income taxes paid	(820)	
Net cash from operating activities		1,090
Cash flows from investing activities		
Purchase of property, plant and equipment	(840)	
Proceeds from sale of equipment	30	
Interest received	250	
Dividends received	250	
Net cash used in investing activities		(310)
Cash flows from financing activities		
Proceeds from issuance of share capital	330	
Proceeds from long-term borrowings	330	
Payment of finance lease liabilities	(100)	
Dividends paid*	(1,250)	
Net cash used in financing activities		(690)
Net increase in cash and cash equivalents		90
Cash and cash equivalents at beginning of period		230
Cash and cash equivalents at end of period		320

* This could also be shown as an operating cash flow

Cash and cash equivalents:

	20X9 $'000	*20X8* $'000
Cash on hand and balances with banks	50	35
Short-term investments	270	195
Cash and cash equivalents	320	230

HKAS 7.18

2.2 Cash generated from operations

The standard offers a choice of method for the calculation of cash generated from operations:

(a) The **direct method** involves disclosing major classes of gross cash receipts and gross cash payments

(b) The **indirect method** involves adjusting the profit or loss for the effects of:

1 transactions of a non-cash nature
2 any deferrals or accrual of past or future operating cash receipts or payments and
3 items of income or expense associated with investing or financing cash flows

The example shown above in section 2.1.4 uses the direct method.

HKAS 7.19

2.2.1 The direct method

The direct method involves listing cash receipts and cash payments in respect of day-to-day transactions. A simple example may be as follows:

	$
Cash in respect of cash sales	X
Cash received from credit customers	X
Cash purchases	(X)
Cash paid to credit suppliers	(X)
Cash expenses paid (including wages)	(X)
Cash generated from operations	X

The most obvious way to obtain information about gross cash receipts and payments is simply to extract the information from the accounting records. An alternative method involves adjusting sales, cost of sales and other items in the statement of profit or loss for:

- changes in inventories, receivables and payables during the period
- other non-cash items
- other items for which the cash effects are investing or financing cash flow.

Practically, this involves reconstructing nominal ledger accounts in order to extract cash flows. This may be a laborious task, however, and the indirect method described below may be easier.

HKAS 7.20

2.2.2 The indirect method

This method is undoubtedly **easier** from the point of view of the preparer of the statement of cash flows. The profit or loss for the period is adjusted for the following:

- Changes during the period in inventories, operating receivables and payables
- Non-cash items, e.g. depreciation, provisions, profits/losses on the sales of assets
- Other items, the cash flows from which should be classified under investing or financing activities.

A **proforma** of such a calculation is as follows:

	$
Profit before taxation (statement of profit or loss)	X
Depreciation	X
Loss (profit) on sale of non-current assets (working capital)	X
(Increase)/decrease in inventories	(X)/X
(Increase)/decrease in receivables	(X)/X
Increase/(decrease) in payables	X/(X)
Cash generated from operations	X
Interest (paid)/received	(X)
Income taxes paid	(X)
Net cash flows from operating activities	X

It is important to understand why **certain items are added and others subtracted**. Note the following points:

(a) Depreciation is not a cash expense, but is deducted in arriving at the profit figure in the statement of profit or loss. It makes sense, therefore, to eliminate it by adding it back.

(b) By the same logic, a loss on a disposal of a non-current asset (arising through underprovision of depreciation) needs to be added back and a profit deducted.

(c) An increase in inventories means less cash – you have spent cash on buying inventory.

(d) An increase in receivables means the company's debtors have not paid as much, and therefore there is less cash.

(e) A decrease in payables means the company has paid more to suppliers and so has less cash.

The illustration below shows a full statement of cash flows using the indirect method.

Illustration: Indirect method

STATEMENT OF CASH FLOWS (INDIRECT METHOD) FOR THE YEAR ENDED 31 DECEMBER 20X9

	$'000	$'000
Cash flows from operating activities		
Profit before taxation	2,630	
Adjustments for:		
Depreciation	540	
Investment income	(450)	
Interest expense	390	
	3,110	
Increase in trade and other receivables	(600)	
Decrease in inventories	1,000	
Decrease in trade payables	(1,280)	
Cash generated from operations	2,230	
Interest paid	(320)	
Income taxes paid	(820)	
Net cash from operating activities		1,090
Cash flows from investing activities		
Purchase of property, plant and equipment	(840)	
Proceeds from sale of equipment	30	
Interest received	250	
Dividends received	250	
Net cash used in investing activities		(310)
Cash flows from financing activities		
Proceeds from issue of share capital	330	
Proceeds from long-term borrowings	330	
Payment of finance lease liabilities	(100)	
Dividends paid*	(1,250)	
Net cash used in financing activities		(690)
Net increase in cash and cash equivalents		90
Cash and cash equivalents at beginning of period		230
Cash and cash equivalents at end of period		320

* This could also be shown as an operating cash flow

Cash and cash equivalents:

	20X9	*20X8*
	$'000	$'000
Cash on hand and balances with banks	50	35
Short-term investments	270	195
Cash and cash equivalents	320	230

2.2.3 Indirect versus direct

Use of the direct method is encouraged, but not required, by HKAS 7, as this method provides information which may be useful in estimating future cash flows, which is not available under the indirect method.

2.3 Specific cash flows

HKAS 7.31,34

2.3.1 Interest and dividends

Sources (cash inflows) and uses (outflows) of cash relating to interest and dividends should be **separately disclosed**. Each cash flow should be classified consistently from period to period either as operating, investing or financing.

Dividends paid by the entity can be classified in **one of two ways**:

(a) As a **financing cash flow**, showing the cost of obtaining financial resources.

(b) As a component of **cash flows from operating activities** so that users can assess the entity's ability to pay dividends out of operating cash flows.

Interest paid or received is calculated by reference to the statement of profit or loss amount for the year adjusted for any accrual or other statement of financial position amount.

Dividends paid or received are identified in the notes to a set of financial statements.

Example: Interest

Odile Co. reports the following amounts in its financial statements relating to interest:

	$
Finance costs in the statement of profit or loss	8.7
Interest accrued at start of year	1.2
Interest accrued at end of year	3.1

What is Odile Co.'s interest paid?

Solution

Interest paid is calculated as 1.2m + 8.7m – 3.1m = $6.8 million.

HKAS 7.35,36

2.3.2 Taxes on income

Cash flows relating to taxes should also be **separately disclosed**. They should be classified as items under operating activities unless they can be specifically identified with financing and investing activities.

It is often difficult to match cash flows arising from taxes with the originating underlying transaction, therefore tax cash flows are usually classified as arising from operating activities.

Tax paid (or refunded) is calculated by reference to the tax charge (or credit) for the year, adjusted for any statement of financial position amounts.

Example: Taxes on income

Allister's estimated tax payable for the year ended 31 March 20X1 is $89,100. The equivalent figure for the year ended 31 March 20X0 was $97,200. The tax charge reported in the statement of profit or loss for the year ended 31 March 20X1 was $101,000, which included a $12,000 increase in deferred tax.

What tax was paid in the year?

Solution

	$
Tax liability b/f	97,200
Tax charge ($101,000 – $12,000)	89,000
	186,200
Tax liability c/f	(89,100)
Tax paid	97,100

2.3.3 Finance lease payments

Rentals under a finance lease include capital and interest elements. These are split out for the purpose of inclusion in the statement of cash flows and reported as "financing" and "operating" cash flows respectively.

Example: Lotus Co.

The notes to the financial statements of Lotus Co. show the following in respect of finance leases:

Year ended 31 December	*20X9*	*20X8*
	$'000	$'000
Amounts payable within one year	12	8
Within 2-5 years	110	66
	122	74
Less finance charges allocated	(14)	(8)
	108	66

Additions to non-current assets acquired under finance leases were shown in the non-current asset note at $56,000.

What is the capital repayment to be shown in the statement of cash flows for Lotus Co. in the year ended 31 December 20X9?

Solution

Finance leases

	$'000
Balance at 31 December 20X8	66
Additions for the year	56
Balance at 31 December 20X9	(108)
Capital repayment (balancing fig)	14

2.3.4 Cash flows associated with non-current assets

Where non-current assets are acquired through purchase, rather than lease, the additions figure in the non-current asset note (adjusted for any outstanding amount owed) equates to the cash outflow.

Where non-current assets are disposed of, the cash proceeds is calculated by adding any profit on disposal (or deducting any loss) to (from) the carrying value of the disposals (identified from the non-current asset note).

Example: Cash flows associated with non-current assets

The following extracts are taken from the financial statements of Rooibus for the year ended 30 September 20X0:

STATEMENT OF FINANCIAL POSITION

	20X0	*20W9*
	$m	$m
Cost of PPE	520	420
Accumulated depreciation	165	189

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

Depreciation charge	55
Loss on disposal of PPE	5.5
Other comprehensive income	
Revaluation surplus (land)	20

Assets costing $85m were disposed of in the year.

Required

What cash has Rooibus paid to acquire new non-current assets in the period, and what are the proceeds of sale of old non-current assets?

Solution

Cost	$m	*Depreciation*	$m
b/f	420	b/f	189
Additions (balancing)	165	Charge	55
Revaluation	20	Disposals (balancing)	(79)
Disposal	(85)	c/f	165
c/f	520		

Cash paid to acquire non-current assets $165m

Proceeds of sale of non-current assets (85m – 79m – 5.5m) $0.5m

2.3.5 Borrowings and share capital

When calculating the proceeds of a share or loan issue or loan repaid, the balance outstanding at the start of the period should be compared with the balance at the end of the period.

2.4 Disclosure

HKAS 7.43

2.4.1 Non cash transactions

Investing and financing transactions that do not require the use of **cash** or **cash equivalents** shall be excluded from a statement of cash flows. Such transactions shall be disclosed elsewhere in the financial statements in a way that provides all the relevant information about these **investing** and **financing activities**.

HKAS 7.45,46

2.4.2 Components of cash and cash equivalents

The components of cash and cash equivalents should be disclosed and a **reconciliation** should be presented, showing the amounts in the statement of cash flows reconciled with the equivalent items reported in the statement of financial position.

It is also necessary to disclose the **accounting policy** used in deciding the items included in cash and cash equivalents, in accordance with HKAS 1, but also because of the wide range of cash management practices worldwide.

HKAS 7.48,50

2.4.3 Other disclosures

All entities should disclose, together with a **commentary by management**, any other information likely to be of importance.

(a) Restrictions on the use of or access to any part of cash equivalents.

(b) The amount of undrawn borrowing facilities which are available.

(c) Cash flows which increased operating capacity compared to cash flows which merely maintained operating capacity.

2.5 Producing a statement of cash flows

Remember the steps involved in preparation of a statement of cash flows using the indirect method:

Step 1
Set out the proforma leaving plenty of space.

Step 2
Complete the reconciliation of profit before tax to net cash from operating activities, as far as possible.

Step 3
Calculate the following where appropriate.

- Tax paid
- Dividends paid
- Interest paid/received
- Purchase and sale of non-current assets
- Issues of shares
- Repayment of loans

Step 4
Work out the profit if not already given using: opening and closing balances, tax charge and dividends.

Step 5
Slot the figures into the statement and any notes required.

Example: Kowloon Co.

Set out below are the financial statements of Kowloon Co.. You are the financial controller, faced with the task of implementing HKAS 7 *Statement of Cash Flows*.

KOWLOON CO.
STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X9

	$'000
Revenue	2,553
Cost of sales	(1,814)
Gross profit	739
Other income: interest received	25
Distribution costs	(125)
Administrative expenses	(264)
Finance costs	(75)
Profit before tax	300
Income tax expense	(140)
Profit for the year	160

KOWLOON CO.
STATEMENTS OF FINANCIAL POSITION AS AT 31 DECEMBER

	20X9	*20X8*
Assets	$'000	$'000
Non-current assets		
Property, plant and equipment	380	305
Intangible assets	250	200
Investments	–	25
Current assets		
Inventories	150	102
Receivables	390	315
Short-term investments	50	–
Cash at bank	2	1
Total assets	1,222	948
Equity and liabilities		
Equity		
Share capital	360	300
Revaluation surplus	100	91
Retained earnings	260	180
Non-current liabilities		
Long-term loan	170	50
Current liabilities		
Trade payables	127	119
Bank overdraft	85	98
Taxation	120	110
Total equity and liabilities	1,222	948

The following information is available:

(a) The proceeds of the sale of non-current asset investments amounted to $30,000.

(b) Fixtures and fittings, with an original cost of $85,000 and a net book value of $45,000, were sold for $32,000 during the year.

(c) The following information relates to property, plant and equipment.

	31.12.20X9	*31.12.20X8*
	$'000	$'000
Cost	720	595
Accumulated depreciation	(340)	(290)
Net book value	380	305

(d) 50,000 $1 ordinary shares were issued during the year at a premium of 20 cents per share.

(e) The short-term investments are highly liquid and are close to maturity.

(f) Dividends of $80,000 were paid during the year.

Required

Prepare a statement of cash flows for the year to 31 December 20X9 using the format laid out in HKAS 7.

Solution

KOWLOON CO.
STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 20X9

	$'000	$'000
Cash flows from operating activities		
Profit before tax	300	
Depreciation charge (W1)	90	
Loss on sale of property, plant and equipment (45 – 32)	13	
Profit on sale of non-current asset investments (30 – 25)	(5)	
Interest expense (net) (75 – 25)	50	
(Increase)/decrease in inventories (102 – 150)	(48)	
(Increase)/decrease in receivables (315 – 390)	(75)	
Increase/(decrease) in payables (127 – 119)	8	
	333	
Interest paid	(75)	
Dividends paid	(80)	
Tax paid (110 + 140 – 120)	(130)	
Net cash from operating activities		48
Cash flows from investing activities		
Payments to acquire property, plant and equipment (W2)	(201)	
Payments to acquire intangible non-current assets (250 – 200)	(50)	
Receipts from sales of property, plant and equipment	32	
Receipts from sale of non-current asset investments	30	
Interest received	25	
Net cash used in investing activities		(164)
Cash flows from financing activities		
Issue of share capital (360 – 300)	60	
Long-term loan (170 – 50)	120	
Net cash from financing activities		180
Increase in cash and cash equivalents		64
Cash and cash equivalents at 1.1.X9		(97)
Cash and cash equivalents at 31.12.X9		(33)

ANALYSIS OF CASH AND CASH EQUIVALENTS

	31.12.X9	*31.12.X8*
	$'000	$'000
Cash at bank	2	1
Short-term investments	50	-
Overdraft	(85)	(98)
	(33)	(97)

WORKINGS

1 *Depreciation charge*

	$'000
Accumulated depreciation at 31 December 20X8	290
Accumulated depreciation on assets sold (85 – 45)	(40)
Accumulated depreciation 31 December 20X9	(340)
Charge for the year	(90)

2 *Purchase of property, plant and equipment*

	$'000
Cost at 31 December 20X8	595
Revaluation (100 – 91)	9
Cost on assets sold	(85)
Cost 31 December 20X9	(720)
Purchase for the year (balancing fig)	(201)

3 Consolidated statements of cash flows

Topic highlights

A consolidated statement of cash flows includes extra line items for cash flows associated with:

- acquisitions and disposals of subsidiaries
- non-controlling interests
- associates and joint ventures

Note that accounting for group financial statements is covered in Section D of this Learning Pack.

HKAS 7.37,39

Consolidated statements of cash flows are prepared in the same way as a single company statement of cash flows, however they include extra line items:

- Acquisitions and disposals of subsidiaries are reported as cash flows from investing activities
- Dividends paid to the non-controlling interests are reported as cash flows from financing activities
- Dividends received from associates and joint ventures accounted for using the equity method are reported as cash flows from operating activities

Cash flows that are **internal to the group** should be eliminated in the preparation of a consolidated statement of cash flows.

Example: Elimination of intra-group cash flows

Cann Co. disposed of property, plant and equipment with a carrying value of $215,000 in the year ended 31 October. The company reported a profit on the combined disposals of $39,500. Included within the disposal figures was a machine sold to Cann's subsidiary Wood Co. for $12,400.

During the year, Wood disposed of property, plant and equipment with a carrying value of $43,000, recording a loss on disposal of $5,600. All disposals were made to companies outside the group.

What amount will be reported as proceeds on disposal of property, plant and equipment in the consolidated statement of cash flows?

Solution

	$'000	$'000
Cann		
Carrying amount on disposal		215.0
Profit on disposal		39.5
		254.5
Less: intercompany proceeds		(12.4)
		242.1
Wood		
Carrying amount on disposal	43.0	
Loss on disposal	(5.6)	
		37.4
Consolidated proceeds on disposal		279.5

You should also remember that adjustments made to consolidated profit for non-cash items in the reconciliation to cash flows from operating activities should reflect the amounts included within the *consolidated* statement of profit or loss and other comprehensive income. Therefore, for example, the amount of depreciation or profit on disposal should take into account any consolidation adjustment.

Example: Consolidation adjustments

Landon Co. acquired 80% of Crowther Co. a number of years ago. In the year ended 31 December 20X1, Landon reported a depreciation charge of $560,000 and Crowther reported a depreciation charge of $320,000. At the start of that year, Landon transferred a machine to Crowther with a resulting increase in depreciation of $10,000 per annum.

The adjustment required to consolidated profit for the purposes of calculating cash flows from operating activities is therefore:

	$'000
Landon depreciation	560
Crowther depreciation	320
Consolidation adjustment	(10)
Added back to profit in respect of depreciation	870

HKAS 7.39,42

3.1 Acquisitions and disposals of subsidiaries

Where a subsidiary undertaking **joins or leaves** a group during a financial year the cash flows of the group should include the cash flows of the subsidiary undertaking concerned for the same period as that for which the group's statement of profit or loss and other comprehensive income includes the results of the subsidiary undertaking.

If a subsidiary is acquired or disposed of during the accounting period **the net cash effect of the purchase or sale transaction should be shown separately under "Cash flows from investing activities"**.

The net cash effect is the cash purchase price/cash disposal proceeds net of any cash or cash equivalents acquired or disposed of:

Subsidiary acquired		Subsidiary disposed of	
Cash price	(X)	Cash proceeds	X
Subsidiary's cash and cash equivalents at acquisition date	X	Subsidiary's cash and cash equivalents at disposal date	(X)
Cash to acquire subsidiary	(X)	Proceeds of sale of subsidiary	X

As the cash effect of the acquisition/disposal of the subsidiary is dealt with in a single line item, care must be taken not to double count the effects of the acquisition/disposal when looking at the movements in individual asset balances.

Each of the individual assets and liabilities of a subsidiary acquired/disposed of during the period must be excluded when comparing group statements of financial position for cash flow calculations as follows:

- Where a subsidiary is **acquired in the period: property, plant and equipment**, inventories, payables, receivables etc. at the date of acquisition should be subtracted from the movement on these items.
- Where a subsidiary is **disposed of in the period: property, plant and equipment**, inventories, payables, receivables etc. at the date of disposal should be added to the movement on these items.

Example: Disposal of subsidiary

Extracts from the statements of financial position of the Burke Group at 31 December are as follows:

	20X2	*20X1*
	$'000	$'000
Current assets		
Inventory	664	791
Trade receivables	515	532
Cash	214	431
Current liabilities		
Trade payables	590	645

During the year ended 31 December 20X2, the Burke Group sold its controlling interest in Bryan Co. for $6.5 million in cash. On the disposal date, balances included in Bryan's statement of financial position were as follows:

	$'000
Current assets	
Inventory	103
Trade receivables	45
Cash	79
Current liabilities	
Trade payables	67

(a) What adjustments are required to consolidated profit in respect of working capital in order to calculate cash flows from operating activities?

(b) What is the cash flow reported in investing activities in respect of the disposal of Bryan Co.?

Solution

(a) Working capital adjustments must take account of the disposal of Bryan Co.

	$'000
Inventory	
b/f	791
c/f	664
Decrease	127
Less: amount attributable to disposal	(103)
Decrease in inventory (added back to profit)	24

Trade receivables	
b/f	532
c/f	515
Decrease	17
Less: amount attributable to disposal	(45)
Increase in receivables (deducted from profit)	(28)

Trade payables	
b/f	645
c/f	590
Decrease	55
Less: amount attributable to disposal	(67)
Increase in payables (added back to profit)	12

(b) Proceeds from disposal of Bryan Co.

	$'000
Cash proceeds	6,500
Cash in Bryan Co. at disposal	(79)
Proceeds from disposal of Bryan Co.	6,421

HKAS 7.40

3.1.1 Disclosure

An entity shall disclose, in aggregate, in respect of both obtaining and losing control of subsidiaries or other businesses during the period each of the following:

(a) The total consideration paid or received.

(b) The portion of the consideration consisting of cash and cash equivalents.

(c) The amount of cash and cash equivalents in the subsidiaries or other businesses over which control is obtained or lost.

(d) The amount of the assets and liabilities other than cash or cash equivalents in the subsidiaries or other businesses over which control is obtained or lost, summarised by each major category.

Disclosures (c) and (d) are not required in respect of subsidiaries controlled by investment entities and measured at fair value through profit or loss.

HKAS 7.42A

3.1.2 Changes in ownership interest with no loss of control

Changes in ownership interests in a subsidiary that do not result in a loss of control, such as the subsequent purchase or sale by a parent of a subsidiary's equity instruments, are accounted for as equity transactions (see HKFRS 10 *Consolidated Financial Statements*) unless the subsidiary is held by an investment entity and measured at fair value through profit or loss.

Accordingly, the resulting cash flows are classified in the same way as other transactions with owners, as cash flows from financing activities.

3.2 The non-controlling interest

The group statement of cash flows should only deal with flows of cash and cash equivalents which are external to the group, so all intra-group cash flows should be eliminated.

Dividends paid to non-controlling interests should be included under the heading "Cash from financing activities" and disclosed separately.

Example: Non-controlling interest

The following are extracts of the consolidated results for Marcus Company for the year ended 31 December 20X9.

CONSOLIDATED STATEMENT OF PROFIT OR LOSS (EXTRACT)

	$'000
Group profit before tax	200
Income tax expense	(32)
Profit for the year	168
Profit attributable to:	
Owners of the parent	126
Non-controlling interests	42
	168

CONSOLIDATED STATEMENT OF FINANCIAL POSITION (EXTRACT)

	20X9	*20X8*
	$'000	$'000
Non-controlling interests	362	345

Calculate the dividends paid to the non-controlling interest during the year.

Solution

The non-controlling interests share of profit after tax represents retained profit plus dividends paid.

NON-CONTROLLING INTEREST

	$'000
Balance as at 31 December 20X8	345
Profit for the period	42
Balance as at 31 December 20X9	(362)
Dividend paid (balancing fig)	25

3.3 Associates and joint ventures

The following cash flows should be included in a consolidated statement of cash flows in respect of an associate or joint venture:

- Cash inflows from sales to the associate or joint venture
- Cash outflows from purchases from the associate or joint venture
- Dividends from the associate or joint venture
- Investments in an associate or joint venture

As transactions and balances between group companies and associates/joint ventures are not cancelled for the purpose of producing consolidated financial statements, the normal approach to adjusting consolidated operating profit for movements in working capital will ensure that cash inflows from sales to associates/joint ventures and cash outflows on purchases from associates/joint ventures are included within consolidated cash flow from operating activities.

Within the reconciliation of profit to cash flows from operating activities, however, the share of profit from a joint venture or associate must be eliminated. This is treated as a non-cash item of income and deducted from consolidated profit in calculating consolidated cash flows from operating activities.

Instead, the dividend actually received from the associate/joint venture is included in the operating cash flows section of the statement of cash flows. This is calculated by reconciling the opening investment in associate/joint venture balance to the closing balance.

Where a group invests in or divests of an associate or joint venture in the year, the associated cash flow is disclosed within the investing activities section of the statement of cash flows.

Example: Associate

The following are extracts of the consolidated results of Connie Company for the year ended 31 December 20X9.

CONSOLIDATED STATEMENT OF PROFIT OR LOSS (EXTRACT)

	$'000
Group profit before tax	224
Share of associate's profit after tax	36
	260
Tax (group)	42
Profit after tax	218

CONSOLIDATED STATEMENT OF FINANCIAL POSITION (EXTRACTS)

	20X9	*20X8*
	$'000	$'000
Investment in associate	312	306

Calculate the dividend received from the associate.

Solution

The associate profit after tax represents retained profit plus dividend.

ASSOCIATE

	$'000
Balance as at 31 December 20X8	306
Share of profit for the period	36
Balance as at 31 December 20X9	(312)
Dividend received from associate (balancing fig)	30

3.4 Foreign currency cash flows

Foreign exchange issues are relevant to the consolidated statement of cash flows in two situations:

(i) Where an entity has transacted during the period in a currency other than its own functional/reporting currency

(ii) Where a subsidiary has a different functional currency from that of the rest of the group.

3.4.1 Transactions in foreign currency – settled

In accordance with HKAS 21, where transactions denominated in a foreign currency have taken place during a period, and been subsequently settled, any foreign exchange gain or loss is recognised in profit or loss.

For the purposes of preparing the statement of consolidated cash flows, no adjustment is required in respect of these exchange gains or losses, as they represent amounts realised in cash flows. The following example will help you to understand this.

Example: Settled transactions

Flora Co. sold goods denominated in pounds sterling in the year ended 31 October 20X1. At the date of the transaction, a trade receivable and revenue of $40,000 were recorded after applying the spot exchange rate on the date of the transaction. Before the period end, the customer paid the amount due, which on the date of payment could be exchanged by Flora for $37,000. Accordingly, Flora recognised an exchange loss of $3,000.

HKAS 7 requires that the applicable exchange rate in the case of foreign currency cash flows is that applied on the date of the cash flow. Therefore, $37,000 must be reported as a cash inflow within cash flows from operating activities in Flora's statement of cash flows.

As this amount is already included within profit for the year, no further adjustment is required:

	$'000
Revenue	40
Exchange loss	(3)
Net amount reported in profit	37

3.4.2 Transactions in foreign currency – unsettled

Where a foreign currency transaction has taken place during the period, however is not settled at the period end, any monetary items are re-translated in accordance with HKAS 21 giving rise to an exchange difference recognised in profit or loss. In addition a "foreign currency" balance is included in the year-end statement of financial position.

On preparation of the statement of cash flows, therefore:

(i) the exchange gain or loss forms an adjustment within the reconciliation of profit to cash flows from operating activities;

(ii) the exchange gain or loss is taken into account when calculating the movement in the relevant monetary balance.

The following example will help you to understand why this is the case.

Example: Unsettled transactions

Webb Co. purchased goods denominated in Zloty during the year ended 31 December 20X2 for ZTY 150,000. This was Webb's first transaction with a new supplier. At the date of the purchase the ZTY:$ exchange rate was 1.25:1 and accordingly a purchase and payable were recorded at $120,000. At the period end, Webb had not paid the amount due to the supplier and the trade payable balance was retranslated using the closing rate to $100,000, resulting in an exchange gain of $20,000.

In respect of this transaction, a $100,000 expense is therefore reported in profit ($120,000 purchases net of $20,000 exchange gain).

In preparing the statement of cash flows, HKAS 7 requires that the gain on retranslation is deducted from profits (which include the $100,000 net expense) as a non-cash item, so meaning that the transaction in Zloty has a net effect on cash of:

	$'000
Expense within profit figure	(100)
Deduct non-cash gain	(20)
	(120)

It is clear from the scenario that no cash flow has occurred in respect of this transaction and the adjustment for movement in payables must therefore serve to eliminate the $120,000. In order to make the increase in trade payables equal to the $120,000 and so eliminate it in full, the exchange gain must once again be taken into account:

	$'000
ZTY payables b/f	–
ZTY payables c/f	100
Increase	100
Remove effect of exchange gain	20
Increase in trade payables (add back to profit in reconciliation)	120

Therefore, the net effect on cash flows from operating activities is nil ($100,000 expense – $20,000 gain + $120,000 increase in payables).

3.4.3 Foreign subsidiary

The cash flows of a foreign subsidiary must be translated into the functional currency of the group for inclusion in the consolidated statement of cash flows.

The applicable exchange rate is the spot rate on the dates of the cash flows, however the average rate for a period may be used if this approximates to the actual rate. HKAS 21 does not allow the use of the closing rate.

Self-test question 1

The draft consolidated accounts for Bestway Co. are shown below:

DRAFT CONSOLIDATED STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 DECEMBER 20X8

		$'000
Operating profit		13,365
Share of profits after tax of associates		4,950
Finance cost		(1,350)
Profit before taxation		16,965
Income tax		(4,860)
Profit for the year		12,105
Attributable to:	owners of the parent	11,205
	non-controlling interest	900
		12,105

DRAFT CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER

	20X8		*20X7*	
	$'000	$'000	$'000	$'000
Assets				
Non-current assets				
Buildings		18,675		19,800
Machinery		16,200		2,700
		34,875		22,500
Goodwill		900		-
Investments in associates		13,590		12,690
		49,365		35,190
Current assets				
Inventories	17,775		9,000	
Trade receivables	16,650		11,475	
Cash	40,635		16,380	
		75,060		36,855
		124,425		72,045

	20X8		20X7	
	$'000	$'000	$'000	$'000
Equity and liabilities				
Equity				
Share capital	61,407		36,855	
Retained earnings	31,005		22,500	
	92,412		59,355	
Non-controlling interest	1,035		–	
		93,447		59,355
Non-current liabilities				
Loans	19,530		6,030	
Deferred tax	270		117	
		19,800		6,147
Current liabilities				
Trade payables	6,660		4,320	
Income tax	4,158		1,953	
Accrued finance charges	360		270	
		11,178		6,543
		124,425		72,045

Notes

1 There had been no acquisitions or disposals of buildings during the year. The depreciation charge for the year was $1,125,000 for buildings and $1,800,000 for machinery. Machinery costing $3m was sold for $3m resulting in a profit of $900,000.

2 On 1 January 20X8 Bestway Co. acquired a 75% interest in Oneway Co.. The net assets at acquisition were as follows:

	$'000
Machinery	1,485
Inventories	288
Trade receivables	252
Cash	1,008
Trade payables	(612)
Income tax	(153)
	2,268
Non-controlling interest	(567)
	1,701
Goodwill	900
	2,601
7,920,000 shares issued as part consideration	2,475
Balance of consideration paid in cash	126
	2,601

3 A dividend of $2,700,000 was paid during the year.

Required

Prepare a consolidated statement of cash flows for the Bestway Group for the year ended 31 December 20X8 as required by HKAS 7.

(The answer is at the end of the chapter)

Topic recap

HKAS 7 Statement of Cash Flows

A statement of cash flows is a useful indicator of a company's liquidity and solvency.

Presentation

Cash flows from operating activities may include:
- cash receipts from sales
- cash payments for operating expenses
- cash flows associated with income tax
- interest paid
- dividends paid

Direct method: include gross operating cash flows

Indirect method: adjust profit for non-cash items, accrued /deferred amounts and non-operating cash flows.

Cash flows from investing activities may include:
- receipts from the sale of non-current assets and investments
- payments to acquire non-current assets and investments
- interest received
- dividends received

Cash flows from financing activities may include:
- proceeds of share / debt issue
- payments on redemption of shares
- repayments of debt
- dividends paid

Change in cash and cash equivalents (including deposits available on demand, money market holdings, government bonds, treasury bills, overdrafts repayable on demand)

Consolidated statement of cash flows

Acquisition/Disposal of subsidiary
- Cash paid on acquisition/received on disposal is stated net of cash in the subsidiary on disposal date
- Acquisition/disposal is taken into account when calculating movements in working capital and cash flows.

Non-controlling interest
Include dividends paid to the non-controlling interest as a cash flow from financing activities.

Associates/joint ventures
- Eliminate share of profit or loss in calculation of cash generated from operations
- Include dividend received from associate/JV as cash flow from operating activities

Foreign currency cash flows
- Do not adjust for exchange differences on settled amounts
- Adjust for exchange differences on unsettled amounts
- Translate cash flows of a foreign subsidiary at spot rate on the date of the cash flows (or average rate) for inclusion in consolidated statement of cash flows

Disclose:
- Non-cash transactions
- Components of cash & cash equivalents

Answer to self-test question

Answer 1

BESTWAY CO

CONSOLIDATED STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 20X8

	$'000	$'000
Cash flows from operating activities		
Net profit before tax	16,965	
Adjustments for:		
Depreciation (1,125 + 1,800)	2,925	
Profit on sale of plant	(900)	
Share of associate's profits	(4,950)	
Interest payable	1,350	
Operating profit before working capital changes	15,390	
Increase in trade and other receivables (16,650 – 11,475 – 252)	(4,923)	
Increase in inventories (17,775 – 9,000 – 288)	(8,487)	
Increase in trade payables (6,660 – 4,320 – 612)	1,728	
Cash generated from operations	3,708	
Interest paid (270 + 1,350 – 360)	(1,260)	
Income taxes paid (W1)	(2,655)	
Net cash used in operating activities		(207)
Cash flows from investing activities		
Purchase of subsidiary undertaking (W2)	882	
Purchase of property, plant and equipment (W3)	(15,915)	
Proceeds from sale of plant	3,000	
Dividends from associate (W4)	4,050	
Dividends paid to non-controlling interest (W5)	(432)	
Net cash used in investing activities		(8,415)
Cash flows from financing activities		
Issue of ordinary share capital (W6)	22,077	
Issue of loan notes (19,530 – 6,030)	13,500	
Dividends paid	(2,700)	
Net cash from financing activities		32,877
Net increase in cash and cash equivalents		24,255
Cash at 1.1.X8		16,380
Cash at 31.12.X8		40,635

WORKINGS

1 *Taxation*

	$'000	$'000
Opening balance		
Income tax	1,953	
Deferred tax	117	
		2,070
Statement of profit or loss expense		4,860
On acquisition of subsidiary		153
Closing balances		
Income tax	4,158	
Deferred tax	270	
		(4,428)
Cash outflow		2,655

2 *Purchase of subsidiary*

	$'000
Cash received on acquisition	1,008
Less cash consideration	(126)
Cash inflow	882

3 *Purchase of tangible non-current assets: machinery*

	$'000
Carrying value at 1 Jan X8	2,700
Depreciation	(1,800)
Disposal (3,000 – 900)	(2,100)
On acquisition of subsidiary	1,485
	285
Cash outflow on additions	15,915
Carrying value at 31 Dec 20X8	16,200

4 *Dividends from associate*

	$'000
Opening balance	12,690
Share of profit after tax	4,950
	17,640
Closing balance	(13,590)
Cash inflow	4,050

5 *Non-controlling interest*

	$'000
Opening balance	–
Profit for year	900
On acquisition	567
	1,467
Closing balance	(1,035)
Cash outflow	432

6 *Issue of ordinary share capital*

	$'000
Closing balance	61,407
Non-cash consideration	(2,475)
Opening balance	(36,855)
Cash inflow	22,077

Exam practice

Chong Co. — 36 minutes

Chong Co. provides bookkeeping services for over 1,000 clients. The company now plans to expand into banking and finance services but feels to do so it may have to expand the office. This has prompted worries about the company's current cash flow position, especially the cash flow from its present operations, and whether the cash flow is sufficient to support such a relocation and expansion.

The directors of Chong Co. require cash flow information quickly and have asked you to provide a calculation of the company's net cash flow from operating activities for the year ended 31 October 20X7. Unfortunately, the urgency of the request has meant that the company's statement of profit or loss and other comprehensive income is not yet available. However, they have provided you with the following information:

SUMMARISED DRAFT STATEMENTS OF FINANCIAL POSITION AS AT 31 OCTOBER

		20X7		*20X6*
		$'000		$'000
Assets				
Non-current assets				
Property, plant and equipment at cost		1,240		1,016
Less depreciation		276		232
		964		784
Current assets				
Receivables	380		319	
Cash at bank	64		1	
		444		320
Total assets		1,408		1,104
Equity and liabilities				
Capital and reserves				
Equity share capital		740		460
Retained profits		224		86
		964		546
Non-current liabilities				
Long-term bond		120		280
Deferred taxation		72		44
		192		324
Current liabilities				
Trade payables		212		146
Bank overdraft		-		56
Taxation payable		40		32
		252		234
		1,408		1,104

Additional cash flow information:

(i) Property, plant and equipment costing $52,000, and in respect of which $32,000 depreciation had been provided, was disposed of during the year. The items were sold for $16,000. Operating profit includes any profits or losses on disposal.

(ii) The company paid a dividend of $40,000 during the year.

(iii) A finance charge of $15,000 has been recognised as an expense for the year. The actual cash payment was $12,000.

(iv) The tax charge of $88,000 includes deferred tax of $28,000.

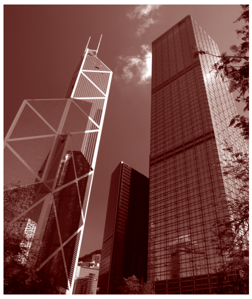
(v) Part of the bond was repaid during the year. This incurred a redemption penalty of $8,000 which has been written off against income.

Required

(a) Prepare a statement of cash flows in accordance with HKAS 7 to calculate the company's net cash flow from operating activities. (**Note**: a full statement of cash flows showing "cash flow from investing activities" and "cash flow from financing activities" is NOT required in answer to this part of the question.) **(12 marks)**

(b) Comment on whether the "net cash flow from operating activities" calculated in (a) above is sufficient to support the proposed expansion of the office. **(8 marks)**

(Total = 20 marks)


chapter 20

Related party disclosures

Topic list

Learning focus

Related party transactions are a controversial area of accounting. They are, however, relatively common in practice. You must be able to identify related parties and make the necessary disclosures.