JUNE 2011 SUPPLEMENT

Qualification Programme

Module A
Financial Reporting

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

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Introduction

This Supplement has been produced for those candidates preparing for the June 2011 examination session of the HKICPA Qualification Programme.

It is designed to be used in conjunction with the 2010 edition of the Learning Pack, and it will bring you fully up to date for developments that have occurred in the period since publication of the Learning Pack and 28 December 2010, the cut-off date for examinable standards and legislation for the June 2011 examination.

The supplement contains two sections:

Part A contains a list of any notified errors in the material in the current edition of the Learning Pack. These are identified in chapter order, therefore as you start a new chapter in the Learning Pack you are advised to refer to the list to see whether there is anything relevant.

Part B comprises a technical update on developments that will be examinable in June 2011 that are not currently covered in the Learning Pack. The topics covered are listed on the contents page, and again are covered in chapter order.

In each case the text in the supplement explains how the Learning Pack is affected by the change, for example whether the new material should be read in addition to the current material in the Learning Pack, or whether the new material should be regarded as a replacement.

Careful study of both the Learning Pack and this supplement should ensure that you are fully prepared for the June 2011 examination session.

Good luck with your studies!

Part A: Identified Errata

Chapter 2 — **Financial reporting framework**

Section 5.1
Page 34

Replace the text currently shown on page 34 in section 5.1 ('Companies listed on the Main Board.....website for public inspection') with the following:

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.

Section 5.2
Page 35

Websites

Add the sentence below under the last paragraph of section 5.2.

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

Chapter 7 — **Intangible assets and impairment of assets**

Section 4.6
Topic highlights
Page 144

Delete the existing sentence 'Where the recoverable amount exceeds the carrying amount of an asset the difference should be recognised as an impairment loss' and replace with 'Where the carrying amount exceeds the recoverable amount of an asset the difference should be recognised as an impairment loss.'

Chapter 12 — **Share-based payment**

Answers to exam practice questions
Page 663

In the fourth paragraph delete 'balance sheet' and replace with 'statement of financial position'. Delete the final two paragraphs ('The fee…when incurred') and replace with 'The fee for the due diligence exercise on Fortune Limited's financial statements is an acquisition-related cost. Accordingly, Broom Limited should recognise $300,000 as an expense in the consolidated income statement for 20X6 in accordance with the requirements of HKFRS 3.'

Chapter 16 — **Borrowing costs**

Self-test question 1
Page 336

Self-test answer 1
Page 341

Replace the question on page 336 and the answer on page 341 with the revised versions below:

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 per cent and Vitality Co can invest surplus funds at 5 per cent.

Required

Ignoring compound interest, calculate the borrowing costs which must 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.

Self-test Answer 1

	Asset A	Asset B
	$	$
Borrowing costs		
To 31 December 20X9 $500,000/$1,000,000 × 8%	40,000	80,000
Less: investment income		
To 30 June 20X9 $250,000/$500,000 × 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

	$	$
DEBIT Asset A	33,750	
DEBIT Asset B	67,500	
DEBIT Finance costs (6,250 + 12,500)	18,750	
CREDIT Accrued interest		120,000

FLASHCARDS IDENTIFIED ERRATA

Chapter 20 **Related party disclosures**

Page 120

In point (3) change the phrase 'or a parent' to 'or its parent'.

In the sentence at the bottom of the page change the phrase 'has significant influence / is key management of' to 'has significant influence over'.

Chapter 28 **Consolidated accounts: accounting for associates and joint ventures**

Page 160

Delete the final sentence ('Can only be applied where consolidated accounts are prepared, ie the parent also has a subsidiary') and replace with:

'Applied where consolidated accounts are prepared, ie the parent also has a subsidiary. Also, where an investor has an associate but no subsidiaries, then the investor does not prepare consolidated accounts, but includes the associate in its own accounts using the equity method'.

Part B: Technical Update

Chapter 2	**Financial reporting framework**

Section 5.2
Page 35

In December 2010, the Hong Kong Stock Exchange accepted Mainland Accounting and Auditing Standards.

In your Learning Pack the following new section should be inserted after section 5.2, Chapter 2:

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.

Section 7
Page 38

In your Learning Pack the following should be inserted after section 7.2, Chapter 2:

7.3 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 is effective 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.

Certain chapters of a revised Conceptual Framework were issued by the HKICPA in September 2010. As a result the current Framework includes certain revised chapters, which sit alongside as yet unrevised chapters from the old Framework.

Section 7
Page 38

In your Learning Pack the following sentence should be added at the end of section 7, Chapter 2:

The amended listing rules came into effect on 15 December 2010.

Section 9
Page 41

In your Learning Pack the following should replace the first paragraph of section 9, Chapter 2:

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 HKFRSs are based and

hence which 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 *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, and covered in Sections 10 – 12 of this chapter. As you read through them, think about the impact the *Framework* has had on HKFRSs, particularly the definitions.

Section 9.4
Page 42

In your Learning Pack the following should replace the first four points of section 9.4, Chapter 2:

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**.

Section 9.5
Page 43

In your Learning Pack the following should replace section 9.5, Chapter 2:

9.5 Users and their information needs

Conceptual Framework para OB2

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.

Section 10
Page 43 to 48

In your Learning Pack the following should replace sections 10.1 to section 10.6 inclusive, Chapter 2:

10.1 The objective of financial statements

Conceptual Framework para OB2 – 11

Topic highlights

The *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 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 revised 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.

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

Conceptual Framework para OB12

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.

10.2.1 Economic resources and claims

Conceptual Framework para OB13 – 14

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.

10.2.2 Changes in economic resources and claims

Conceptual Framework para OB15 – 21

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.

10.3 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.

At the time of writing, this section of the Conceptual Framework is due to be re-deliberated, and a final chapter is unlikely to be issued in the very near future.

10.4 Qualitative characteristics of financial statements

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 represents what it purports to represent. The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable.

The revised 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.

10.4.1 Fundamental qualitative characteristics

Conceptual Framework para QC5 – 16

The fundamental qualitative characteristics are relevance and faithful representation.

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.

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.

10.4.2 Application of the fundamental qualitative characteristics

Conceptual Framework para QC17 – 18

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 help 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.

10.4.3 Enhancing qualitative characteristics

Conceptual Framework para QC19 – 32

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

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.

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.

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.

Understandability

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

Some transactions are inherently complex and cannot be made easy to understand. Whilst 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.

10.4.4 Application of the enhancing qualitative characteristics

Conceptual Framework para QC33 – 34

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.

10.4.5 The cost constraint on useful financial reporting

Conceptual Framework para QC35 – 39

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.

10.5 Underlying assumption

Conceptual Framework para 4.1

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.

In your Learning Pack sections 10.7 - 10.15, Chapter 2, are renumbered as sections 10.6 – 10.14.

In your Learning Pack the following replaces section 14, Chapter 2:

14 Current developments

Section 14
Page 55

14.1 Conceptual Framework

14.1.1 Introduction

As we saw earlier in this chapter, the IASB and FASB have now completed the first phase of their joint project to develop a common *Conceptual Framework for Financial Reporting.* 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
- Purpose and Status of Framework
- Applicability to Not-For-Profit entities

At the time of writing, the timing of the last three phases has not yet been determined and deliberations will take place in the second half of 2011 with regard to the first two.

As regards the Reporting Entity phase, an Exposure Draft was issued in March 2010, and as a result of the feedback received, deliberations are likely to continue for some time.

14.2 Management Commentary: *Practice Statement: Management Commentary*

(known as Management Discussion and Analysis in Hong Kong)

Management commentary

A management commentary 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.

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.

Contents

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

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.

In your Learning Pack the following replace the eighth and ninth bullet points of the Topic Recap, Chapter 2:

- 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.'

- **Going concern** is the underlying assumption in preparing financial statements.

Chapter 14 **Income taxes**

An amendment to HKAS 12 was issued in December 2010. It addresses the issue of deferred tax on investment properties and incorporates the guidance within HK(SIC) Int-21 into the main standard.

Section 5.2
Page 292

In your Learning Pack the following should be added at the end of section 5.2.2 (immediately before self-test question 5), Chapter 14:

HKAS 12 para 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.

As there is no capital gains tax in Hong Kong, this 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.

The presumption is rebutted where the investment property is depreciable and is held with the intention of consuming substantially all of 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 whilst the asset is still owned by the entity.

Section 9.1
Page 300

In your Learning Pack the following should be added at the end of section 9.1, Chapter 14:

HK(SIC) Int-21 has been incorporated into HKAS 12 as part of the amendments

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to HKAS 12 issued in December 2010. It is therefore withdrawn for accounting periods starting on or after 1 January 2012.

Chapter 17 **Financial Instruments**

In November 2010 the HKICPA issued an expanded version of HKFRS 9. The version of the standard issued in 2009 (and included within the Learning Pack) provides guidance in relation to the classification and measurement of financial assets. The expanded standard adds to this by providing guidance on the classification and measurement of financial liabilities and the derecognition of financial assets and liabilities.

Section 3 to 3.2.1
Pages 354 to 356

In your Learning Pack sections 3 – 3.2.1 inclusive, Chapter 17 you should remove references to HKAS 39 and replace them with HKFRS 9. The classification rules set out in those sections are unchanged from those previously contained in HKAS 39.

Sections 3.3 to 3.5
Pages 357 to 358

In your Learning Pack the following should replace sections 3.3 – 3.5 inclusive, Chapter 17:

3.3 Reclassification of financial instruments

> **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.

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 derecognised 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.

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

> **Self-test question 4**
>
> Can you think of an example of a situation in which:
>
> (a) an entity has transferred substantially all the risks and rewards of ownership of a financial asset?
>
> (b) an entity has retained substantially all the risks and rewards of ownership of a financial asset?
>
> **(The answer is at the end of the chapter)**

A financial liability which is extinguished ie, when the obligation specified in the contract is discharged or cancelled or expires, should be derecognised by an entity.

3.4.1 Partial derecognition

Partial derecognition of a financial asset 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 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.

In your Learning Pack section 4.1, Chapter 17 references to HKAS 39 should be amended to HKFRS 9

In your Learning Pack the following should replace section 4.3.2, Chapter 17:

4.3.2 Financial liabilities at fair value through profit or loss

HKFRS 9 para 5.7.1

Financial liabilities which are held for trading and so classified at fair value through profit or loss are remeasured to fair value each year with the gain or loss recognised in profit or loss.

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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 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.

In your Learning Pack the following should replace the whole of section 5, Chapter 17:

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.

Section 5
Pages 366 to 367

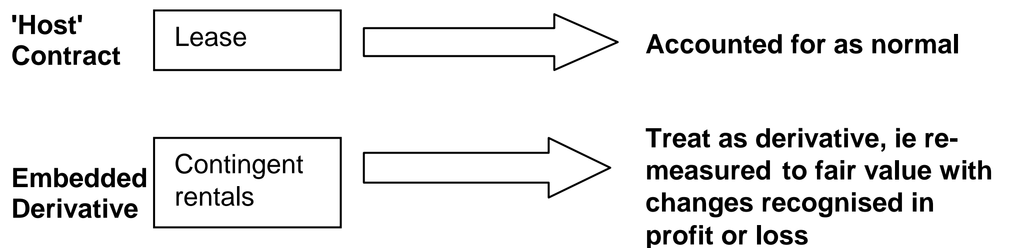
Derivative contracts may be 'embedded' in contracts that are not themselves derivatives (and may not be financial instruments). These non-derivatives are known as host contracts, and may comprise:

- 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:



(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.

5.2 Accounting treatment of embedded derivatives

Topic highlights

Where the host contract is an asset 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 para 4.3.2 – 4.3.4

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 para 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 above which applied to financial assets as well as other host contracts prior to the issue of HKFRS 9.

HKFRS 9 para 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.

In your Learning Pack the following should replace section 8, Chapter 17:

Section 8 Page 383

8 Current Issues

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) is divided into five main phases. As each phase is completed, as well as its separate project on the derecognition of financial instruments, the relevant portions of IAS 39 will be deleted and chapters in IFRS 9 will be created to replace the requirements in IAS 39. The

replacement of IAS 39 in its entirety is aimed to be completed by the end of 2011. 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 in June 2009. This formed the basis of an exposure draft, *Financial Instruments: Amortised Cost and Impairment*, published in November 2009 with a comment deadline of 30 June 2010. A supplement to the ED was issued in January 2011.

Phases 4 and 5 of the project relate to hedge accounting and asset and liability offsetting respectively and are currently underway.

In your Learning Pack the following should replace the fifth bullet point of the Topic Recap, Chapter 17:

Topic recap
Page 384

- **HKFRS 9** *Financial Instruments* is a recent standard designed to simplify accounting for financial instruments. The HKFRS states that **all financial assets and liabilities** should be **recognised in the statement of financial position, including derivatives**.

In your Learning Pack the following should replace the answer to self test question 4, Chapter 17:

HKFRS 9 includes the following examples:

Answer 4
Page 385

HKFRS 9 para B3.2.4

(a) (i) An unconditional sale of a financial asset

(ii) A sale of a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase

(b) (i) A sale and repurchase transaction where the repurchase price is a fixed price or the sale price plus a lender's return

(ii) A sale of a financial asset together with a total return swap that transfers the market risk exposure back to the entity

(iii) A sale of short-term receivables in which the entity guarantees to compensate the transferee for credit losses that are likely to occur.

Improvements to HKFRS were issued by the HKICPA in June 2010. The document amended six standards including HKFRS 7. HKFRS 7 is amended to clarify a number of the required disclosures.

In your Learning Pack the following should replace section 7.6.2, Chapter 17:

Section 7.6.2
Page 380

HKFRS 7 para 34

HKFRS 7 para 36 – 38

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.

HK Interpretation 5 was issued in November 2010. It clarifies the treatment of a term loan subject to a repayment on demand clause.

Answer 7.6.3
Page 382

In your Learning Pack the following should be added to the end of the existing text in section 7.6.3, Chapter 17:

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.

Chapter 24 **Interim financial reporting**

Improvements to HKFRS were issued by the HKICPA in June 2010. The document amended six standards including HKAS 34. The amendments to HKAS 34 place greater emphasis on the disclosure principles of HKAS 34 involving significant events and transactions.

Section 1.5.1
Page 494

HKAS 34 para 15 - 15A

In your Learning Pack the following should replace section 1.5.1, Chapter 24:

According to HKAS 34, an entity should include in its interim report an explanation of events and transactions that are **significant** to an understanding of changes in financial position and performance since the end of the last reporting period. Information disclosed in relation to those events and transactions should update the relevant information presented in the most recent annual financial report.

It is not necessary for the notes to the interim accounts to provide relatively insignificant updates to the information provided in the most recent annual financial report.

In addition to disclosing significant events and transactions, an entity should include the following in its interim financial statements:

(a) A statement that the same accounting policies and methods of computation are followed in the interim financial statements as compared with the most recent annual financial statements. If any policy or method has changed, a description of the nature and effect of the change is required;

(b) Explanatory comments about the seasonality or cyclicality of interim operations;

(c) The nature and amount of items affecting assets, liabilities, equity, net income or cash flows that are unusual because of their nature, size or incidence;

(d) The nature and amount of changes in estimates of amounts reported in earlier interim reports of the same financial year, or prior financial years;

(e) The issue, repayment and repurchase of debt and equity securities;

(f) Dividends paid for ordinary and other shares:

(g) Where segment information is provided in the annual financial statements, the following should be disclosed in the interim financial statements:

  (i) Revenues from external customers (if included in the measure of profit reviewed by the chief operating decision maker);

  (ii) Intersegment revenues (if included in the measure of profit reviewed by the chief operating decision maker);

  (iii) A measure of segment profit or loss;

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

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

  (vi) A reconciliation of total profit or loss of reportable segments to the entity's profit or loss before tax and discontinued operations.

(h) Events after the interim period that have not been reflected in the financial statements for the interim period;

(i) The effect of the acquisition or disposal of subsidiaries during the interim period.

Answer 1
Page 500

In your Learning Pack the following should replace the answer to self test question 1, Chapter 24:

HKAS 34 para 15B

HKAS 34 provides the following list of events and transactions for which disclosures would be required if they were significant:

(a) The write-down of inventories to net realisable value and the reversal of such a write down;

(b) Recognition of a loss from the impairment of financial assets, property, plant and equipment, intangible assets, or other assets, and the reversal of such a loss;

(c) The reversal of any provisions for the costs of restructuring;

(d) Acquisitions and disposals of items of property, plant and equipment;

(e) Litigation settlements;

(f) Corrections of prior period errors;

(g) Changes in the business or economic circumstances that affect the fair value of the entity's financial assets and financial liabilities, whether those assets and liabilities are recognised at fair value or amortised cost;

(h) Any loan default or breach of a loan agreement that has not been remedied on or before the end of the reporting period;

(i) Related party transactions;

(j) Transfers between levels of the fair value hierarchy used in measuring the fair value of financial instruments;

(k) Changes in the classification of financial assets as a result of a change in the purpose or use of those assets; and

(l) Changes in contingent liabilities or contingent assets.

This list is not exhaustive.

Individual HKFRS provide guidance regarding disclosure requirements for many of the items listed above. When the events or transactions listed are significant, the interim report should provide an explanation of and update to the relevant information included in the financial statements of the last annual reporting period.

Chapter 25 **Presentation of financial statements**

Improvements to HKFRS were issued by the HKICPA in June 2010. The document amended six standards including HKAS 1. The amendment to HKAS 1 clarifies that an analysis of other comprehensive income may be presented either in the statement of changes in equity or in the notes to the accounts.

Section 1.1.3
Page 506

In your Learning Pack the following should replace section 1.1.3, Chapter 25:

As mentioned in the previous section, the statement of changes in equity focuses on reporting changes in equity as a result of transactions with owners in their capacity as owners.

Elements of profit or loss and other comprehensive income do make up part of the overall change in equity in a period, and are therefore reported in the statement of changes in equity, however it is not the primary purpose of the statement of changes in equity to report these items.

Section 1.5
Page 514

In your Learning Pack the following should be deleted from the start of (c)(ii), section 1.5, Chapter 25:

'each item of'

Section 1.5
Page 514

In your Learning Pack the following paragraph should be added to the end of section 1.5, Chapter 25:

HKAS 1 para 106A

An analysis of the other comprehensive income reported in the statement of changes in equity must be provided either:

– within the statement of changes in equity itself, or
– in the notes to the accounts.

The analysis should identify, for each balance within shareholders' funds, individual items of other comprehensive income aggregated within it. This enables users of the accounts to see in which reserve each type of other comprehensive income is accumulated.

HK Interpretation 5 was issued in November 2010. It clarifies the treatment of a term loan subject to a repayment on demand clause.

In your Learning Pack the following should be added to the end of the existing text in section 1.3.3, Chapter 26:

HK Interpretation 5 was issued in November 2010. It sets out the conclusions of the HKICPA in relation to whether a term loan subject to a repayment on demand clause should be classified as current or non-current.

HKICPA concludes that the classification depends on the rights and obligations of the lender and borrower as contractually agreed and in force at the reporting date. Where a lender has an unconditional right to call the loan at any time, it must be classified by the borrower as current, regardless of the probability of the lender exercising their right within 12 months.

Chapter 26 **Principles of consolidation**

Improvements to HKFRS were issued by the HKICPA in June 2010. The document amended six standards including HKFRS 3 (Revised). HKFRS 3 (Revised) was amended to clarify the rules regarding the measurement of

the non-controlling interest.

Section 4.2
Page 538

In your Learning Pack the following should replace section 4.2, Chapter 26:

HKFRS 3
para 30

The revised HKFRS 3 views the **group as an economic entity**. This means that it treats **all providers of equity including non-controlling interests as shareholders in the group**, even if they are not shareholders in the parent. It is for this reason that the non-controlling interest forms part of the calculation of goodwill.

The question now arises as to how it should be valued. HKFRS 3 applies a different rule to the measurement of the non-controlling interest depending on whether or not the relevant shareholders are entitled to a proportionate share of the entity's net assets in the event of liquidation.

Where holders of the non-controlling interest are entitled to a proportionate share of the net assets on a liquidation, HKFRS 3 requires that **the non-controlling interest in the acquiree is measured either at:**

– fair value or

– the non-controlling interests' proportionate share of the acquiree's identifiable net assets.

Where holders of the non-controlling interest are not entitled to a proportionate share of the net assets on a liquidation, the non-controlling interest should be measured at fair value.

The non-controlling interests measured at **fair value** will be different from the non-controlling interests measured at **proportionate share of the acquiree's net assets**. The difference is goodwill attributable to the non-controlling interests. This will become more apparent when we see some examples.

Section 4.2.2
Page 540

In your Learning Pack the following should be inserted at the start of section 4.2.2, Chapter 26:

Where available, the choice…

Appendix:
HKFRS for Private Entities

New Chapter: HKFRS for Private Entities

The HKFRS for Private Entities, issued in April 2010, is now of sufficient importance that it warrants a chapter in its own right.

You should regard this section as a new additional chapter in your Learning Pack.

1 Background

Topic highlights

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).

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.

The standard is examinable in the 2011 exams.

1.1 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 was developed by the IASB to apply to general purpose financial statements of entities which are **not publicly accountable** (rather than those which meet certain size definitions).

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

1.1.1 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 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*

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.*

1.2 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.

1.2.1 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 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.

1.2.2 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

1.2.3 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.

2 Financial Reporting in Hong Kong

Topic highlights

Until recently, a two tier reporting system existed in Hong Kong:

the SME-FRS was applicable to most small and medium sized entities and 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-tier reporting system

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

1 the SME-FRF&FRS which **can only** be applied to those unlisted entities which:

   (a) meet the criteria laid out in Companies Ordinance section 141D in the case of Hong Kong incorporated companies; or

   (b) meet certain size limits in the case of overseas companies;

2 the new HKFRS for Private Entities which can be applied by any private entity; and

3 full HKFRS which **must** be applied by publicly quoted entities and **can** be applied by any private entity.

The scope and applicability of full HKFRS and the SME-FRF&FRS are unchanged. Preparers can continue to use either of these options to prepare their financial statements, even if they qualify to use HKFRS for Private Entities. The options available to each type of entity are summarised in the following table:

	Can apply:
Private companies which meet the criteria to use the SME-FRF&FRS	– **SME-FRF&FRS** – **HKFRS for PEs** – **Full HKFRS**
Private companies which meet the criteria to use the SME-FRF&FRS	– **HKFRS for PEs** – **Full HKFRS**
Publicly listed companies	– **Full HKFRS**

3 Hong Kong Financial Reporting Standard for Private Entities

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.

3.1 Overview

Topic highlights

The HKFRS is a self-contained set of accounting principles that are based on full HKFRSs but simplified to an extent suitable for private entities. The standard is 339 pages long, which represents less than ten per cent of a volume of full HKFRS, and organised by topic to make it more like a reference manual.

It includes simplifications that reflect the needs of users of private companies' financial statements and the cost-benefit considerations of preparers. It is 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 with regard to financial instruments.

The HKFRS for Private Entities is effective upon issue.

3.1.1 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.

3.2 Simplified accounting

The HKFRS 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**

Goodwill and those intangible assets with an indefinite life are always amortized over their estimated useful life (or ten years if it cannot be estimated). An impairment test is performed only if there are indications of impairment (rather than annually).

(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. Where there is a published price quotation, the fair value model must be applied.

(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 can be applied without undue cost or effort.

(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.

(j) **Borrowing costs**

All borrowing costs are expensed immediately.

(k) **Government grants**

Government grants are recognised in income (at fair value) when the performance conditions are met.

(l) **Investment property**

If an entity can measure the fair value of an item of investment property reliably, without due cost or effort, it must use fair value. Otherwise the cost model is applied.

3.3 Simplified presentation

In order to reduce costs for preparers, whilst still meeting the needs of users, the HKFRS for Private Entities has simplified financial statement presentation requirements as follows:

- 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.
- 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.
- All deferred tax assets and liabilities are classified as non-current assets or liabilities.

3.4 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

3.5 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 3.2 above):

	Treatment disallowed in HKFRS for Private Entities:
Property, plant and equipment and intangible assets	Revaluation model
Investments in jointly controlled entities	Proportionate consolidation
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 that 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.

3.6 Simplified disclosure

A number of disclosure requirements contained in full HKFRS have been omitted from the HKFRS for Private Entities, mainly because:

- 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:

- 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 comprehensive income and amounts reported to tax authorities.
- In relation to investments in associates, the following disclosures are omitted:
  (a) Summarised financial information relating to assets, liabilities, revenues and profit or loss.
  (b) 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.

3.7 Updates and amendments to the HKFRS for Private Entities

The HKICPA do not intend to make any changes to the HKFRS for Private Entities until two years' of financial statements have been prepared by a broad range of entities using the standard. At this time a review of users' experiences will be conducted and amendments to the standard will be made to:

1 address any issues arising from this review, and
2 consider new and amended full HKFRS issued since April 2010.

Beyond this, the HKICPA anticipate that the standard will be amended approximately once every three years, with proposed changes issued in one go within an 'omnibus Exposure Draft'.

Thus the number and frequency of amendments is reduced compared to those made to full HKFRS, and so the burden on companies to keep up to date is also reduced.

4 Impact of the HKFRS for Private Entities

Topic highlights

The HKFRS for Private Entities is likely to affect 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.

4.1 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 new HKFRS 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 a single set of high quality and current accounting principles and concepts, condensed and specifically tailored for private entities; and
– the burden of preparing financial statements in accordance with full HKFRSs is reduced.

4.2 Advantages and disadvantages of the HKFRS for Private Entities

4.2.1 Advantages

There are a number of advantages, including the following:

– The standard is effectively a 'one stop shop', containing all the accounting guidance that a private entity requires.

– Complex treatment is omitted, rules are simplified and disclosures reduced.

– It is structured by topic, making it easier to use.

– It is written in a style which is easy to read and understand.

– Guidance which is only relevant to larger, listed companies is excluded.

4.2.2 Disadvantages

Despite the obvious advantages, commentators have suggested that the HKFRS has not gone far enough to simplify accounting for smaller entities. Possible drawbacks include:

– the scope is too wide as it is, extending to all non-publicly accountable entities

– the standard is onerous for small companies to apply

– further simplification could have been made, such as removing the requirements to:

  - amortise goodwill and intangibles
  - recognise deferred tax
  - identify and account for operating and finance leases separately
  - produce consolidated accounts
  - measure equity-settled share-based payments
  - value intangibles separately from goodwill on a business combination
  - use fair values

Topic Recap

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

Self-test question 1 Private entities

Published in April 2010, the *HKFRS for Private Entities* has introduced new concepts and principles that are different from the full HKFRS and have simplified complexity without reducing the value of financial reporting by SMEs.

The *HKFRS for Private Entities* simplifies accounting requirements by removing choices of accounting treatment, eliminating topics that are not generally relevant to private entities, simplifying methods for recognition and measurement and reducing the disclosure requirements of full HKFRS.

Required

(a) Explain the advantages and disadvantages of unlisted entities adopting the *HKFRS for Private Entities* instead of using full HKFRS. **10 marks**

(b) Identify examples from full HKFRS where choice exists or there are complex recognition and measurement requirements. Explain how the *HKFRS for Private Entities* removes this choice or simplifies the recognition and measurement requirements. **(13 marks)**

Appropriateness and quality of discussion. **(2 marks)**

(Total = 25 marks)

Answer to self-test question 1

Private entities

(a) **Advantages**

- Although originally designed to be suitable for all types of entity, Hong Kong Financial Reporting Standards (HKFRSs) have in recent years become increasingly complex. They are now designed primarily to meet the information needs of institutional investors in large listed entities.

  In contrast the shareholders of smaller private entities are often also directors. Through managing the company and maintaining the financial records, they are already aware of the company's financial performance and position and so do not need the level of detail in financial statements required by external institutional investors of larger companies.

  The main external users of SMEs tend to be lenders, trade suppliers and the tax authorities. They have different needs from institutional investors and are more likely to focus on shorter-term cash flows, liquidity and solvency.

- It can be argued that full HKFRS are too complex for the preparers of private entity accounts to understand. In particular they tend to include a sizeable amount of implementation guidance and disclosure requirements appropriate for public companies.

- Unlike full HKFRS , choice is largely omitted from the HKFRS for Private Entities, so making financial statements prepared under it more comparable.

- The management of many private entities feel that following full HKFRS places an unacceptable burden on them – a burden that has been growing as HKFRS become more detailed and more countries adopt them. The **cost of following full HKFRS often appears to outweigh the benefits**.

- The **disclosure** requirements of full HKFRS are very **extensive** and as such, can result in **information overload** for the users of unlisted company accounts, reducing the understandability of financial statements. The disclosure requirements of the HKFRS for PEs are greatly reduced in comparison.

Disadvantages

- From a practical perspective, the changeover from full HKFRS to the simplified *HKFRS for Private Entities*, will require training and possible changes in systems. This will place both a **time and cost** burden on entities choosing to make the change.

- If eligible entities adopt the simplified HKFRS for private entities, their accounts will no longer be comparable with other companies following full HKFRS, whether they are listed companies or private entities choosing not to switch to the HKFRS for PEs. This may make it harder to attract investors.
- Full HKFRS are well established and act as a form of quality control where financial statements are prepared in accordance with them. It could therefore be argued that financial statements which do not comply with full HKFRS will lose their credibility.
- The *HKFRS for Private Entities* **reduce disclosures** required by full HKFRS substantially. Although this has many benefits, there is a risk that the omission of certain key information might actually make the financial statements **harder to understand**.

Conclusion

The board believes that the advantages for private entities of having a separate simplified set of HKFRSs outweigh the disadvantages. They believe that both preparers and users of private entity accounts will benefit.

(b) **Examples of full HKFRS with choice**

1 HKFRS 3 *Business Combinations* requires goodwill to be calculated as the excess of consideration plus the non-controlling interest over the fair value of the net assets of the acquiree. It allows an entity to measure the non-controlling interest at either fair value or as a share of net assets at acquisition. This choice of measurement method impacts the value of goodwill calculated, with measurement of the NCI at fair value resulting in 'full' goodwill, and measurement of the NCI as a proportion of net assets resulting in 'partial' goodwill.

The *HKFRS for Private Entities* requires that goodwill is calculated as the excess of cost over the share of the fair value of net assets acquired ie the non-controlling interest is excluded from the calculation. Therefore goodwill recognized is always 'partial' goodwill. This avoids the need for private entities to determine the fair value of the non-controlling interests not purchased when undertaking a business combination.

2 HKAS 16 *Property, Plant and Equipment* allows assets to be held under the cost or revaluation model.

The *HKFRS for Private Entities* does not permit the application of the revaluation model.

3 HKAS 19 *Employee Benefits* allows three possible treatments for the recognition of actuarial gains and losses on defined benefit pension plans:

(1) Immediate recognition in profit or loss
(2) Immediate recognition in other comprehensive income)
(3) Deferred recognition using the '10% corridor' method

The *HKFRS for Private Entities* allows either of the first two methods, however does not allow the deferral option. The recognition of actuarial gains and losses in other comprehensive income is one of the rare uses of other comprehensive income in the HKFRS for Private Entities.

4 HKAS 31 *Interests in Joint Ventures* offers the choice of either equity accounting for or proportionately consolidating jointly controlled entities.

Proportionate consolidation is not allowed in consolidated financial statements under the *HKFRS for Private Entities,* although it does allow an alternative choice of keeping the investment at cost or fair value (as that is the way it is recorded in the separate financial statements of the investor) or equity accounting.

5 HKAS 38 *Intangible Assets* allows either the cost model or revaluation model (where there is an active market).

The *HKFRS for Private Entities* does not permit the revaluation model to be used.

6 HKAS 40, allows either the cost model or fair value model (through profit or loss) to be applied to investment properties.

The HKFRS for Private Entities requires the fair value model (through profit or loss) to be used as long as fair value can be measure without undue cost or effort. This promotes consistency in the treatment of investment properties between private entities' financial statements.

Examples of HKFRSs with complex recognition and measurement requirements

1 HKFRS 3 *Business Combinations* requires goodwill to be tested annually for impairment. This requires the assets of the business to be combined into cash-generating units or even a group of cash-generating units in order to determine any impairment loss. The impairment must then be allocated to goodwill and the other individual assets. This is a complex exercise.

The *HKFRS for Private Entities* requires goodwill to be amortised instead. This is a much simpler approach and the *HKFRS for Private Entities* specifies that if an entity is unable to make a reliable estimate of the useful life, it is presumed to be ten years, simplifying things even further.

2 HKAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* requires grants to be recognised only when it is reasonably certain that the entity will comply with the conditions attached to the grant and the grants will be received. Grants relating to income are recognised in profit or loss over the period the related costs are recognised in profit or loss. Grants relating to assets are either netted off the cost of the asset (reducing depreciation by the amount of the grant over the asset's useful life) or presented as deferred income (and released to profit or loss as income over the useful life of the asset).

The *HKFRS for Private Entities* simplifies this and specifies that where there are no specified future performance conditions, the grant should be recognised as income when it is receivable. Otherwise, it should be recognised as income when the performance conditions are met.

3 HKAS 23 *Borrowing Costs* requires borrowing costs relating to qualifying assets to be capitalised for the period of construction. Where general borrowings are used to fund construction, a complex calculation to establish the weighted average cost of capital is required.

The *HKFRS for Private Entities* requires all borrowing costs to be expensed, so removing the need for such a complex calculation.

4 HKAS 36 *Impairment of Assets* requires annual impairment tests for goodwill, intangible assets with an indefinite life, and intangible assets not yet available for use. This is a complex, time-consuming and expensive test.

The *HKFRS for Private Entities* only requires impairment tests where there are indicators of impairment.

The full HKFRS also requires impairment losses to be charged firstly to other comprehensive income for revalued assets then to profit or loss.

The *HKFRS for Private Entities* requires all impairment losses to be recognised in profit or loss, given that tangible and intangible assets cannot be revalued under the *HKFRS for Private Entities*.

5 HKAS 38 *Intangible Assets* requires internally generated assets to be capitalised if certain criteria (proving future economic benefits) are met. Testing these criteria for each type of internally generated asset is both onerous and judgemental, and in practice and leads to inconsistency with some items being expensed and some capitalised.

The *HKFRS for Private Entities* removes these capitalisation criteria and requires all internally generated research and development expenditure to be expensed through profit or loss.